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INTRODUCTION

Since 1879, the Constitution of the State of California has contained an apparently severe restriction on the power of certain local governmental entities to incur debt.[1] The current provision is found in article XVI, section 18:

> No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the qualified electors thereof, voting at an election to be held for that purpose . . . .

Quoting from debates that took place at the constitutional convention in 1879, the California Supreme Court articulated the purpose of the provision to be to end "the practice prevalent both in California and in the eastern states, a practice that has grown rapidly of late years, of extravagance and expenditure in engaging in improvements of various kinds which has resulted in an enormous increase of municipal indebtedness."[2] In theory, article

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1. The California Constitution of 1849 contained no debt limit which was applicable to local governmental units. Restrictions on municipal indebtedness were contained in individual city charters, rather than in the general law. CAL. CONST. art. IV, § 37 (1849) authorized the legislature to restrict the cities' power of "borrowing money, contracting debts, and loaning their credit, so as to prevent abuses . . . ." In practice, however, state "regulation" of local government debt consisted of numerous special measures that authorized the creation of debt by a particular city in order to finance the construction of a specific enterprise. For example, in 1866, the legislature authorized the City of Petaluma to issue $500,000 of bonds to construct locks, dams and canals to accommodate vessels in Petaluma Creek. This ambitious project was never completed. *See* Beebe, Hodgman & Sutherland, *Joint Power Authority Revenue Bonds,* 41 S. CAL. L. REV. 24 (1968).

2. City of Long Beach v. Lisenby, 180 Cal. 52, 56, 179 P. 198, 199 (1919). In the early nineteenth century, state and local governments borrowed heavily, primarily to finance transportation systems, such as canals and railroads. In the eastern states, many such ventures ended in financial disaster with the onset of the Panic of 1837. Even tax revenues were not sufficient to meet the obligations, and many states found themselves on the verge

XVI, section 18 operates as a ban on floating indebtedness, the carrying forward of any debt from fiscal year to year. Local entities must operate on a pay-as-you-go basis, absent a waiver by two-thirds of the electorate.[3] The apparent result of the constitutional debt limit is to curb the capacity of local governmental units to engage in municipal improvements.

However, judicial interpretation has so narrowed the applicability of the debt limit in the area of capital improvements that

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of bankruptcy. State debt limitations were enacted during this period to prevent the recurrence of such economic disaster. *See* Nichols, *Debt Limitations and the Bona Fide Long-term Lease with an Option to Purchase: Another Look at Lord Coke,* 9 URB. LAW. 405-06 (1977).

California's economy was finally affected by the depression of 1873, and the debt limit history of her sister states became quite meaningful to the constitutional convention. Indeed, the California Supreme Court attributes to the drafters a clear understanding of the horrors to which municipal extravagance could lead.

> In the constitutional provision under consideration, the framers had in mind the great and ever-growing evil to which the municipalities of the state were subjected by the creation of a debt in one year, which debt was not, and was not expected to be, paid out of the revenues of that year, but was carried on into succeeding years, increasing like a rolling snowball as it went, until the burden of it became almost unbearable upon the taxpayers. It was to prevent this abuse that the constitutional provision was enacted . . . . The taxpayers of municipalities are thus protected against the improvident creation of inordinate debts, which may be charged against them and their property in ever increasing volume from year to year.

McBean v. City of Fresno, 112 Cal. 159, 164, 44 P. 358, 359 (1896) (citations omitted).

In 1879, the predecessor of the current debt restriction was enacted, stripping the state legislature of any power with respect to the creation of indebtedness by local governmental units. The debt limit, as well as a ban on special legislation, CAL. CONST., art. IV, § 16, were designed to curb the power of special interest groups which had influenced the state legislators to make piecemeal authorizations of local debt. All debt was thereafter required to be approved by two-thirds majority vote of the people.

3. The palpable object of the provision was and is to confine municipal expenditures for each year to the income and revenue of such year, save only in the cases where two-thirds of the qualified electors shall determine, as in the section provided. It places a limit—a check—upon the power of municipal officers to expend money beyond the resources provided for the current year.

> It is a residuum of power vested in the electors, to be used by them in case of emergency calling for its exercise.

