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December 10, 1985

Honorable George Deukmejian
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and Members of the Senate

Honorable James Nielsen
Senate Minority Floor Leader

Honorable Willie L. Brown, Jr.
Speaker of the Assembly

Honorable Patrick Nolan
Assembly Minority Floor Leader

Dear Governor and Members of the Legislature:

On July 25, 1985, the Commission on California State Government Organization and Economy conducted a public hearing on certain issues of school construction finance with particular focus on impact fees imposed on developers by local government. As you are aware, "impact" fees, also called "mitigation" fees or "exactions," are any fee, contribution of improvements, or dedication of land which cities, counties, or special districts may require of developers as a condition to subdivide land. Our hearing and additional research focused on the use of these fees as a source of local revenue to finance school facilities although they may also be used to finance other infrastructure needs such as streets and sidewalks, police and fire stations, libraries, and low-cost public housing.

The purpose of this letter is to report our findings and recommendations on issues and apparent problems associated with impact fees. Based upon testimony received at our hearing and subsequent information obtained by the Commission, we found the following:

- A multi-billion dollar shortfall in school construction funding, out-dated facility standards, and constraints in acquiring temporary facilities appear to have contributed to increased use of impact fees.

- State and local planning for needed schools are not adequately coordinated to ensure overall economy.

- Impact fees are an expedient but inherently inequitable and problematic means of raising local revenue for schools.

- Current statutes are not adequately explicit regarding impact fees. As a result, there are no standard methods or guidelines for determining impact fees.

- Reporting and auditing requirements of impact fees are insufficient to ensure accountability.

Multi-Billion Dollar Shortfall in School Construction Funding, Outdated Facility Standards and Constraints in Acquiring Temporary Facilities Appear to Have Contributed to Increased Use of Impact Fees

According to testimony received at our hearing, there is at least a $4 billion shortfall in State funding projected through 1989-90 for the school facility construction and reconstruction needs which potentially qualify for assistance under programs administered by the State Allocation Board (SAB). The $4 billion shortfall is based on new construction and reconstruction needs estimated with current needs to be approximately $3.0 billion and $2.0 billion respectively while designated tidelands oil revenues through 1988-89 (the last year authorized) and unexpended bond revenues total less than $1.1 billion.

Additionally, some school districts which have a substantial need for additional permanent school facilities and reconstruction of existing facilities will not be eligible for State funding because they are "overbuilt" according to State area standards adopted in statute more than 40 years ago. Consequently, many of these districts have relied upon impact fees as a means of financing the entire cost of new schools and reconstruction. According to representatives of overbuilt school districts, the eligibility criteria for State subvention of new facilities are outdated and inappropriately penalized for historic construction features such as larger libraries, auditoriums, overhangs, and corridors which were built without State funding and are not readily convertible to suitable classroom space. Also, residential growth often occurs outside the proximity or attendance area of facilities which would otherwise have at least some useful excess capacity.

In addition to the $4 billion shortfall described above, these "overbuilt" districts have an estimated $1 billion need for new construction and a nearly $1 billion need for reconstruction through 1989-90. Therefore, there is a total shortfall of about $6 billion in school facility needs (exclusive of deferred maintenance).

School districts which do not qualify on a timely basis for limited State school construction funding will become increasingly reliant on impact fees to finance new permanent facilities, interim facilities, and even the reconstruction of existing facilities. Impact fees for school facilities could average more than $300 million annually through 1989-90. If impact fees are designated by local governments as a suitable revenue source to fund even one-half of the more than $3 billion in otherwise unfunded new construction needs (permanent facilities excluding reconstruction needs) through 1989-90, fees would average $300 million annually. Additionally, fees utilized to finance interim facilities or even a portion of otherwise unfunded reconstruction needs could increase this total.

State and Local Planning for Schools Needs Better Coordination

According to a survey on impact fees reported by the Coalition for Adequate School Housing (C.A.S.H.) this year, 60 percent of approximately 200 districts assessing fees have applied to the SAB for State funding of permanent or interim school facilities. It is evident in these cases that inordinate delays or anticipated delays in processing applications for facilities could require school districts to incur extra costs passed on to developers and ultimately to home buyers.

