Clearing Away Roadblocks to Funding California's Infrastructure

by Darien Shanske

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I. Introduction

No one disputes that California, like much of the rest of the country, has a desperate need for infrastructure investment. California's politicians are aware of this and significant additional resources have been committed over the last few years. Indeed, California has been at the forefront of several novel ways of financing infrastructure. Yet the funding gap remains vast. To be sure, significant federal assistance has been forthcoming, but that will not be sufficient, especially to the extent that federal aid only ensures that previously planned projects are not abandoned as California, like most states, endures yet another severe budget crisis. And federal aid will be only for a limited time — coming up with better ways for California to invest in itself is thus an additional (and much needed) form of economic stimulus.

> ***There are highly effective ways to build infrastructure that have been stymied by changes to the California Constitution.***

This report began when I was given the opportunity to address California legislative staffers on the issue of infrastructure financing. Given the consensus about the need and California's willingness to experiment with novel financing techniques, it was unclear what I should talk about. In reviewing the recommendations of others and the history and theory of infrastructure finance, it became clear to me that a major way forward for California lay not in novelty, but in tradition. There are venerable and powerful ways to finance infrastructure that California has allowed to wither away. Or more precisely and sadly, there are highly effective ways to build infrastructure that have been stymied by changes to the California Constitution.

There have already been thoughtful proposals for revising California's Constitution,[1] and the economic crisis may offer a unique opportunity to implement common-sense reforms.[2] This report will identify provisions that obstruct the building of needed infrastructure in California and elsewhere and then will make proposals as to how those provisions can be improved. Related statutory fixes will also be addressed. The proposals are offered as pragmatic, even technocratic, fixes, and thus should be within the bounds of possibility despite political polarization. Indeed, to the extent that many of the proposals involve empowering local government entities, the same entities that have borne much of the

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[1]The California Constitution Revision Commission, "Final Report and Recommendations to the Governor and the Legislature," 1996. That report anticipates the proposals contained herein in many ways, in particular through advocating giving local communities more control over their finances, but also striving to make the local governments themselves more efficient. *Id.* at 74-79. The Commission on the 21st Century Economy makes no such proposal (report is available at http://www.cotce.ca.gov/documents/reports/documents/Commission_on_th e_21st_Century_Economy-Final_Report.pdf), despite having heard testimony about the serious problems affecting local finance. *See* Testimony From the Meeting of April 9, 2009, *available at* http://www.cotce.ca.gov/meetings/2009/4-9/testimony/.

[2]There are serious discussions about convening a new constitutional convention. *See* "Repair California: Californians for a State Constitutional Convention," *available at* http://www.repaircalifornia.org/about_california_convention.php (last visited Aug. 15, 2009).

brunt of the budget cuts,[3] these proposals should not be controversial because they are essential to just roughly maintaining the level of infrastructure that we have.

A. The Need

It is unhelpful just to throw paralyzingly large numbers around as to how much additional funding is required.[4] There are several reasons for that. First, to the extent the California economy is changing, some needs might actually lessen. For instance, less resource-intensive industries are, and should be, California's economic future.[5] If California's economy becomes more service oriented than manufacturing oriented (and if the manufacturing that remains is more energy efficient), we might not need to increase or even maintain our current level of energy production.

Second, and similarly, we are not passive participants as to our future needs. If we develop more intelligently, we will need less infrastructure — and different infrastructure — the reverse, sadly, is also true. And that is not just a matter of deciding *what* we fund (for example, public transit versus roads), but *how* we fund it. One popular catchphrase in the literature is "demand management." As for a lot of the resources that we are discussing, we *want* people to consume less, and demand management simply means that scarce resources should generally be priced according to their true cost. Demand-based pricing for water, electricity, and roads makes sense not only as a matter of efficiency or equity, but proper pricing also achieves the independent goal of conservation.[6]

That will be a theme of this article — we need to enter into virtuous cycles. If we have the right funding mechanisms and incentives in place, that will tend to lead to production of the right amount of proper infrastructure.

B. Where State and Local Funding for Infrastructure Comes From

It would be inaccurate to say that the state budget must meet all our infrastructure needs. In 2006 California local governments issued almost $40 billion in bonds, most of which were for projects that we would consider infrastructure.[7] In 2006 the state issued just over $12 billion in bonds,[8] though the state spent many more billions on infrastructure directly.[9] In total, by at least one reliable estimate, local and regional entities account for 80 percent of capital spending in California.[10] Therefore, perhaps the single most effective action the state could take would be to empower more and better local government infrastructure finance.

II. Sketch of an 'Ideal' Theory of Infrastructure Finance

We cannot assess how we are doing and what we should be doing without some sort of theoretical baseline. That is especially true for California, which has participated to some extent in every innovative financing technique that I know of. Therefore, to gain some perspective, I will present a thumbnail sketch of an ideal system of infrastructure finance. I put "ideal" in quotes because this system is not necessarily ideal in terms of equity or efficiency, nor is it entirely descriptive of what California now does. Still, pragmatically, it is a reasonable approximation of the system the state should be shooting for.[11]

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[3]Legislative Analyst's Office, July 2009 Budget Package, p. 2-3, *available at* http://lao.ca.gov/2009/bud/july_09_budget_package/July_2009_Budget_Package_072909.pdf (shifting $1.7 billion in redevelopment funds, borrowing $1.9 billion from local governments, and decreasing funding for transportation); ABX 4-14, ABX 4-15, 2009-2010 Calif. Leg. Sess. (Calif. 2009) (temporarily cutting funding to local governments and allowing them to borrow until repayment by the state).

[4]One common number is $500 billion. Hanak, "Paying for Infrastructure: California's Choices," *At Issue* (January 2009), *available at* http://www.ppic.org/main/publication.asp?i=863. This report is the single best and most concise treatment of the problem California is facing and how to solve it; it does not, however, focus on the legal roadblocks. The knee-buckling number at the national level has been recently estimated at $2.2 trillion. *See* "Report Card for America's Infrastructure" (2009), *available at* http://www.infrastructurereportcard.org/.

[5]Hanak et al., "California 2025: Taking on the Future," Public Policy Institute of California, p. 68, June 2005, *available at* http://www.ppic.org/main/publication.asp?i=489.

[6]Hanak, *supra* note 5, at 114-115.

[7]California Debt and Investment Advisory Commission, "California Public Debt Issuance by Type and Refunding for the Period January 1, 2006 to December 31, 2006," *available at* http://www.treasurer.ca.gov/cdiac/debtdata/2006/type.pdf. That is not at all unusual; for reasons noted below, local governments have taken the lead in providing infrastructure since the 19th century. John Wallis, "Constitutions, Corporations and Corruption: American States and Constitutional Change, 1842-1852," *J. Econ. Hist.*, 2005, 211, 245.