Bradford v. City of San Francisco, 112 Cal. 537, 545, 44 P. 912, 914 (1896). In *Bradford,* city officials had underestimated expenses and overestimated revenues, thereby exhausting city funds by May 1. The court enjoined the city officials both from incurring any debt in the last two months of the fiscal year and from levying a property tax rate in the following fiscal year to make up any deficit in current funds. *Id.* at 539, 547, 44 P. at 912, 915.

long-term debt has in fact snowballed.[4] The residuary power of the people to control governmental indebtedness has, in many

4. Although the history of the debt limit clearly suggests the drafters' dominant concern with the dangers of long-term debt to finance municipal improvements, the case law demonstrates that it has been the ordinary creditor whose debt is a current expense who has felt the impact of the provision most harshly. Ordinary creditors who transact business with a local governmental entity must do so at their peril:

> Whoever deals with a municipality does so with notice of the limitation of its powers, and with notice also that he can receive compensation for his labor or materials only from the revenues and income previously provided for the fiscal year during which his labor and materials are furnished . . . . Even though at the time of making his contract there are funds in the treasury sufficient to meet the amount of his claim, he is charged with notice that these funds are liable to be paid out for municipal expenditures before his contract can mature into a claim against the city . . . . In dealing with the municipality he must rely upon the integrity of its officers that they will not incur any liabilities during the year in excess of the income and revenues provided for that year, and, as a prudent man, he will ascertain not only the amount of that income, but also the amount of the claims already existing, and of those that are likely to be incurred.

Weaver v. City of San Francisco, 111 Cal. 319, 325-26, 43 P. 972, 974 (1896). *Weaver* involved an action which was brought against the municipality for payment for plumbing services rendered. City revenues and income had already been exhausted because of an underestimate of expenses for the general election. The court held that the creditor had no right to receive payment out of the income and revenues of the city for any year subsequent to that during which his claim accrued. *Id.* at 327-28, 43 P. at 975. The creditor's judgment could be satisfied only out of income or revenue provided for the fiscal year in which the liability had been incurred. *Id.* A similar result was reached in Higgins v. City of San Diego, 118 Cal. 524, 50 P. 670 (1897), where the court entered judgment for a water company against the city for the reasonable value of the use of its distributing plant even though the revenues of the fiscal year had been exhausted. Higgins v. City of San Diego, 118 Cal. 537, 556, 45 P. 824, 832 (1896), *modified on rehearing,* 118 Cal. 524, 50 P. 670 (1897) (en banc). The court held that the plaintiff was entitled to an ordinary general judgment, without any direction as to the source of revenues out of which such judgment could be satisfied, because of the possibility that future provision for the payment of the debt might be made by a vote of the electorate. Higgins v. City of San Diego, 118 Cal. 524, 527, 50 P. 670, 671 (1897). Even if there had been sufficient money in the general fund at the time the contract was made, as well as at the time of contract performance, the claimant was bound to look only to the income of the fiscal year in which payment was due in satisfaction of his judgment. *See, e.g.,* W.W. Montague & Co. v. English, 119 Cal. 225, 51 P. 327 (1897). In *Montague,* a mandamus proceeding was brought to compel the city treasurer to pay a warrant for the purchase of water pipe. At the time the contract was made, as well as at the time of delivery of the pipe, there was sufficient money in the water fund, derived from the sale of the bonds, to meet the obligation. Such funds were later exhausted. The contract was held to be valid, hence enforceable. *Id.* at 228-29, 51 P. at 328-29. Nonetheless, the court held the claimant was bound to look only to the unexpended income, if any, of the fiscal year in which the debt was incurred for payment of the warrant. *Id.* Of course, contractual claims arising after revenues have already been exhausted are void and will not warrant a judgment of any character. Higgins v. City of San Diego, 118 Cal. 524, 528, 50 P. at 670, 671 (1897). In *Higgins,* the court held instances, become illusory. The courts have given the phrase "any indebtedness or liability" a meaning much narrower than its usage in common parlance.[5] As will be shown, an obligation is not a debt if it is imposed by law; when a local body is legally obligated to provide certain public facilities or services, substantial expenditures of public funds are not subject to popular control.[6] A "debt" must be free of contingencies to come within the constitutional provision; capital acquisitions in the form of lease-purchase agreements are free of popular control because of the contingency inherent in the concept of rent.[7] Moreover, if a debt is not to be repaid from general revenues, it is not a "debt" after all; capital improvements financed by user charges or special assessments, charges levied against benefited property, are free

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that claims for the value of water supplied after city revenues were exhausted were void and would not warrant a judgment. *Id.*