At our hearing, the Commission received testimony that long delays in processing school district applications for permanent school construction -- exacerbated by inaction for one year on a backlog of 70 school district applications for a total of 373 State emergency relocatable classrooms -- may have resulted in local assessments of exorbitant or otherwise unnecessary impact fees to finance interim facilities to relieve overcrowding. Subsequently, the Department of General Services' Office of Local Assistance, which acts as staff to the SAB, received significant staff augmentations and streamlined its procedures to resolve the entire backlog of applications for emergency classrooms. A total of approximately 1,000 emergency classrooms will be located on sites throughout the State by the end of this year, and purchase orders have been approved for 225 additional units with scheduled delivery dates of January through June 1986.

The SAB's emergency classroom program permits some school districts the opportunity to lease portable classrooms from the State for up to five years at the rate of $2,000 annually while comparable units leased from commercial sources would typically be leased at rates of $6,000 to $8,000 annually.

Annual funding though 1988-89 of $7.5 million from tidelands oil revenues and approximately $2 million in lease payments will limit the manufacture of State emergency classrooms to about 300 units annually. Within this limit, the current Budget Act authorizes the SAB to order and inventory at least the number of units (225) distributed during the previous year. Additionally, AB 1061 (Bader), as enacted in 1985 authorizes the SAB to contract for the construction or purchase of the number of portable classrooms it deems will be required by eligible applicants during succeeding 12-month periods.

However, enrollment in K-12 public schools is projected to grow by about 100,000 students annually for 5 years through 1989-90. Assuming that one-half of the new student growth would need to be accommodated in portable classrooms designed for up to 30 students each, then nearly 1,700 new units are needed each year through 1989-90. This unmet need would be only slightly mitigated by the recycling of some of the approximately 1,000 SAB classrooms already in the field.

The Commission concludes that even with the increased availability of portable classrooms through the State's emergency classroom program, demand will far outstrip supply through the remainder of this decade. Consequently, school districts will make increased use of impact fees to finance interim facilities from commercial as well as State sources.

Notwithstanding reported improvements in the Office of Local Assistance's processing of applications for emergency classrooms, the Commission identified two areas in which coordination of State and local planning for school facilities could further improve the accountability and economy of impact fees.

First, at the time of our hearing there was no requirement that school districts must apply for whatever State assistance might be available through programs administered by the SAB. Consequently, there was no assurance or certification in any particular case that school districts had availed themselves of what would be the most economic solution to resolving their school facility needs.

Subsequent to our hearing, AB 2089 was enacted (Chapter 836, Statutes of 1985). This measure appears to remedy the deficiency the Commission identified by providing, in part, that any school district seeking impact fees to mitigate overcrowding through interim facilities must submit to the city council or board of supervisors a completed application to the Office of Local Assistance for preliminary determination of its eligibility to receive SAB-administered funds for school facilities. However, we conclude that Section 65971 of the Government Code as amended by AB 2089 does not necessarily remedy this problem because it does not legally preempt noncompliant fee ordinances which are enacted under other explicit or implicit statutory authorities. As discussed in a following section, this amendment to the School Facilities Act of 1977 constitutes only a model for local ordinances until such time as the Legislature might determine that the Act should preempt other authorities.

Second, to the extent that the Office of Local Assistance limits the projection period which school districts may use for the purpose of establishing eligibility for State assistance in funding permanent school facilities, districts may not have sufficient lead time to establish their eligibility and receive an apportionment in time to meet their actual needs. Consequently, they may rely on excessive impact fees to mitigate overcrowding while they await State assistance which might otherwise have been provided on a more timely basis. This problem has not yet been addressed.

School Facility Finance is Inequitable and Problematic

The Commission found that school facility finance places an inequitable burden on potential home buyers and may preclude affordable housing in some cases.

According to the California Supreme Court's first Serrano v. Priest decision, public education differs from other government services because high geographic mobility of students and graduates makes the "general public" and entire State, "not merely the particular community where the schools are located," the beneficiary of education. Therefore, some conclude that funding for school facilities should not be assigned to designated groups, such as developers and new home buyers, but should appropriately be supplanted by increased State funding. Additionally, they charge that the prospect of excessive impact fees may render some potential developments including "affordable housing" infeasible. Others

conclude that revenues needed to meet the capital needs of education associated with community development should be borne by a defined beneficiary group which is broader than that of home buyers but more specific than that of the entire State.

Until such time as the Legislature and the Governor concur with the policy argument that increased State funding should supplant the user-fee concept embodied in exactions paid by developers, "benefit assessment districts" constitute the most logical alternative means of broadening the local funding base.