[8]*See* California Debt and Investment Advisory Commission, *supra* note 7.

[9]Of course, local governments did as well.

[10]Hanak, *supra* note 4, at 5.

[11]Primarily, I am taking our decentralized system as a given and am advocating policies that will make it work better. *See generally*, Gruber, *Public Finance and Public Policy*, Worth, 2007, at 268-270 (discussing optimal fiscal federalism). There is considerable evidence supporting decentralizing as a general matter. *See* Hills Jr., "Compared to What? Tiebout and the Comparative Merits of Congress and the States in Constitutional Federalism," in *The Tiebout Model at Fifty* (William A. Fischel ed., Lincoln Institute of Land Policy, 2006), 239-263. I am less sanguine regarding our decentralized system, particularly because of the wildly divergent size and nature of the current set of local government

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This little model requires two distinctions and results in a two by two matrix:

Self-Supporting, Easily Monetized For example, water fees fund water treatment plant	**Not Self-Supporting, Easily Monetized** For example, regional highway funded in part by tolls
Self-Supporting, Not Easily Monetized For example, school in wealthy district funded by property tax	**Not Self-Supporting, Not Easily Monetized** For example, school in poorer district subsidized by state

First, some benefits provided by infrastructure are easily monetized, and second, some benefits can support themselves. Water treatment is an example of an easily monetized and self-supporting benefit — the top left corner of the matrix. Sufficient fees can be charged to finance the building of water treatment plants and to keep them running.

Some other benefits are easily monetized but not self-sustaining — that is the top right corner of the matrix. An example of that might be many public transit systems or a regional highway. That is, it is easy to charge tickets for public transit, but most public transit cannot survive by tickets alone. There are also benefits that are not so easily monetized but can be self-supporting, such as public schools in relatively affluent areas that can be fully financed by local property taxes — that is the bottom left corner. Finally, there are benefits that cannot be easily monetized or support themselves: Public schools in poorer areas might be an example. I should emphasize that these categories in no way imply a hierarchy one way or another.

As to these four general categories, our first general principle is a simple one: *Projects that produce easily monetized, self-supporting benefits, such as water treatment plants, should generally be allowed to support themselves*.

As to those projects that can be self-supporting, but either are not monetizable or where user fees will not likely be sufficient, it is important to come up with creative ways to allow the project to pay for itself. There are traditional ways to do that when the benefit can be spatially isolated. One classic example is public schools. As long as the law creates the right relationship between who is in a school district and who is outside,[12] supposing sufficient local resources (we are in the self-supporting quadrant), the residents of the district will pay for adequate schools and do so out of self-interest because local property owners will impound their investment in local education into their home prices.[13]

Another important example of this dynamic involves the assessment district — assessment district financing has a venerable history.[14] For example, one can use an assessment district to build a local road. Everyone with property beside the road can be assessed their pro rata share for the road based on frontage.

This principle of assessing landowners for the benefit received from public infrastructure is important, and not just as a matter of equity. Typically, a new piece of infrastructure increases nearby land values. If that is so, and the benefiting landowners are not paying more for the improvement, but the improvement is instead built using general taxation, limited general tax dollars at all levels of government are being used to subsidize a project that does not need it. I want to emphasize how unfortunate it is to violate what is called the principle of "fiscal equivalence," that is, having a sound link between benefit and burden (when possible).[15] It is not just relatively unfair and wasteful, but potentially absolutely wasteful because requiring local beneficiaries to pay is a reasonable way to try to assess project need in the first place. The waste goes back the other way because if a sensible project is to be paid for by general tax dollars, taxpayers who do not benefit will resist the expenditure, making the whole community worse off in the long run.[16] Also, if the assessment against property is based (as it should be) on relatively uncontroversial and conservative metrics of how much the property's value should be increased,[17] it encourages more intensive use of the

entities. If a government entity is too small, it is likely to be too parochial, but if it is too big, it is going to have all of the problems that decentralizers worry about in large centralized governments (for example, log rolling). If an entity is concerned only with one service, it will focus on that service (say, water), even if resources would be better spent elsewhere (for example, education). Local governments are also particularly susceptible to manipulation by the larger institutions that might become involved in infrastructure projects (e.g., banks). *See* Walsh, "Nationwide Inquiry on Bids for Municipal Bonds," *The New York Times*, Jan. 9, 2009, A1.

[12]The laws must also allow for local financing of schools. After Proposition 13, that is less true in California; a small step to changing that situation is discussed below.

[13]*See generally* Fischel, *The Homevoter Hypothesis: How Home Values Influence Local Government Taxation, School Finance, and Land Use Policies*, Harvard University Press, 2001.

[14]*See generally* Diamond, "The Death and Transfiguration of Benefit Taxation: Special Assessments in Nineteenth-Century America," 22 *J. Legal Stud.,* 201, (1983).

[15]*See generally* Weingast, "Second Generation Fiscal Federalism: The Implications of Fiscal Incentives," 65 *J. Urb. Econ.*, 279, 285 (2009).

[16]Wallis, *supra* note 7, at 222.

[17]For an example of a thorough study of the increase in land value caused by proximity to transit, see Transportation Research Board, "Economic Impact Analysis of Transit Developments: Guidebooks for Practitioners," 1998, *TCRP Report*

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land — another plus. And so this is our second general principle: *The benefit principle should be used whenever possible*.

The benefit assessment principle has generally been applied at the local level, and I believe that is where it should continue to be primarily used. But there is important potential for this principle at a regional level, even if that means that the benefit principle cannot cover the entire cost of the project. Consider the following: Virginia has received a lot of attention for using cutting-edge public-private partnerships to fund new transportation infrastructure.[18] But Virginia found that simply using tolls to pay for that new infrastructure was insufficient, and in at least one instance Virginia used a regional assessment to make up the difference — landowners around a new piece of infrastructure agreed to be assessed more to defray part of its cost.[19]

The third principle follows from the second, and it relates to those services for which there should be a price to encourage conservation. The principle is simple: *A price should be imposed even if that price is not sufficient to cover the full cost of the improvement*. An example of that would be to put a toll on a highway even if any reasonable toll would be insufficient to maintain that highway.

> ***General tax dollars should be spent only after all self-sustaining projects are paying for themselves and demand pricing has encouraged conservation.***

Note that, if working properly, under our model: *General tax dollars should be spent only after all self-sustaining projects are paying for themselves, and demand pricing has encouraged conservation*. That is our fourth principle. For the most part that means that state and federal tax dollars should be used primarily on large regional projects (or more equitable distribution) not covered by demand pricing, local benefits, or local general taxation. That includes not only physical pieces of infrastructure but also more intangible long-term capital assets, like the education of our children. Obviously, state and federal funding is also good at spurring on and guiding local involvement, and so using some state money essentially as seed money is likely to be a wise investment.

