PUBLIC FINANCE

WHY CALIFORNIA DISSOLVED ITS RDAS

Abuse finally brought down this vehicle to skirt constitutional limits and fiscal responsibility.

BY SHIRLEY SVORNY

California shut down its 400-plus local redevelopment agencies (RDAs) in 2012, following years of local governments using the entities to skirt constitutional requirements and fiscal responsibility. The story of the local governments' abuses—and the end of the state's tolerance of such shenanigans—is both troubling and fascinating.

The California Constitution requires municipal governments to secure voter approval (a two-thirds supermajority, in fact) to issue debt or increase tax rates. In what seems a direct violation of the intent of the constitution, state legislators authorized the formation of RDAs with access to "tax increment financing," allowing municipal governments to borrow without voter approval under the notion that new tax revenues ostensibly generated by RDA activities would service the debt.

RDAs were not the only way around the state constitution. As legal scholar Janice Kosel pointed out, by 1976 the courts had carved out several types of debt that were not held to the constitutional requirement for voter approval, including debt to finance state-mandated capital expenditures, debt in the form of installment payments for capital improvements (lease-purchase agreements), debt that resulted from a capital investment that supposedly would produce enough revenue to repay the debt (as with a sewer system or zoo), and debt issued in the form of special assessment bonds (where only landowners who benefit are assessed). Another legal option was for a city to set up a nonprofit entity from which it agreed to rent an asset such as a building. The future revenue stream could then be sold (as a certificate of participation) to raise funds.

It is the method or source of payment that distinguishes those arrangements from traditional municipal general obliga-

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tion bonds. However, they are similar to bonds in that they all involve a promise of future payment and, more important, they all expand the size and scope of municipal government. Framers of the state constitution wanted voters to have the power to limit municipal government debt issuance and growth, yet each of the subsequent exceptions—whether crafted by the legislature or the courts—circumvented that intention.

RDAs gave city politicians access to property tax revenues that would have gone to other local government agencies, including education districts. In addition, education financing laws required the state to offset ("backfill") education property tax revenue increases that were shifted to RDAs. The result was an increase in overall funding for areas that set up RDAs. By 2009–2010, 12 percent of California property tax revenues were being redirected to RDAs in the state.

UNDERSTANDING RDAS

In 1952 the California legislature allowed municipal governments to form RDAs in urban areas deemed blighted. RDAs were especially attractive because they had access to tax increment financing. In tax increment financing, the existing level of tax revenues—i.e., the "frozen base"—is set aside; it remains a source of funds for local government spending. Any additional ("incremental") taxes beyond the base are shifted to the RDA for the life of the project. With that assignment of future tax revenue as collateral, the agency could borrow money to fund current spending on development projects and subsidies to developers.

At the time RDAs were first conceived, federal urban renewal grants required large cities to provide matching funds. The state legislature created RDAs and access to tax increment financing so that cities could raise the required matching funds without voter approval. Also, tax increment financing had the added benefit that all local government entities entitled to the property tax (cities, counties, special districts, K–14 education districts) would share in the cost of urban renewal.

Once the redevelopment apparatus was in place, municipal governments found they could use it whenever they wanted to circumvent the constitutional requirement for voter approval of debt. It came in handy when, after the passage of Proposition 13 in 1978, fiscal constraints and a new constitutional limit on raising municipal tax rates (including the same two-thirds voter approval requirement that applies to municipal debt issuance) precluded other traditional ways to raise money. With few other legal avenues to raise funds, RDAs grew rapidly.

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The rise of the RDAs was met with several legitimate complaints. First, RDAs received all of the incremental tax revenue even though RDA subsidies, expenditures, or investments in a community were not responsible for all the growth in property tax revenues; some portion of the tax increment was the result of inflation and the general increase in property values across the state. Second, according to critics, RDA subsidies often just moved jobs and sales taxes from one jurisdiction to another within California, without a net benefit to the state. Finally, the RDAs sometimes seemed to violate the principles of the state's redevelopment law, declaring blight where there was none, and developing agricultural land and vacant land where new construction was likely even without the redevelopment designation—just to obtain the associated tax increment revenue.