However, because school facilities have not been shown to confer a very specific benefit according to current legal criteria, the Legislature must explicitly authorize the use of benefit districts for school construction finance before this mechanism may become generally available and attractive to growing communities. One approach, that embodied in SB 999 of 1985 for example, would be for the Legislature to authorize local governments to assess up to 1 percent of the value of all new residential and commercial improvements within a defined area to be used exclusively for school facility needs associated with development. This could generate an estimated $250 million in annual revenues.

However, there are preliminary indications that Mello-Roos financing, which is similar to benefit assessment districts, might be used more frequently in the future.[1] Therefore this could reduce local reliance on impact fees to finance school faculty needs.

The Commission also received testimony that "overbuilt" school districts which are experiencing significant projected growth in enrollment do not qualify for any State assistance in financing permanent school construction because they technically exceed strict area allowances adopted nearly 40 years ago. Therefore, they must rely on fees far in excess of those which SAB-qualified districts may require to finance a local match to SAB apportionments of tidelands oil revenues for permanent construction.

Inequities of Impact Fees: Virtually No Standardized Methods For Determining Impact Fees

The Commission found that impact fees range from about $300 for interim school facilities up to nearly $6,000 for permanent facilities. Because there is no statutory limitation on the purposes for which fees may be assessed and no standardization of specific methods or data required to justify fees, the enormous variance in fees may in part reflect arbitrary and inequitable determinations by local government.

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[1] The Mello-Roos Act, enacted in 1982, permits local governments to levy special taxes on undeveloped land with two-thirds approval of the owners of the property.

The School Facilities Act of 1977 (G.C. Section 65970 et seq, still remembered as SB 201), constitutes the model for most local ordinances which have required developers to pay impact fees as a condition for receiving building permits. According to the C.A.S.H. survey, about two-thirds of school districts which receive these fees collect them under an ordinance closely patterned after the School Facilities Act provisions for mitigating overcrowding through the use of interim facilities for as long as five years or until permanent school facilities are available for accommodating students from new housing developments. Within the model as defined in statute, school districts must convince city or county government that overcrowding will exist, the extent of overcrowding, and where, when, and how impact fees will be used to mitigate the overcrowding for up to five years. Alternatively, the residential builder can provide classrooms on a school site for up to five years and thereafter remove them.

Although this model is widely used, undoubtedly because of its apparent fairness in defining general limits on the process of enacting fee ordinances, traditional interpretations of the explicit and implied powers of local government to regulate development do not require any unit of local government to model its ordinance on the parameters set forth in the School Facilities Act. In a 7-0 decision by the California Supreme Court on September 26, 1985 (Candid Enterprises, Inc. v. Grossmont Union High School District), the high Court reversed a Court of Appeals decision and held that the provisions of Government Code (Sec. 65970 ff, known as SB 201) do <u>not</u> preempt or prevent any other local arrangements which may require builders to pay fees for school construction.

Even if the statutory model for impact fees preempted other statutory authorities relating to school construction finance, a lack of statutory specificity in these provisions could result in significant differences in how various city or county governments determine the extent of a developer's liability for financing school facilities.

For example, there is no standard for defining overcrowding based on a specified number of students per needed classroom. Although the C.A.S.H. survey reported that approximately 75 percent of school districts with impact fees have contracts for 30 students per classroom, there is no State requirement that a single standard or even prevailing local standards should be utilized. Therefore, an undetermined number of school districts may receive inordinate fees based on small class sizes. Since portable classrooms universally have a design capacity of 30 students per classroom, arbitrary calculations based on loadings of 25 students or less per classroom could significantly increase the costs associated with interim facilities.

In addition, there are no statutory requirements or incentives to utilize State emergency classrooms costing $2,000 per unit rather than nearly equivalent portables which are commercially available and rent for up to $8,000 per unit. Thus, to the extent that State emergency classrooms are a sanctioned and available alternative to mitigate overcrowding, fees may be based on the market rate for portables with no regard for possible economy.

Reporting and Auditing Requirements Are Insufficient to Ensure Accountability

Although there are significant reporting and audit requirements which apply to all school impact fees, fees are not categorized according to their specific purposes. Additionally, there are no specific State audit requirements to ensure that expenditures of these fees comply soley with the purposes for which they were collected.

The School Facilities Act provided that any school district receiving funds "pursuant to this chapter" shall maintain a separate account for impaction fees and shall expend them only for the purpose of mitigating overcrowding. School districts are required to report to the city council or board of supervisors by October 15 of each year on the balance in the account at the end of the previous fiscal year, the use of any facilities to relieve overcrowding, and the persistence of overcrowding within specific attendance areas of school districts.