III. Evaluations and Recommendations

Returning to our simple matrix, we will start at the top left. Both as independent entities and as enterprises within other entities, many self-sustaining projects have been allowed to proceed on their own, per our ideal.[20] Probably more of our public infrastructure should be paid for in that way. Recently, the U.S. Supreme Court allowed a two-county waste management authority to compel residents to use a state-of-the-art waste treatment center, clearing one obstacle to the greater use of demand management by government entities.[21]

One big obstacle to even maintaining the current level of demand management in California has been the advent of Proposition 218, passed by the voters in 1996. In short, Proposition 218 makes it more difficult for fees to be raised for water service or to generally charge higher fees for more resource-intensive use of property.[22] Just last year the Legislature tried to mitigate the impact of Proposition 218 on water fees with AB 2882.[23] However, there are limits to the Band-Aids the Legislature can apply. It is hard to understand why a technical correction to Proposition 218 should be politically impossible.[24] Indeed, Proposition 218 already exempts electric utility and gas service from most of its

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35, *available at* http://www.trb.org/TRBNet/ProjectDisplay.asp?ProjectID=1137. For a survey of the many studies conducted around the world on financing transit through value capture, see Smith and Gihring, "Financing Transit Systems Through Value Capture: An Annotated Bibliography," *Victoria Transport Policy Institute*, November 2006, *available at* http://www.vtpi.org/smith.pdf.

[18]*See* discussion of public-private partnerships (P3s) *infra*.

[19]*Understanding Contemporary Public Private Highway Transactions: The Future of Highway Finance? Before the Subcomm. on Highways, Transit and Pipelines of the H. Comm. on Transp. and Infrastructure*, p. 23, 109-175 (2006) (testimony of Virginia Gov. Tim Kaine (D)); *see also,* Muro et al., "MetroPolicy: Shaping a New Federal Partnership for a Metropolitan Nation," *The Brookings Institution*, 2008, p. 76, *available at* http://www.brookings.edu/reports/2008/06_metropolicy.aspx; Hagman and Misczynski, *Windfalls for Wipeouts*, 1978, p. 322.

[20]Hanak, *supra* note 5, at 136; *see also* Hanak and Rueben, "Funding Innovations for California Infrastructure: Promise and Pitfalls," *USC Keston Institute for Infrastructure*, Mar. 20, 2006, p. 8, *available at* http://www.usc.edu/schools/sppd/keston/pdf/cal-infrastructure-promise-pitfall.pdf.

[21]*United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786 (2007).

[22]The details are complicated, but the gist of the problem is that Proposition 218 imposes significant new requirements on local agencies seeking to raise fees, including most especially for the cost of water. *See Bighorn-Desert Water Agency v. Verjil*, 138 P.3d 220 (Calif. 2006); *Pajaro Valley Water Mgmt. Agency v. Amhrein*, 59 Calif. Rptr. 3d 484 (Calif. Ct. App. 2007) (following *Bighorn* and invalidating fee increase); Hanak, *supra* note 4, at 6. Those harmful effects were predicted from the start. *See* Soldani, "The Impact of Proposition 218 on California's Water Delivery System: Should Water Be 'Above the Law'?" 10 *San Joaquin Agric. L. Rev.* 183 (2000).

[23]AB 2882, 2007-2008 Leg. Sess. (Calif. 2008).

[24]Gov. Arnold Schwarzenegger (R) has already proposed amending Proposition 218 regarding flood control; the reasonable idea is that individuals who purchase homes in flood

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strictures. Thus, article 13D, section 3(b) of the California Constitution, added by Proposition 218, currently reads:

> For purposes of this article, fees for the provision of electrical or gas service shall not be deemed charges or fees imposed as an incident of property ownership.

The simplest and best fix of the problem posed by article 13D's limitation on the ability of local agencies to use demand management for water use is simply to add "water service" to the list of exempted services. However, that fix would not necessarily help with the imposition of fees in connection with other natural resource issues, such as charging higher fees to those wishing to locate construction in flood plains. Therefore, my proposal would add the phrase "or any other natural resource related fee, as such service is determined by the Legislature."[25] That addition builds in the necessary flexibility and political accountability. Without question, one concern of the proponents of Proposition 218 was that cash-starved local agencies were pushing the concept of an assessment or fee to the limit.[26] By requiring legislative approval of any new type of natural resource fee, the taxpayers are assured that any such fee would emerge from the state authorities, providing greater transparency and accountability than many ad hoc decisions made at the local level.

Unfortunately, fixing article 13D is not enough. Article 13C, section 3, also added by Proposition 218, reads:

> Notwithstanding any other provision of this Constitution, including, but not limited to, Sections 8 and 9 of Article II, the initiative power shall not be prohibited or otherwise limited in matters of reducing or repealing any local tax, assessment, fee or charge.

That provision has been found to mean that fees for water service can be lowered by initiative.[27] This power is destabilizing and inhibits the proper pricing of natural resources as we move into a more resource-constrained future.[28] There are various ways to fix that problem. I think it would be simplest to amend the provision just discussed in article 13D so that neither article 13C nor article 13D applies to natural resource fees.

Thus, summing up, my first proposal is: *Amend the California Constitution to enable better resource management*. A new Article 13D, section 3(b) of the California Constitution would read:

> For purposes of this article and Article 13C, fees for the provision of electrical, water, gas or other service related to a natural resource, as such service is determined by the Legislature, shall not be deemed charges, fees or taxes.[29]

It should be observed that this technical correction is analytically appropriate because those fees are prices for the consumption of valuable resources. The current situation, which analogizes fees for water service to a local tax, is not the correct analysis. In the case of a local tax, voters can interact with the level of taxation through voice (that is, voting) or exit (that is, leaving the jurisdiction).[30] These expedients are meant to some extent to mimic an ordinary pricing mechanism, but it is generally understood that a local property tax is still a tax and it cannot be perfectly correlated to the specific benefits that any particular taxpayer receives.[31] There is no need for such mimicry with the consumption of water — as with any consumer good, if one wants to pay less for water, one can simply consume less. Proposition 218 does not make the pricing of water more marketlike, but *less* marketlike. Again, it is essential that more, not fewer, natural resources are priced properly.

Moving to the bottom left of our matrix — as for projects that can be self-supporting, but not through a straightforward user fee, there is an even more

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zones should pay more to take into account the additional costs that they are ultimately imposing on the larger community. *See* Hanak and Rueben, *supra* note 20, at 20. SB 310, 2009-2010 Leg. Sess. (Calif. 2010), just passed and signed by the governor, gives some local governments the power to impose regulatory fees to protect watersheds; the legislation is, by necessity, careful not to authorize the imposition of fees that would be governed by Proposition 218. That approach should not be necessary. *See* Calif. Water Code section 16103(a)(3).