A local entity cannot make up any deficiencies due a contracting party by increasing taxes in future years. Smith v. Broderick, 107 Cal. 644, 40 P. 1033 (1895). In that case, the plaintiff had a judgment for merchandise sold and delivered, but the City Auditor discovered that there was a deficiency in the general fund for the fiscal year in which the debt had been incurred and refused to make payment. The court held that the creditor's right to relief was unaffected by the judgment; that is, the creditor still could look only to the income and revenue for the fiscal year in which the debt had been incurred, not to future tax levies, for satisfaction of the judgment. *Id.* at 654-55, 40 P. at 1036-37. "If there are not revenues for any given year sufficient and available for the payment of claims for that year, those claims become waste paper." McBean v. City of Fresno, 112 Cal. 159, 164-65, 44 P. 358, 360 (1896). Violation of the "pay-as-you-go" concept of municipal finance acts as a virtual total bar to recovery by the creditor. *Cf.* Litchfield v. Ballou, 114 U.S. 190 (1885). In *Litchfield,* the court held that when a constitutional prohibition against indebtedness is violated, bondholders are denied even the equitable remedy of restitution on a theory of money had and received. *Id.* at 193-95. Accordingly, the sense of the following admonition is clear:

> [O]rdinary prudence would dictate, in view of the foregoing provision of the constitution, that the tax levy should be large enough to meet any unforeseen demand, and to enable the municipality to discharge all of its obligations. If the amount of money so provided is not needed for the expenditures of the year it can be carried forward into the next fiscal year; whereas, if the revenue thus provided is not sufficient to meet the expenditures, there is no provision for meeting the deficiency, except by "the assent of two-thirds of the qualified electors thereof voting at an election to be held for that purpose."

Smith v. Broderick, 107 Cal. 644, 649-50, 40 P. 1033, 1035 (1895). In recent years, municipalities have, in fact, routinely provided in their annual budgets for a contingency reserve fund to cover unanticipated expenses, thereby reducing the creditor's risk of nonpayment.

5. Such interpretations by California courts are hardly unique. *See* Bowman, *The Anachronism Called Debt Limitation,* 52 IOWA L. REV. 863 (1967); Comment, *Municipal Debt Limitations in Pennsylvania,* 15 VILL. L. REV. 612 (1970); Note, *Constitutional Restrictions Upon Municipal Indebtedness,* 1966 UTAH L. REV. 462.

6. *See* text accompanying notes 13-29 *infra.*

7. *See* text accompanying notes 39-56 *infra.*

of the constitutional provision because they are outside of the drafters' policy to protect property taxpayers.[8]

Perhaps the courts have been motivated by a concern for economic development and a perception that the debt limit was too rigid and restrictive for the needs of a modern, urbanized population. Nonetheless, it is the thesis of this article that such judicial interpretations have thwarted the drafters' clearly indicated intent to curb excessive tax levies and to restrict the growth of public debt. Capital borrowing has not been significantly impeded. It has simply been diverted into less secure and more costly modes of financing, using techniques that require either no approval of the electorate or a simple majority vote. Furthermore, these sophisticated financing devices are exceedingly difficult for the general public to fathom and thereby undermine the drafters' foremost aim of popular control of the creation of local government debt. It is the purpose of this article to explore the various means by which the judiciary has thwarted the drafters' intent, as well as to examine the financing mechanisms devised by municipalities to evade popular control of debt creation. The economic and political dilemmas associated with these financing mechanisms will also be discussed.

I. LOCAL GOVERNMENT FINANCING MECHANISMS

The procedures generally contemplated by article XVI, section 18 for municipal borrowing to finance capital improvements have been codified by the legislature in Government Code sections 43600-43904. In particular, the legislature has expressly provided the means whereby a municipality may incur "indebtedness for any municipal improvement requiring an expenditure greater than the amount allowed for it by the annual tax levy."[9] The local governing board is directed to adopt by a two-thirds vote a resolution finding that the "public interest or necessity demands the acquisition, construction, or completion of any municipal improvement."[10] At a subsequent meeting, the local legislative body must adopt, again by a two-thirds vote, an ordinance calling an election at which the proposed borrowing is submitted for authorization by a two-thirds majority vote of the

8. *See* text accompanying notes 57-59 & note 98 *infra*.
9. CAL. GOV'T CODE §43602 (West 1966).
10. *Id.* § 43607.

electorate.[11] If the borrowing is approved by the electorate and bonds are sold to finance the construction of the improvement, the local governing board is authorized to levy and collect a tax sufficient to pay the principal and interest on the bonds as they become due[12]—hence their designation as general obligation bonds, secured by the taxing power of the issuing entity.