Subsequent legislation (Chapter 921, Statutes of 1983) imposed parallel requirements that any fees collected by local agencies "to provide for an improvement to be constructed to serve a residential development as a condition to approving the development" shall be deposited in a separate capital facilities account fund and shall be expended "solely for the purpose for which the fee was collected." Additionally, any interest income earned on the fund is subject to the same restriction.

When Chapter 921 became effective in 1984, the State Department of Education initiated reporting requirements which incorporated impact fee data into the annual budget documents it requires of all school districts and county offices of education. However, an attempt to cross-validate the Department's initial report of impact fees in the Capital Facilities Fund with data collected in the C.A.S.H. survey of fees identified instances of underreporting and irregular categorizations on the Department's Form J-41.

All school district funds, including those dedicated to the mitigation to overcrowding, are subject to the annual audits prepared by independent auditors under contract with school boards. These audits must at least satisfy the minimum standards embodied in the accounting manual published by the State Controller. Additionally, because these funds are collected by the city or county on behalf of school districts, they are sometimes subject to a second audit conducted by the city or county auditor-controller.

However, the Controller's audit manual which directs the work of independent school auditors and State overseers does not yet incorporate specific guidelines or requirements to ensure at least minimum compliance audits of these funds.

Recommendations

Based on the Commission's examination of existing State and local procedures relating to the assessment of impact fees, we recommend the

following actions to improve accountability in the funding of school facilities:

(1) The Legislature should consider enacting legislation which would authorize benefit assessment districts to finance the local costs of school construction. For example, revenues based on 1 percent of the cost of residential and commercial improvements might be sufficient to supplant all school-related impact fees.

(2) All local ordinances which enact fees for school facilities should include a schedule specifying how and when the fees will be utilized to relieve conditions of overcrowding. If the Legislature does not preempt future impact fees through increased State funding of school facility needs or establishment of benefit assessment districts, it should enact legislation which would, after a specified date, preempt subsequent local ordinances which might substantively deviate from model procedures specified in the School Facilities Act of 1977 (G.C. Sec. 65970 et seq).

(3) The Legislature should enact a specific standard for defining "overcrowding," such as 27-30 students per classroom (except for special education), and a model procedure for determining impact fees on regional- or county-wide bases.

(4) The State Allocation Board (SAB) should reevaluate historic area allowances and eligibility criteria which reportedly penalize overbuilt school districts and contribute to the expanded use of fees in some districts. Consequently, the SAB may wish to propose recommendations for legislative adoption as to how greater equity could be introduced into the system for allocating its available funds.

(5) The State Allocation Board should critically evaluate and adopt refinements or alternatives to its current methods for projecting districts' eligibility for SAB-administered funds in order to reduce unnecessary lag time and associated costs for permanent facilities. For example, the Board should consider the feasibility of utilizing information from building permits rather than requiring districts to wait until residential foundations have been laid.

(6) The State Department of Education should critically review and improve its specific instructions which require school districts to report developer-paid contributions and impact fees on Parts IX and XI of the Department's Annual Financial and Budget Report (Form J-41). For example, Part IX (Restricted Funds) should be amended to clearly indicate the amount and specific purpose of developers' donations paid in lieu of fees to school districts. Additionally, it may be useful to amend the Department's instructions and local reporting for Part XI to distinguish such specific objects of impact fee expenditures as site acquisition, site improvement,

building purchase, building improvement, and whether the school facilities are permanent or temporary.

(7) The State Controller should include specific compliance audit guidelines to be followed by independent auditors of the capital facilities account fund established by Chapter 921, Statutes of 1983, including all impact fees.

For example, the Controller should direct auditors to review the compliance of school districts with their approved plans for instituting specific measures to mitigate overcrowding in those cases where districts carry forward more than a specified percentage of capital facilities fund income plus the beginning balance for one or more years.

Additionally, the Controller should implement audit criteria which would apply to fees already collected for the purpose of providing a 10 percent local match to State funds for constructing permanent facilities since the State Allocation Board does not currently require local revenues for this purpose.

The Commission concludes that the current approach of financing school facilities is systemically inequitable, inadequately coordinated with State programs, fertile ground for arbitrary determinations, and lacking in essential elements of accountability to the public. Timely implementation of our specific recommendations concerning impact fees will certainly bring a greater degree of the consistency and accountability we expect in financing schools.

Respectfully submitted,

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K-12 Impact Fee Study
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