[25]*Cf.* Calif. Const. art. 13, section 8 (permitting the Legislature to define "open space lands" for property tax purposes); Calif. Revenue and Taxation Code section 422 (defining open space land).

[26]California Ballot Measures Database, "Argument in Favor of Proposition 218," *available at* http://library.uchastings.edu/library/california-research/ca-ballot- measures.html #ballotprops.

[27]*Bighorn*, *supra* note 22, at 220.

[28]That is not an imagined horrible event. In at least one recent case, voters used an initiative to lower their sewer rates, which, not surprisingly, triggered a downgrade of that city's sewer revenue bonds. Ward, "Voters Undercut Sewer Debt," *Bond Buyer*, Feb. 27, 2009. The possibility of that kind of action in the future will no doubt make California revenue bonds more expensive, if they are marketable at all.

[29]As a matter of drafting, it may well be clearer to omit the clause about the Legislature from this section and just add a new definition of service related to a natural resource into the definitional list in section 2 of article 13C.

[30]Those options come from Hirschman, *Exit, Voice and Loyalty*, Harvard University Press, 1970.

[31]Two excellent papers that ponder the question of the extent to which the local property tax functions as a price are Galle, "A Republic of the Mind: Cognitive Biases, Fiscal Federalism, And Section 164 of the Tax Code," 82 *Ind. L.J.* 673 (2007); and Kaplow, "Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax," 82 *Va. L. Rev.* 413 (1996).

serious gap. The two-thirds voter requirement for most general obligation bonds and for increasing so-called special taxes has depressed local contributions to projects that people want and that are self-funding in the value they add.[32] Proof of the untapped potential comes from the enormous number of school bonds that have been passed since the threshold for school bonds was lowered in 2000 to 55 percent (under some conditions).[33] The number of bond measures more than doubled and almost half of the money finally approved (over $20 billion) would not have been approved if not for the lower threshold.[34]

That indicates that the state has not just left real money on the table in connection with other infrastructure, but also that the state has probably not allocated its own limited funds optimally. The state has received authorization to issue over $20 billion in school bonds since the passage of Proposition 39, and so Proposition 39 not only doubled the local contribution, but has also presumably allowed the state funds to be better targeted toward the projects that really cannot fund themselves.

> ***One way forward on infrastructure finance is to lower the approval threshold for local bonds more generally, though perhaps only for specified projects.***

Therefore, one way forward on infrastructure finance is to lower the approval threshold for local bonds more generally, though perhaps only for specified projects.[35] There are several such proposals before the Legislature, as there has often been over the last several years.[36] It is doubtful that most cities and counties are the right level of government at which to decide on optimal transportation projects.[37] Fortunately, the state has regional transportation planning agencies and regional transportation plans.[38] It would be wise to tie any new funding source or lessening of approval thresholds to projects that are found to advance regional needs.

Second proposal: *Lower constitutional bond and tax approval thresholds to 55 percent generally, but pass a statutory requirement that ties these new mechanisms to regional needs*.[39]

Decreasing those thresholds is not the only way to spur more local participation in projects that increase local land values. Assessment district financing is a time-honored way to use the increase in land values generated by a piece of infrastructure to pay for itself. There are already myriad benefit assessment statutes available under California law, including several that are directly usable by regional transit agencies to capture value near transit stations.[40] Unfortunately, all of those plans are hamstrung by Proposition 218. Proposition 218 would also prevent the extensive use of a new regional type

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[32]Calif. Const. art. 13A, section (1)(b)(2); California is one of only eight states that require a supermajority to pass local general obligation bonds. Hanak and Rueben, *supra* note 20, at 6.

[33]Calif. Const. art. 13A, section (1)(b)(3); Calif. Educ. Code section 15268.

[34]Hanak and Rueben, *supra* note 20, at 8-9.

[35]*Cf.* Hanak and Rueben, *supra* note 20, at 8-9.

[36]*See*, *e.g.*, ACA 9, 2009-2010 Leg. Sess. (Calif. 2009); ACA 10, 2007-2008 Leg. Sess (Calif. 2007). The wisest of those proposals do not just lower the threshold for bonds as such, but for local taxes (for example, a parcel tax, which is a kind of special tax). First, that is because if governments cannot pay for ongoing services or maintenance, one-time expenditures for infrastructure are of limited value (why build a new school with a track if one cannot increase taxes to pay for a track instructor?). Second, the distinction between a capital expenditure using bond funds and a service expenditure using local taxes is not clear. Again, the school analogy indicates that in many cases an ongoing investment in local schools is an investment not only in one's children, but also in one's property in the school district. Such expenditures generally require an increase in taxes for operations, not just the approval of a tax increase to fund some capital projects.

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[37]*Cf.* Hanak, *supra* note 5, at 147-148.

[38]*See* Calif. Gov't Code sections 29532 and 65080. There is another problem mitigated by increased use of long-term regional plans, one pointed out to me by a particularly sharp conference attendee. To the extent that the state and federal governments will provide funding to communities that cannot fund their share of projects, there is a perverse incentive for communities that can fund their projects to avoid doing so. To some extent that problem is insoluble, which is why the fact that there is already a tradition of local initiative in financing is so important. If we had to start from scratch with communities expecting help from the center, we would be in deep trouble. As it is, gamesmanship can be limited by providing bonuses to communities that provide their share of funding. Of course, the question is what is a fair share and how should any incentives be structured so as to make sense to spend central government dollars on them. This is the benefit of large-scale, long-term, professionally drawn regional plans. Communities will have years to know what is expected of them and what they might or might not enjoy if they contribute; that would obviate the need for inefficient ad hoc bargaining as to specific localities and projects.

[39]The need for such a change is particularly dire because, as noted above, the state has chosen to close its budget gap not only by cutting local funding, but also by enabling these same localities to borrow against the state's promise (and obligation) to make them whole. *See supra* note 3. There is some merit to the state's plan to the extent that it makes sense to borrow during an economic downturn, but the plan is problematic to the extent that the borrowing is entirely reliant on the state's credit. It would have been wise to at least give local governments more power to borrow on their own.

[40]*See* Calif. Pub. Util. section 33000 (Southern California Rapid Transit District assessment authorization); Calif. Pub. Util. section 99000 (transit district assessment authorization).

of assessment district. Only a constitutional fix seems possible here as well.