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11. *Id.* §§ 43608, 43614. The supermajority requirement of article XI, section 18 (current version at CAL. CONST. art. XVI, §18) was invalidated in Westbrook v. Mihaly, 2 Cal. 3d 765, 471 P.2d 487, 87 Cal. Rptr. 839 (1970), on the theory that the dilution of the votes of the proponents of a bond measure was a violation of the equal protection clause of the United States Constitution. *Id.* at 798-99, 471 P.2d at 511-12, 87 Cal. Rptr. at 862-64. That decision has been vacated in light of the United States Supreme Court's decision in Gordon v. Lance, 403 U.S. 1 (1971), that the requirement of a supermajority on tax and revenue measures is constitutional because it does not discriminate against any identifiable class. *Id.* at 5-7. For a discussion of recent unsuccessful attempts in California to lower the two-thirds vote requirement *see* Beebe, Hodgman & Sutherland, *supra* note 1, at 28-31.

12. CAL. GOV'T CODE § 43632 (West 1966). In reality, however, many general obligation bonds are actually redeemed from the revenues generated by the facility constructed with bond proceeds; funds derived from charges imposed for the use of the facility or the service it provides may be sufficient to meet bond service requirements, so that it may never be necessary to levy a property tax for debt repayment purposes. If the revenues are insufficient to meet the principal and interest payments as they become due, however, the city is legally obligated to levy property taxes sufficient to meet any deficiencies. *Id.* Because of that obligation, the legislature has chosen the property tax base as the foundation for additional statutory limitations on the total indebtedness of local governmental units. For example, all cities are subject to a statutory limitation on the total principal amount of general obligation bonds which may be currently issued and outstanding, namely 15% of the assessed valuation of all real and personal property within the entity. *Id.* §43605. The total amount of bonded indebtedness of a county cannot exceed 5% of the taxable property of the county as shown by the last equalized assessment roll. *Id.* §29909. The "last equalized assessment roll" refers to assessed valuations after all complaints, corrections and modifications have been made by the local board of equalization.

California's statutory debt limit is illustrative of the most prevalent type of debt limit among the American states, the debt-to-property ratio. It is usually expressed in terms of indebtedness as a fixed percentage of assessed valuation of the local entity's taxable property; some states allow a higher debt-to-property ratio if the debt is approved by the voters. The debt-to-property ratio was selected as the standard because the owners of real property subject to assessment made up the class whose interests were at stake and had to be protected against fiscal abuse. *See* Bowman, *supra* note 5, at 865-67. This kind of debt limit has been the subject of much criticism. For example, the limitation fails to consider either the debt-carrying capacity or particular needs of a local unit. It induces the creation of additional local entities when the debt limit has been reached. *See* text accompanying notes 125-26 *infra*. The limitation is an unrealistic measure because it looks to only a fragment of the revenue base, property taxes. Furthermore, "it is difficult to find instances where the levels of state-imposed percentage limits on local debt appear to reflect a reasoned consideration of the prudent or 'safe' borrowing requirements of local government." ADVISORY COMMISSION ON INTER-GOVERNMENTAL RELATIONS, STATE CONSTITUTIONAL AND STATUTORY RESTRICTIONS ON LOCAL GOVERNMENT DEBT 43 (1961) [hereinafter cited as ACIR].

A. Obligations Imposed By Law

The norm of general obligation bond-financing has been circumvented through a number of artifices. The first is based on a judicial interpretation of the purposes underlying the debt limit. "The clear intent expressed in the constitutional clause was to limit and restrict the power of the municipality as to any indebtedness or liability which it has *discretion* to incur or not to incur."[13] Accordingly, article XVI, section 18 has been held to apply only to those forms of indebtedness or liability created by the voluntary action of governmental officials—not to obligations imposed by law and specified by statute.[14]

The unarticulated rationale for this exception undoubtedly is that it is pointless to submit obligations imposed by law to the electorate for approval, since the local entity cannot refuse to pay the debt, regardless of election outcome.[15] Nonetheless, this exception to the debt limit is at odds with the intent of the drafters to ensure popular approval of debt creation. The judiciary has permitted the legislature to redefine debt, thereby restricting the scope of the constitutional provision, by simply enacting statutes imposing specific obligations on local entities.[16] Under the guise of obligations imposed by law, the efficacy of the debt limit in curbing capital expenditures and ensuring popular approval thereof has been subjected to the will of the legislature.