HOW LOCALITIES REDEVELOPED AND MADE MONEY

Under the guise of redevelopment, cities funded a wide range of projects without voter approval, skirting the provisions of the state constitution aimed at protecting residents from that sort of behavior. Zev Yaroslavsky, chairman of the Los Angeles County Board of Supervisors, was quoted by the *Los Angeles Times* as saying that redevelopment "evolved into a honey pot that was tapped to underwrite billions of dollars' worth of commercial and other for-profit projects." Politicians were able to offer the type of subsidies to developers that a supermajority of voters would not have approved.

California's school finance laws required the state to backfill K–14 education funding syphoned off by redevelopment agencies as part of the tax increment. Those funds—$2 billion in 2009–2010 alone—were not distributed based on a statutory formula or other legislative directive. Rather, they were simply awarded by the state, creating a windfall for cities that moved first and with little regard for formal definitions of blight to expand land areas under RDAs.

A hypothetical example may help clarify that flow of funds. If, from the date of the formation of an RDA, property taxes in the RDA area increased by $20,000, that incremental tax revenue would be the property of the RDA rather than the city, special districts, county, and K-14 education district that would have received portions of the tax. According to the California Legislative Analyst's Office, statewide about half of the property tax increment would have gone to K–12 schools and community colleges—$10,000 in this example—and the remaining half would have been divided roughly equally among the county, city, and special districts in the area. Because state funds were used to backfill the tax increment dollars that redevelopment took from education, about $10,000 would have been allocated by the state to the K–14 districts in the hypothetical RDA area. In other words, the establishment of an RDA would increase available funds in the community by $10,000. That created a strong incentive for a city to declare areas blighted and to create RDAs.

THE REDEVELOPMENT GAME

Local governments that moved quickly to declare broad areas in their jurisdiction blighted and in need of redevelopment were able to increase the aggregate revenues at their disposal. Some cities caught on faster than others. To capture the benefits of redevelopment funding, even affluent cities declared large areas blighted. Coronado declared the entire city area blighted and then used tax increment financing revenues to improve its schools. Lancaster declared an area blighted to raise money for a new mall.

The leaders of counties and special districts realized they had the power to capture a portion of the backfill dollars: they could threaten to oppose a city's efforts to increase its RDA territory. With that leverage, many counties and special districts negotiated pass-through revenues from the redevelopment tax increment that were larger than what they would have gotten in the absence of redevelopment. The deals make clear that all parties were aware that the state backfill to education would increase total revenues at the disposal of local public entities.

For a city interested in increasing its retail tax base, redevelopment agencies offered both funding and the power to take private property through eminent domain. Cities benefited from RDA subsidies to retail development because the retail sales tax has been a significant source of discretionary funds for local governments in California. Where RDA subsidies to developers were successful in attracting large retail stores or auto dealerships, the increase in sales tax was available to local politicians for discretionary spending.

Politicians were engaged in a complicated shell game with taxpayer dollars. Writing for the Legislative Analyst's Office in 2012, Marianne O'Malley gave examples of how cities were able to transfer borrowed money raised by RDAs through tax increment financing to fund day-to-day city services:

> Frequently, RDA–city or RDA–county financial agreements were established for the purpose of reducing the sponsoring government's costs or increasing its revenues. For example, many RDAs paid a significant share of their sponsoring local government's administrative costs (such as part of the salaries for the city council and city manager). Doing so freed up city or county funds so that they could be used for other purposes. Some RDAs also lent money to their city or county without charging interest on the loans, allowing the city or county to invest the funds and keep the earnings. Other sponsoring governments charged their RDAs above market interest rates for loans, thereby allowing the city or county to benefit from unusually high interest earnings.

State legislators became concerned about the growing drain on the state general fund from the backfill requirement. They also took a jaundiced view of the negotiated deals to share the tax increment, which kept counties and special districts from opposing city efforts to use redevelopment to capture and borrow against the tax increment.