It is unobjectionable that Proposition 218 requires more transparency in connection with assessments. Proposition 218 does its mischief in various technical changes it makes to the law. First, it weighs voting by how much each landowner is going to pay should the new assessment be passed.[41] Even worse, Proposition 218 does not require that a majority of all landowners in the district protest to stop an assessment, but only a majority of those who actually vote — thus giving even more power to a determined minority.[42] There are good arguments that assessment district votes should not be limited to landowners to begin with,[43] but weighing the vote of the landowners by the size of their assessment is particularly unjustifiable. If done properly, the whole point of an assessment is that, for each parcel, the assessment levied is proportional to the benefit that parcel is going to receive. In other words, in a properly designed assessment district, each property owner should have the same stake in the vote and so there is no reason to give additional privileges to large landowners. Combined with the rule that gives an effective veto to merely a majority of the weighted ballots *actually* cast, Proposition 218 is designed to prevent the building of infrastructure. This voting regime should be changed — or rather, the voting requirements should be left out of the constitution altogether and the statutory requirements in the various assessments acts should once again be the law.[44]

Proposition 218 mandates a "detailed engineer's report prepared by a registered professional engineer certified by the State of California" for each assessment.[45] There is nothing problematic about demanding rigor, though clearly this requirement poses a significant upfront cost to local governments. This provision should therefore be amended to allow for local governments to impose assessments for some projects within a statutory safe harbor. That legislation should also provide for the possibility of regionwide benefits to enable larger-scale improvements.[46] There has been considerable work already done estimating the benefits provided to property from local improvements.[47] The Legislature should take conservative estimates and place them in the law, along with an annual adjustment for inflation. In a statute, the thresholds could be changed generally or specifically if the need arises. The statute should make it clear that local governments are free to reach other arrangements with local landowners. A similar arrangement is already in place in connection with some development impact fees.[48] It would also be reasonable to establish special presumptions for approved regional projects.

Proposition 218 insists that the benefit conferred on a property by an assessment cannot be a "general enhancement of property value."[49] That limitation is incomprehensible. Measurable increase in the value of the property should be the gold standard of assessment law, and thus that provision is hopeless and should be eliminated.

Finally, Proposition 218 shifted the burden of justifying an assessment onto the local government. Proposition 218 did not specify what exactly would be the new standard of review. The California Supreme Court, in a unanimous vote, found that the new standard of review would be *de novo*.[50] That is, the court has decided to give local governments no deference at all regarding the assessments that they approve. If that rule is not changed, all the other proposed changes would amount to little because of the litigation risk that any assessment now brings with it as a matter of *constitutional* law (that is, a statutory safe harbor will be of little use). I propose a two-part change. First, for any assessment within a statutory safe harbor, the level of review should return to an abuse of discretion standard, which is what it was before Proposition 218.[51] Second, for assessments beyond the safe harbor, local governments should be accorded some, but less, deference. I propose the substantial evidence standard adopted by the intermediate appellate court in the *Santa Clara* assessment case.[52]

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[41]Calif. Const. art. 13D, section 4(e).

[42]For a development of this critique and survey of pre-Proposition 218 assessment law, see Cole, Comment, "Special Assessment Law Under California's Proposition 218 and the One-Person, One-Vote Challenge," 29 *McGeorge L. Rev.* 845, 870 (1998).

[43]One common argument is that there is no reason to believe that an assessment would not be passed onto renters just as much as any property tax increase, and so why should they not get to vote? *See also generally* Cole, *supra* note 42.

[44]*See, e.g.*, Legislative Analyst Report for Proposition 218, *available at* the California Ballot Measures Database, http://library.uchastings.edu/library/california-research/ca-ballot-measures.html#ballotprops ("state laws generally require local governments to reject a proposed assessment if more than 50 percent of the property owners protest in writing"). If individual statutes do have weighted voting or supermajority requirements, I think they should be changed for the reason stated above, which is that they overprotect large landowners.

[45]Calif. Const. art. 13D, section 4(b).

[46]Hayes, Note, "Rapid Transit Financing: Use of the Special Assessment," 29 *Stan L. Rev.* 794, 816-818 (1976) (advocating regional assessment districts for regional projects).

[47]*See supra* note 17.

[48]*See* Calif. Gov't Code section 65995.5(h) (incorporating a specific report as a means of calculating development impact fees).

[49]Calif. Const. art. 13D, section 2(i).

[50]*Silicon Valley Taxpayers Ass'n v. Santa Clara County Open Space Auth.*, 187 P.3d 37, 50 (Calif. 2008).

[51]*Id.* at 46.

[52]*Id.* at 48.

My third proposal is therefore: *Amend the California Constitution to allow communities and regions to invest in themselves*. That requires abandoning Proposition 218's weighted actual voting regime, creating safe harbors for assessment calculations, eliminating the notion that an increase in property value is not a special benefit, and restoring some measure of judicial deference to local decisionmaking.

The California Supreme Court has decided to give local governments no deference at all regarding the assessments that they approve.

If the Legislature is going to help clear the legal obstacles to greater use of the assessment principle, as I believe it should, I think it should act to clear the financial obstacles to greater use of assessment financing. The logic of assessment financing is that it requires property owners who benefit from the infrastructure to pay for that benefit, but sometimes property owners do not have the liquidity to pay their fair share upfront. Suppose a new piece of infrastructure will increase a piece of property's value by $20,000. Even if there is no dispute that this is the right amount, the property owner might not have the $20,000 upfront. Indeed the property owner might well balk at even paying the $20,000 over some amortization schedule. That seems especially true for property owners on a fixed income.

To resolve that problem, state law allows for payment of assessments to be deferred.[53] The moment that a property is sold is the time when the property owner has realized the benefit and has the liquidity to pay for it, and so it is a fair moment for a property owner to have to pay for any benefit received. However, that deferral option is rarely used because projects cannot be built in the first place without a steady projected cash flow. That is, investors will not be able to assess the bonds issued to finance an improvement if the cash flow can be deferred indefinitely. The state can remedy that by creating a deferred assessment revolving fund, which will also be an opportunity to encourage both regional assessments and the bundling of smaller assessments.[54] After all, an econometric model can be made to predict home turnover and some property owners will want to pay off their assessments immediately or according to an amortization schedule (as is now the norm).[55] The more of those financings that get done, the better the market will be able to estimate the correct payment schedule and interest rate. Also, the larger and more diverse the area benefited, the more likely steady cash flows will be to develop.

Fourth proposal: *The state should encourage the use of deferred assessments through the establishment of a deferred assessment revolving fund*. Creating such a fund is consistent with our simple model in at least three ways. First, general tax dollars are being used to plug a structural hole in local resources. Second, general tax dollars are being directed to projects that have at least significant self-funding potential. Third, by providing this stopgap funding on a revolving basis, the state is optimizing the use of its funds relative to projects financed.

The state should encourage the use of deferred assessments through the establishment of a deferred assessment revolving fund.