13. Lotts v. Board of Park Comm'rs, 13 Cal. App. 2d 625, 635, 57 P.2d 215, 221 (1936) (emphasis added). In *Lotts,* an employee sought payment of a judgment for back wages resulting from the employee's change in status from part-time to full-time. The court held that the debt limit did not act as a bar to recovery since it does not apply to an obligation imposed by law, the obligation of the local entity to pay the salary due its employee. *Id.* at 635-36, 57 P.2d at 221. Presumably, the court could also have relied on the notion that the local entity itself was not subject to the constitutional debt limit. *See* text accompanying notes 125-26 *infra.*

14. *See* text accompanying notes 17-20 *infra.*

15. A writ of mandamus may be issued "to compel the performance of an act which the law specifically enjoins, . . ." Cal. Civ. Proc. Code § 1085 (West 1955).

16. One may maintain that such redefinition is ineffective, as it is an attempt to enact a constitutional amendment without the appropriate formalities. That argument has prevailed in a dispute over the effect of the existence of a state statute on the concept of home rule. The California Constitution, in article XI, section 5, guarantees chartered cities local autonomy with respect to municipal affairs. If the existence of a state statute were determinative of what is not a municipal affair, the legislature, rather than the judiciary, would be the final arbiter of the Constitution and would amend the Constitution to narrow home rule simply by the enactment of a statute. *See* Bishop v. City of San Jose, 1 Cal. 3d 56, 460 P.2d 137, 81 Cal. Rptr. 465 (1969), which held that "the fact, standing alone, that the Legislature has attempted to deal with a particular subject on a statewide basis is not determinative of the issue as between state and municipal affairs, nor does it impair the constitutional authority of a home rule city." *Id.* at 63, 460 P.2d at 141, 81 Cal Rptr. at 469.

Despite this theoretical inconsistency with the policies of the drafters, the exception from the debt limit for obligations imposed by law has been and continues to be a viable doctrine. For example, in *Lewis v. Widber,*[17] the court held the debt limit did not bar the recovery of a judgment for the salary of the chief clerk in the office of the registrar of voters, even though the revenues of the current fiscal year had already been exhausted, because that office was created and the salary fixed by state statute and the Constitution.[18] More recently, in *Wright v. Compton Unified School District,*[19] the legal fees for services rendered in the defense of an employee's defamation suit were held to be an obligation imposed by law.[20]

The debt limit did, however, bar the creditor in *Pacific Undertakers v. Widber*[21] from recovery on a contract for services rendered in burying dead indigents, since the court found that the expenditure, although necessary for the public welfare, was not specifically required by statute.[22] That decision appears to confirm that the courts seek a specific legislative directive—one enforceable by writ of mandamus—before deciding that an obligation is imposed by law. However, in certain circumstances, even a specific statutory mandate will not suffice to evade the debt limit. For example, in *Arthur v. City of Petuluma,*[23] the court decided that although the publication of a city charter was an obligation directed by statute, the initial decision to undertake charter proceedings was a voluntary one.[24] Therefore, the publication costs of a city charter were a discretionary debt within the purview of article XVI, section 18.

Inordinate debt can, of course, be imposed by law. Both discretionary and law-imposed obligations can be dangerous or burdensome. The exception to the debt limit for obligations imposed by law may be appealing in the context of modest current expenses or unanticipated obligations truly outside the control of local governmental officials, such as tort liability.[25] However, it

17. 99 Cal. 412, 33 P. 1128 (1893).
18. *Id.* at 413, 33 P. at 1129.
19. 46 Cal. App. 3d 177, 120 Cal. Rptr. 115 (1975).
20. *Id.* at 181-83, 120 Cal. Rptr. at 117-19. *See* CAL. GOV'T CODE § 995 (West 1966).
21. 113 Cal. 201, 45 P. 273 (1896).
22. *Id.* at 205, 45 P. at 274.
23. 175 Cal. 216, 165 P. 698 (1917).
24. *Id.* at 225, 165 P. at 701.
25. In City of Long Beach v. Lisenby, 180 Cal. 52, 179 P. 198 (1919), the court held