California lawmakers made several attempts to stop this game. O'Malley noted that the California Legislature passed the Community Redevelopment Law Reform Act of 1993 "to address long-standing concerns about misuse of redevelopment powers by local agencies." The act set a statutory formula for sharing tax-increment revenues (ending negotiated pass-through agreements), tightened the definition of blight, and set limits on sales tax subsidies to auto dealerships and volume retailers, among other things. The statutory formula for pass-through payments sought to reduce the state's obligation to backfill education dollars. A secondary purpose of the legislation was to encourage counties and special districts to be more critical of expanding RDAs.

Yet, even after passage of the 1993 act, the ability to get state backfill dollars and circumvent constitutional requirements for issuing debt continued to fuel the expansion of RDA activity. The 1993 statutory formula left a loophole: there was no limit to what RDAs could offer counties and special districts in the form of infrastructure in exchange for their support. Post-1993, RDAs and city officials crafted innovative arrangements to shift resources to counties and special districts. For example, in order to quiet the opposition of public entities troubled by the potential loss of the property tax increment, redevelopment agency proponents in Mammoth Lakes proposed to pay for a library, performing arts theater, gym and aquatics center, improvements to Mammoth Hospital, and water capacity–related investments.

UNANSWERED QUESTIONS

Municipal governments have found it fairly easy to circumvent constitutional restrictions on debt issuance, not only in California but across the country. California voters may have supported Proposition 13's efforts to limit state and municipal government spending, but they paid little attention to the actual operation of municipal governments. Was the omission of in-kind transfers in the 1993 legislation a true oversight? Or is there a Machiavellian story to the history of putting initiatives before voters to limit government spending but leaving loopholes so the limits can be circumvented? Would framers of the state constitution be surprised to learn that the requirements for taking on municipal debt only apply to the local government entities specifically named in the constitution?

Other troubling questions concern the failure of some local governments to decry the advantages shown to other local governments. Why were state subsidies to backfill local education dollars unchallenged by communities that were not on the receiving end? One possible explanation is that RDAs were in, or adjacent to, urban areas. Urban areas in California tend to elect Democrats and the California Legislature has been controlled by Democrats almost continuously since 1970. Perhaps that is why efforts were not made to eliminate the inequities of the distribution of state funds that grew in size to about 5 percent of California property tax revenues.

CONCLUSION

Of all the tax and expenditure limits, a voter approval requirement is considered to be the most restrictive. However, as California's experience demonstrates, even the most restrictive limits are easily circumvented.

As the fiscal burden from the RDA backfill requirement grew, nine state budgets passed between 1992 and 2011 included provisions that required local governments to contribute money to backfill education dollars. In 2010, the redevelopment lobby responded with a successful voter initiative to stop such legislative actions. In response, in June 2011 the California Legislature approved and Gov. Jerry Brown (D) signed legislation that allowed for two options: dissolve the RDAs or require the RDAs to shift some of their funds to education districts. When the second option was deemed unconstitutional by the California Supreme Court, the state shut down its RDAs. Successor agencies are paying off the debt, allowing a transition that will shift future tax revenues back to local governments, special districts, and education.

Many observers believe redevelopment is not finished in California. Of course, supporters of redevelopment—those who ran the agencies and those who would benefit from their expenditures—argue that public redevelopment spending can generate economic growth in a community. However, there is little evidence that RDA employees can adeptly identify investment opportunities that would lead to economic growth rather than just respond to pressures to subsidize politically connected developers.

The battle likely isn't over. Without RDA access to tax increment financing, cities will surely turn to certificates of participation, lease agreements, public–private partnerships, and other legal means to get around the constitutional delegation of power to voters over debt issuance and taxes.

Clearly, RDAs have allowed city and county governments to circumvent constitutional requirements for voter approval of debt and to raise taxes. Actions by California legislators and courts have nearly eliminated the right of local voters to determine how their money is spent by carving out loopholes municipal governments can use to fund projects that voters would not approve. The solution is to require that tax increment financing, and other means of acquiring what is conceptually equivalent to debt, be subject to voter approval. If voters are reluctant to approve deficit spending or increases in tax rates, the response should not be to ignore their voice, but instead to limit the size and scope of local government to those functions voters support. R

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