In trying to clear the way for local governments to fund more good projects, we should consider that we are struggling in part against perverse incentives created by state law.[56] Take the relationship between public transit and residential development. Clearly, the state wants to encourage housing development by transit stops, and there are programs in place to do this that have had some success.[57] However, research suggests that local governments have nevertheless encouraged commercial development near mass transit stops.[58] That makes sense from the local government's perspective because the

[53]*See* Calif. Sts. & High. section 10700 (permitting deferred assessments), and Shoup, "Financing Public Investment by Deferred Special Assessment," 33 *Nat'l Tax J.* 413-414 (1980) (proposing the idea of deferred assessments); *see also* Calif. Const. art. 13, section 8.5 (allowing deferred property assessments for senior citizens); Calif. Revenue and Taxation Code section 20581 et seq. (implementing the Senior Citizens and Disabled Citizens Property Tax Postponement Law).

[54]That is, in making revolving funds available, the state can and should give a preference to larger-scale assessments.

[55]I would propose that only the smaller commercial property owners be allowed to use that deferred assessment mechanism.

[56]For a more general discussion of this problem, see Shanske, "Above All Else Stop Digging: Local Government Law as a (Partial) Cause of (and Solution to) the Current Housing Crisis," *U. Mich. J.L. Reform*, forthcoming.

[57]*See, e.g.*, Little Hoover Commission, "Rebuilding the Dream: Solving California's Affordable Housing," Report #165, May 8, 2002, p. 25, *available at* http://www.lhc.ca.gov/studies/165/report165.pdf.

[58]Boarnet and Crane, "L.A. Story: A Reality Check for Transit-Based Housing," 63 *Journal of the American Planning Association*, pp. 189-204 (Spring 1997).

primary general revenue source still under the control of local governments in California is the sales tax, and any sales tax generated by retail near a transit stop will largely be paid by out-of-jurisdiction shoppers and so is a boon for one jurisdiction at the cost of its neighbors. That kind of wasteful competition mars our whole landscape.

There are different solutions to that problem. Sales taxes could be shared regionally, thus eliminating that perverse incentive.[59] Or the state could make some additional revenue source (like a local income tax) available to local governments, but only if they share the proceeds regionally or pursue other regionally sensible goals.[60] The state can also try to fortify other incentives to smarter growth, such as making additional funds available for transit-oriented development. In Maryland some areas are exclusively marked as eligible for state funding.[61] California could do something similar — and perhaps also mandate that local governments cannot use tax-exempt financing except within a specified radius of a mass transit stop. In the United Kingdom, the national government has gone further, essentially requiring that most development occur "in town."[62] Another option would be to modulate California's development impact fee regime, mandating much higher impact fees for sprawl pattern development or development in environmentally sensitive areas, like flood plains.[63] In short, my fifth proposal is: *Use any or all of the expedients canvassed above to eliminate the perverse incentives that local governments have to build the wrong infrastructure*. That is particularly important because if my other proposals are adopted, local governments will be enabled more generally to fund new infrastructure. We do not want those new resources to, for instance, be chasing sales tax revenue.

A. The Elephant in the Room — Proposition 13

At the heart of California's woes is Proposition 13's extreme and extremely rigid limitation on property taxes.[64] My goal in this report has been to advocate small pragmatic changes that are not ideologically charged, and so I have not addressed Proposition 13. Nevertheless, I will observe, as I have argued elsewhere, that the economic crisis provides an opportunity to reconsider Proposition 13.[65] That observation is germane to this report on infrastructure financing for several reasons. First, as noted above, the distortion of the property market and of land use decisions created by Proposition 13 contributes to the suboptimal production and use of infrastructure. Most notably, Proposition 13 discourages the use of land for intensive multifamily housing and even for many forms of light industry — big retail is the coin of the realm in post-Proposition 13 California.[66] Second, if the strictures of Proposition 13 were slowly relaxed and local revenue is increased, there would be an opportunity for a more rational distribution of resources at the local level.[67]

B. Final Evaluation and Recommendations

It is hard to evaluate how well the state is filling in the gaps and funding larger regional projects. That said, failures at the local and regional levels mean without question that the state is funding some local initiatives that it should not be funding while it is neglecting some projects that it should be funding. Further, the state has not fully used demand management on the infrastructure over which it has control, and by that I mean most especially transportation. Using general tax dollars is not an efficient way to finance transportation, though that is generally how California has proceeded. As part of the last budget compromise, California at the last moment chose to avoid raising the gas tax (one form

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[59]*See, e.g.*, AB 680, 2001-2002 Leg. Sess. (Calif. 2002).

[60]Frug and Barron, *City Bound: How States Stifle Urban Innovation*, Harvard University Press, 2008, p. 212 (proposing states offer new revenue source in return for regional cooperation); Stark, "Proposition 13 as Fiscal Federalism Reform," in *Proposition 13 at 30*, *2009*, 1, 13-14 (proposing local income tax for California); AB 1342, 2009-2010 Leg. Sess. (Calif. 2009) (allowing for imposition of local income tax).

[61]Md. Code Ann., State Fin. & Proc. section 5-7B-01 (restricting state funding to priority areas).

[62]Muro et al., "MetroPolicy: Shaping a New Federal Partnership for a Metropolitan Nation," *The Brookings Institution*, 2008, p. 49, *available at* http://www.brookings.edu/reports/2008/06_metropolicy.aspx.

[63]*Cf.* Hanak and Rueben, *supra* note 20, at 21; Kingsley, "Making It Easy to Be Green: Using Impact Fees to Encourage Green Building," 83 *N.Y. U. Law Rev.* 532 (2008).

[64]I summarize Proposition 13 in Shanske, "Public Tax Dollars for Private Suburban Development: A First Report on a National Phenomenon," 26 *Va. Tax Rev.* 709, 718-719 (2007).

[65]Shanske, "What the Original Property Tax Revolutionaries Wanted (and It Is Not What You Might Think)," 1 *California Journal of Politics and Policy* (2009), (review of Martin, *The Permanent Property Tax Revolt: How the Property Tax Transformed American Politics* (2008)).

[66]Lewis and Barbour, *California Cities and the Local Sales Tax*, Public Policy Institute of California, 1999.

[67]*See* Hill, "Reconsidering AB 8," Legislative Analyst's Office, Feb. 3, 2000; Therese A. McCarty, Terri A. Sexton, Steven M. Sheffrin, and Stephen D. Shelby, "Allocating Property Tax Revenue in California: Living With Proposition 13," *State Tax Notes,* Mar. 25, 2002, p. 1047, *Doc 2002-7198*, or *2002 STT 57-10*

of demand management), but did increase the vehicle license fee, which at least has some connection to the demand for transportation.[68]

The Fastrak system in California has made it easier to raise tolls; perhaps a similar mandatory, but automatic, system can be used to tax total miles driven.[69] Such a system seems already to be feasible and certainly will be. Congestion pricing could be used on highways or within urban areas, as in Mayor Michael Bloomberg's ill-fated plan for New York, which was modeled on that of London. Higher taxes can be imposed on downtown parking lots.[70] Less dramatically, the state could and should simply make it easier for tolls to be imposed on use of its own roads.[71] All those schemes are ways to use demand management to control the use of, and fund, transportation infrastructure. The state income tax provides a relatively easy way to provide rebates so that the demand charges are not too regressive. We do want them to have some bite, however, because we want behavior to be influenced and revenue to be raised.