is contrary to the purposes underlying the enactment of the constitutional debt limit when the doctrine is applied to sustain long-term borrowing to finance capital improvements without popular approval. Nonetheless, the doctrine has been employed to sustain massive borrowing to finance the construction of suitable quarters for the courts of a county,[26] as well as that of police and fire station buildings.[27] At a minimum, California courts have failed to consider that even though a particular expenditure may be imposed by law, a local governing board retains considerable discretion as to the nature of the improvement and, therefore, the amount of the expenditure. The choice between two and twenty courtrooms clearly falls within the constitutional drafters' intent.[28] Yet, perhaps because of the courts' practical inability to determine what is mandatory and what is optional in the design of a particular courthouse, the judiciary has capitulated. Under the guise of the judicial construct of law-imposed obligations, "inordinate debts . . . may be charged against . . . property [taxpayers] in ever increasing volume from year to year."[29]

B. Contingent Obligations

The second generally accepted, judicially created exception to the debt limit is the doctrine of contingent obligations. "A sum payable upon a contingency is not a debt, nor does it become a debt until the contingency happens."[30] The doctrine seems eminently reasonable. Until the occurrence of the condition precedent to an obligation, it is not certain that a local entity will in fact have to pay it. There is no sense in treating an obligation as a debt

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that the claim of a judgment creditor whose action arose in tort was not a liability created by the voluntary action of officials in charge of the affairs of the city and therefore fell outside the scope of the constitutional debt limit. *Id.* at 57, 179 P. at 200.

26. County of Los Angeles v. Byram, 36 Cal. 2d 694, 227 P.2d 4 (1951).

27. City of La Habra v. Pellerin, 216 Cal. App. 2d 99, 30 Cal. Rptr. 752 (1963).

28. Such discretion, and indeed the very ability of local entities to finance capital improvements without voter approval, is tempered by debt limits measured against assessed valuation, *see* note 12 *supra*, tax rate limitations, *see* text accompanying notes 166-69 *infra*, and property tax limitations, *see* text accompanying notes 170-81 *infra*.

29. McBean v. City of Fresno, 112 Cal. 159, 164, 44 P. 358, 359 (1896).

30. Doland v. Clark, 143 Cal. 176, 181, 76 P. 958, 960 (1904). In *Doland*, the court held that a lease with an option to purchase a fire alarm system was not a liability at the time the contract was executed but rather a contingent future liability. *Id.* Accordingly, the compliance of the lease-purchase agreement with the debt limit should be measured not against the aggregate, but the annual rental. *Id.* Thus, the court would annually apply the debt limit to that year's rental: "If there should not be sufficient revenues available when any payment becomes due, then the amount due might be lost to appellant. It would not be carried over as a charge against the income and revenues of a succeeding year." *Id.* at 183, 76 P. at 961.

until the occurrence of the condition. Real needs may go unmet in order to preserve sufficient revenues for the repayment of a debt that may never become due. Voter approval of a contingent obligation is misleading and may well prove to be a useless act if the contingency fails to occur. Therefore, the obligation should be treated as a debt only when the need for payment is certain.[31]

Early applications of this principle were rather straightforward. In *California Pacific Title & Trust Co. v. Boyle,*[32] the Board of Supervisors of San Francisco annually appropriated various sums for the acquisition of contiguous parcels for a public park. The court held that such piecemeal acquisition did not violate the constitutional debt limit.[33]

> It seems clear to us that the city and county of San Francisco has not exceeded its income or revenue for any one year by the purchase of individual parcels of land for a public purpose for a sum within the income and revenue of that year, even though it is the intent to ultimately acquire a large tract, the purchase price of which, in total, would exceed the yearly income or revenue for any one year.[34]

In *Smilie v. Fresno County,*[35] a construction contract for additions to the county courthouse called for payments in monthly installments according to the stage of advancement of the work. Since there was no immediate debt for the aggregate construction cost, the court held that there was no violation of the constitutional debt limit.[36] In *McBean v. City of Fresno,*[37] the court applied the contingent obligation exception to a contract for the care and disposal of city sewage over a five-year period. The city refused payment on the ground that the contract violated the debt limit. The court disagreed because the city became obligated to make payments each year only if the plaintiff performed. "[A]t the

31. *Contra,* American Co. v. City of Lakeport, 220 Cal. 548, 32 P.2d 622 (1934), where the court observed that the validity of an obligation must be determined at the outset. "It is readily apparent that the happening of the contingency does not constitute the 'incurring' of a 'debt' within the meaning of the constitutional [debt limit]." *Id.* at 558, 32 P.2d at 626.