A related way for the state to more properly finance infrastructure is to tie specific projects to specific revenue increases. Like a local government, the state should put before the voters bond measures to build specific projects using specific (and appropriate) revenue, such as tolls or the gas tax.[72] The current system, which has voters vote for projects with no plan or commitment to raise the required revenue, is folly.

And so my final proposal is: *The state should enable proper pricing for infrastructure financing through the use of tolls and by requiring that all statewide bond measures also include provision for tax increases to pay off the bonds.*

IV. Conclusion

At the heart of these proposals is the idea that a very significant percentage of California's infrastructure need could fund itself[73] — if only our legal structures enabled that funding. Once all self-funding projects were taking care of themselves, precious general tax revenue from the state and federal governments could be targeted at the highest-value projects that truly need it. None of the ideas here are particularly novel, and that's a good thing. We do not need to do something entirely new, but something largely old.

V. A Coda on the Silver Bullet That Is Not

The proposed changes outlined above are backwards-looking and pragmatic, even dull. They will take time to implement and to yield results. That is in contrast to the buzz surrounding P3. Major proponents of P3 promise the world — and at little cost or risk.[74] Why should policymakers make the dry changes I recommend when entering into a P3 arrangement will get more infrastructure built faster for less? The point I want to emphasize is that P3 cannot come close to solving our infrastructure problems.

First we must decide what P3 means. If it means simply contracting with a private party to build a piece of infrastructure, using P3 is neither novel nor controversial. If P3 means that a public project largely looks to private financing, that is also not novel. Every time a public entity borrows on the capital markets, it is using private funds. Further, if a public project (say a road) will rely on the revenue it generates (say tolls) to pay back private parties, as is often the case for infrastructure projects, private parties will scrutinize the project plan carefully, which is clearly salutary.

P3 could refer to the "design-build" method of construction. Design-build is an alternative method of construction in which the same entity is responsible for the design and construction of a project (and

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[68]Steinhauer, "In Budget Deal, California Shuts $41 Billion Gap," *The New York Times*, Feb. 19, 2009, A1. Apparently, the revenue from the increase in license fees is not going to be directed to transportation projects. That said, given that other state general revenue is being (mis)directed toward transportation, it is a (tiny) step forward that the state is increasing the amount of general revenue it is raising from license fees.

[69]*Cf.* Hanak, *supra* note 4, at 10. *See also* Finkelstein, "E-ZTax: Salience and Tax Rates," National Bureau of Economic Research (September 2008), *available at* http://www.nber.org/~afinkels/papers/EZTax_Finkelstein_February_07.pdf; Alice Rivlin and Orr, "Road-Use Fees Could Solve Our Transit Woes," Brookings Institution, May 1, 2009, *available at* http://www.brookings.edu/opinions/2009/0501_congestion_pricing_rivlin.aspx.

[70]*Cf.* Hanak, *supra* note 5 at 150.

[71]California has recently done so to some extent in connection with P3-type projects. *See* SB 4XX, 2009-2010 Leg. Sess. (Cal. 2009). A broader expansion of tolling authority, which would have been preferable, was vetoed by the governor last year. *See* AB 3021, 2007-2008 Leg. Sess. (Calif. 2008) (attempt to encourage use of tolling through creation of California Transportation Finance Authority); Dyble, "The Proposed California Transportation Finance Authority: An Analysis of AB 3021," USC Keston Institute for Infrastructure, May 20, 2008, *available at* http://www.usc.edu/schools/sppd/keston/documents/CommentonAB3021andtheCaliforniaTransportationFinanceAuthority.pdf.

[72]*Cf.* Hanak, *supra* note 4, at 6. This has been done. For instance, Proposition 111, passed in 1990, increased the gas

(Footnote continued in next column.)

tax for use in transportation projects. California Ballot Measures Database, *available at* http://library.uchastings.edu/library/california-research/ca-ballot-measures.html#ballotprops.

[73]And some of our need would disappear altogether if resources were priced properly.

[74]*See, e.g.*, Malanga, "Our Spendthrift States Don't Need a Bailout," *The Wall Street Journal*, Nov. 18, 2008, A21.

possibly operation as well). That contrasts with the traditional method in which the design is done by one entity (say an architecture firm) and then other entities (say general contractors) bid to construct that design. Design-build is supposed to produce savings of time and money through having a design-builder contract to provide a completed project at a fixed price. Design-build has been around for a long time and can be efficacious.[75] But design-build is not a panacea. First, it is generally agreed that the modest savings design-build can produce in some projects are not even close to a solution to the kinds of problems we are addressing.[76] Second, design-build has its limitations and no one believes that all projects are suitable for design-build.[77] At any rate, California has been a leader in providing flexibility to its agencies and local governments in using design-build, and so there is little additional benefit to be gained.[78] That said, if gaps remain in the authority given to public agencies to engage in design-build, there is good reason to consider giving all agencies the same flexibility.[79]

Private-public partnerships cannot come close to solving our transportation problems.

When P3 is trotted out as the solution to our infrastructure needs, what is generally meant is that a government entity enters into a long-term lease (like 75 years) with a private party for a piece of existing infrastructure, like a toll road.[80] Prominent recent examples of that kind of transaction include the leasing of the Chicago Skyway and the Indiana Toll Road. Proponents suggest that those transactions are a no-brainer. The government gets a huge payout for the long-term lease of the piece of infrastructure and the private party will maintain that infrastructure better than the government could have. California has experimented with versions of P3 to build new infrastructure,[81] but has been less interested so far in essentially selling existing infrastructure — a position that, as I explain below, I think is wise.[82]

However, I concede that governments should evaluate P3 opportunities. The United Kingdom already has such a process,[83] and soon California will too, thanks to the recent creation of the Public Infrastructure Advisory Commission.[84]

The second point I concede is that such a commission may well find that some uses of P3, particularly in the construction of new infrastructure, are highly consistent with the simple model of infrastructure finance I outlined above and ought to be pursued. For instance, a wise interlocutor observed to me that the state could lease rest areas by state highways for, say, 20 years. The superior rest stops that result could be mandated to have facilities for the recharging of alternative-energy vehicles; that looks like it could be a true win-win situation. Similar leases could be attempted in connection with new mass transit stations and with stops along the new high-speed rail. Such leases follow from the benefit principle discussed above. The state has created (or will have created) value by building the highway or railway, so leasing out state property near the infrastructure is a way for the state to recoup some of its investment through the value it has created. Portland, Ore., did essentially that in connection with financing a transit connection to its airport. The new link was going to make land by the airport much more valuable and so the transit authority raised some of the money for the link by entering into a long-term lease with a private developer for some of this property.[85]

Nevertheless, if evaluated properly, the use of P3, particularly as to pieces of existing infrastructure, will be limited. First, by all accounts, the number of pieces of public infrastructure that can be profitably leased is small because there are not that many

[75]Miller, *Principles of Public and Private Infrastructure Delivery*, Kluwer 2002, 59-60; Hanak and Rueben, *supra* note 20, at 22.

[76]There is evidence, for instance, of about 14 percent time savings. *Public-Private Partnerships: Innovative Contracting, Hearing Before the Subcomm., on Highways, Transit and Pipelines of the House Comm. on Transp. and Infrastructure*, 110-125, at 138 (2007).

[77]*Id.*

[78]*See*, *e.g.*, AB 642, 2007-2008 Leg. Sess. (Calif. 2008) (expanding permission to use design-build to local government entities).

[79]Hanak, *supra* note 4, at 17 (noting that California has still not authorized its department of transportation to use design-build).

[80]2006 Hearings, *supra* note 19, at 30.

[81]Calif. Gov't section 5956; Calif. Sts. and High. section 143.

[82]Saskal, "California P3 Plans Focus on New, Not Existing Facilities," *The Bond Buyer*, Mar. 28, 2007, 18.

[83]Puentes, "Bridge to Somewhere: Rethinking American Transportation for the 21st Century," The Brookings Institution, 2008, p. 65, *available at* http://www.brookings.edu/~/media/Files/rc/reports/2008/06_transportation_puentes/06_transportation_puentes_report.pdf.

[84]SB 4XX, 2009-2010 Leg. Sess. (Calif. 2009) (creating Public Infrastructure Advisory Commission by adding Calif. Sts. and High. section 143(b)).

[85]*Public-Private Partnerships: Innovative Contracting, Hearing Before the Subcomm. on Highways, Transit and Pipelines of the House Comm. on Transp. and Infrastructure*, 110-125, at 7, 71-72 (2007).

pieces of infrastructure that are sufficiently self-supporting and discrete.[86]

Second, as a local government lawyer, I find the case for a P3 transaction involving existing infrastructure not very convincing.[87] If there is a piece of infrastructure that can be operated profitably, there is no need to lease it to a private entity to capture that infrastructure's income stream. California is already full of special districts and authorities designed to capture (and reinvest) value in that way: If an entity does not already exist of the right size and with right powers, the state can create one. That is, the state can create an authority that is limited to collecting tolls on a given road to maintain that road just as if that road had been leased to a private entity. If a private entity has desired expertise, it can be hired by the special authority using toll money. The special authority can issue tax-exempt bonds secured by toll revenue for major improvements, which means that it will be operating with an appealingly low cost of funds.

> ***Much of the infrastructure we are concerned about was built using traditional techniques of public finance, and those are the methods we will need to use to rebuild it.***

And so it is hard to see why a long-term lease to a private entity is required. There *are* esoteric arguments that private investors and management are able to unlock more value than even a specialized authority that can hire the same private firms, but I think those are dubious.[88] So far as I can tell, those arguments rely on at least one weak premise: that the private investors who invest in P3 are different from those who invest in tax-exempt infrastructure bonds and that those P3 investors are essentially willing to lend more money for a lesser return. One does not have to be a believer in strongly efficient capital markets to find that claim mystifying. It could be true that those nontraditional investors in government bonds are willing to take a greater risk in return for a greater reward, but in that case the government has to ask where the risk really ends up. That is, if the private company is unable to make a profit and walks away or goes bankrupt, or if the private entity is only able to make a profit by undermaintaining the road, isn't the government still on the hook?[89] It could also be that P3 investors believe that they will be able to increase revenue more than a public authority could have done. That might be true, though again there is a question about who is bearing the risk in that case. Further, there is an independent political question regarding whether public assets should be privatized so that the public can no longer control how much users pay for them.

Even if the economic arguments for P3 unlocking lots of value are sound, it must be remembered that those long-term leases come with at least one major cost, and that is loss of flexibility.[90] It is unclear, for instance, that we want any given toll road to remain economically viable for the next 30 years, much less 75 — a typical period for such a lease. It could be a good thing if we end up in a world where it is roads that need a subsidy and not mass transit. That's not just a theoretical problem. The Orange County Transit Authority had to buy its way out of just that kind of lease because of the noncompete clause it had entered into with the private party who had leased a highway.[91]

Therefore, in short, there are no silver bullets. Much of the infrastructure we are concerned about was built using traditional techniques of public finance, and those are the methods we will need to use to rebuild it. Nothing will help our ailing infrastructure more than going back to the future. ✰

[86]2006 Hearings, *supra* note 19, at 10-11; Hanak and Rueben, *supra* note 20, at 22.

[87]Since initially making this argument, I have been pleased to find the California Treasurer Bill Lockyer agrees. *See* Lockyer, "Public-Private Infrastructure Fight Ruinous," *Sacramento Bee*, Jan. 26, 2009, at 13A.

[88]2006 Hearings, *supra* note 19 at 31-32, 37, 44-45, 50.

[89]I think the answer is yes and that essentially these kinds of deals should be understood as a form of "taxless finance" (the phrase is from Wallis) in which the government takes on contingent risk to have the benefit of the infrastructure without raising taxes. The appeal of that kind of structure is obvious and it can certainly work, but the risks inherent to such a system remain and can easily swamp the benefits not least because of the political pathologies caused by this kind of "free" provision of infrastructure. For the embrace and collapse of earlier forms of taxless finance in the 1830s, *see generally* Wallis, *supra* note 7, at 222-224, 228-233.

[90]*Cf.* Yescombe, *Public-Private Partnerships: Principles of Policy and Finance*, Elsevier 2007, p. 26-27.

[91]Hanak, et al., *supra* note 5, at 149. The recently passed legislation to encourage the use of P3, SB 4XX, tries to deal with this problem by limiting the amount of money that a private contractor can receive if its returns are driven down by competition (essentially just enough to cover debt service) and also by limiting the circumstances that can trigger such an obligation to pay (for instance, no compensation for projects identified in regional transportation plans). *See* SB 4XX, *supra* note 71 (adding Calif. Sts. and High. section 143(i)). Those limitations are sensible, but they increase the risk that the private party faces upfront and therefore, presumably, that will drive up the cost of the initial P3 contract. Compensating a private party for regulatory risk is simply part of the P3 business proposition and I do not think that it can be legislated or contracted away. If a private party does not assess risks properly and gives the public entity a "deal," that is hardly a win for the public because ultimately public entities will be responsible should the private party fail in its obligations.