32. 209 Cal. 398, 287 P. 968 (1930).

33. *Id.* at 407, 287 P. at 972.

34. *Id.* at 404, 287 P. at 971.

35. 112 Cal. 311, 44 P. 556 (1896).

36. *Id.* at 312, 313, 44 P. at 556-57.

37. 112 Cal. 159, 44 P. 358 (1896).

time of entering into the contract no debt or liability is created for the aggregate amount of the installments to be paid under the contract . . . . [t]he sole debt or liability created is that which arises from year to year in separate amounts as the work is performed."[38]

Local entities relied on the theory of these cases in fabricating what has become a classic financing device to avoid seeking voter approval of the acquisition of capital improvements—the lease-purchase agreement. Ordinarily, rent does not become due until the end of the period specified for payment.[39] Inherent in the very nature of rent is the contingency that the leasehold will actually be furnished during that period. In reliance on that basic contingency, local entities began to fashion rental agreements that in fact operated as the economic equivalent of installment sales contracts for the acquisition of capital improvements. Title to the capital improvement vested in the local entity at the end of the leasehold period, and the periodic payments in the aggregate equalled the full purchase price.

The early cases refused to countenance such contrivance; they ignored the contingency inherent in the concept of rent and properly concluded that the "debt" was the aggregate of rentals which would become due during the whole term of the lease, rather than the rental the local entity was required to pay in any one year. In *Mahoney v. City of San Francisco*,[40] an action to declare a lease invalid for violation of the debt limit, the court concluded that although the document was in the form of a lease, it was, in fact, a sale.[41] Each of the decreasing installments simply amounted to a pro rata portion of the purchase price, together with interest at a fixed rate. In *In re City of San Francisco*[42]

38. *Id.* at 167, 44 P. at 361.

39. The common law principle is that rent becomes due if and when the consideration therefor has been supplied. "[N]o claim for rent arises [except where otherwise indicated] until the lessee shall have enjoyed the premises the whole time for which the payment of rent is stipulated to be made." E. WASHBURN, A TREATISE ON THE AMERICAN LAW OF REAL PROPERTY § 711, at 429 (1902).

40. 201 Cal. 248, 257 P. 49 (1927). The "lease" included an option to purchase the facility for $240,000; rental payments were to be credited against the option price. Each of the ten annual "rental" payments was equal to 10% of the option price, together with interest at 6% on the unpaid balance. Thus, the first year's payment was $36,960—1/10 of $240,000 plus 6% of $216,000. The second year's payment was $35,520—1/10 of $240,000 plus 6% of $192,000. *Id.* at 259, 257 P. at 54.

41. *Id.*

42. 195 Cal. 426, 233 P. 965 (1925).

(hereinafter *San Francisco*), the court focused on recitals in the agreement that cited the ultimate end of the rental agreement as ownership of the facility by the public entity, as well as the fact that the document specified annual payments, but no fixed or determinable "rental". The court concluded that "when read in light of the subject to which it relates and when construed as a whole with a view to determining the end of its creation it is nothing more nor less than an agreement for the conditional sale of the premises . . . ."[43] The theoretical basis for the invalidation of these purported rental agreements was stated in *Garrett v. Swanton.*[44]

> The law is well settled in this state that installment contracts of any kind, where the installment payments are to be made over a period of years and are to be paid out of the ordinary revenue and income of a city, where each installment is not in payment of the consideration furnished that year, and the total amount of said installments when coupled with the other expenditures exceeds the yearly income, are violative of the constitutional provision unless approved by a popular vote.[45]

Ten years later, in *City of Los Angeles v. Offner,*[46] the court paraphrased the *Garrett* reasoning and formulated what has become the traditional test of the validity of a "rental agreement."

> If the lease or other agreement is entered into in good faith and creates no immediate indebtedness for the aggregate installments therein provided for but, on the contrary, confines liability to each installment as it falls due and each year's payment is for the consideration actually furnished that year, no violence is done to the constitutional provision. If, however, the instrument creates a full and complete liability upon its execution, or if its designation as a "lease" is a subterfuge and it is actually a conditional sales contract in which the "rentals" are installment payments on the purchase price for the aggregate of which an immediate and present indebtedness or liability exceed-

43. *Id.* at 434-35, 233 P. at 968.
44. 216 Cal. 220, 13 P. 2d 725 (1932).
45. *Id.* at 226, 13 P. 2d at 728.
46. 19 Cal. 2d 483, 122 P.2d 14 (1942).

> ing the constitutional limitation arises against the public entity, the contract is void.[47]

Implicit in this formulation is the notion that one must look to the terms of the rental agreement and examine the reasonableness of the lease-option provisions. That is, the periodic payments should be equal to the fair rental value. The option price should be the fair market value of the property at the time the option is exercised, rather than the depreciated value of the leased property or, as is commonly the case in nonprofit corporation financing, zero.[48] Nonetheless, later courts have for the most part ignored the heritage of *Mahoney* and *San Francisco* and the implicit directive of *Offner*.[49] At best, they have engaged in only a superficial analysis of the economic significance of the terms of the rental agreement and have relied instead on a rather perfunctory citation of authority beginning with *Offner* to uphold lease-purchase financing without voter approval.[50]

The willingness of the judiciary to accede to the charade of lease-purchase financing as a means of evading the debt limit

47. *Id.* at 486, 122 P.2d at 16 (citations omitted).

48. *See* text accompanying note 53 *infra*.

49. "The *Offner* rule is easy enough to recite. The consistent application of the rule, however, appears to present the courts with somewhat more difficulty." Nichols, *supra* note 2, at 403. *See generally* Rogers, *Municipal Debt Restrictions and Lease-Purchase Financing*, 49 A.B.A.J. 49 (1963); 38 CALIF. L. REV. 962 (1950).

50. County of Los Angeles v. Byram, 36 Cal. 2d 694, 227 P.2d 4 (1951) (construction of county courthouse); Dean v. Kuchel, 35 Cal. 2d 444, 218 P.2d 521 (1950) (state debt limit inapplicable to lease-purchase of state office building); Starr v. City of San Francisco, 72 Cal. App. 3d 164, 140 Cal. Rptr. 73 (1977) (construction of sports arena complex); Ruane v. City of San Diego, 267 Cal. App. 2d 548, 73 Cal. Rptr. 316 (1968) (acquisition and operation of transportation system); County of Los Angeles v. Nesvig, 231 Cal. App. 2d 603, 41 Cal. Rptr. 918 (1965) (construction of music center); City of La Habra v. Pellerin, 216 Cal. App. 2d 99, 30 Cal. Rptr. 752 (1963) (construction of police and fire station buildings).

In other areas of the law the courts have not displayed such reticence to consider economic factors in distinguishing between a lease and a conditional sale. For example, in *In re* Washington Processing Co., 3 U.C.C. Rep. Serv. 475 (S.D. Cal. 1966), the court treated an agreement for the rental of personal property as a sales contract governed by the rules on secured sales in division 9 of the California Commercial Code. The option exercise price was substantially less than the value of the equipment so that the "lessee's" only sensible course at the end of the term of the contract would be to exercise the option. *See also* Puritan Leasing Co. v. August, 16 Cal. 3d 451, 546 P.2d 679, 128 Cal. Rptr. 175 (1976) (a lease for the entire useful life of a chattel is tantamount to a conditional sale). Finally, in Oesterreich v. Commissioner, 226 F.2d 798 (9th Cir. 1955), the court held that a lease of real property was in fact a sale because the lessor agreed to convey the real property to the lessee at the expiration of the lease for a nominal sum, ten dollars. *Id.* at 802-03. Accordingly, the lessor was entitled to treat the periodic payments as long-term capital gains, rather than ordinary income.

has culminated in a surge of nonprofit corporation financing over the last two decades. In effect, a nonprofit corporation simply operates as a borrowing conduit for the long-term financing of a capital acquisition by a local governmental entity. It is formed[51] by a group of citizens in the community having an interest in the development of a proposed facility, *e.g.*, a sports stadium. The nonprofit corporation offers to construct the stadium on public property which it leases from the local entity. It finances construction costs through the issuance of tax-exempt bonds[52] and enters into an agreement with the local entity to provide a source of income, namely rent, sufficient to meet debt service requirements. The sum of the rental payments by the public body amortizes the nonprofit corporation lessor's debt over the term of the lease. The lease term is measured by the maturity period of the bonds, and at the end of the lease term, title to the stadium must automatically vest in the local entity in order to preserve the tax-exempt status of the bonds.[53]

The nonprofit corporation is simply a private corporation which performs a public function. Its board of directors is a private, self-perpetuating body.[54] Its financing activities are insulated from public scrutiny by its form and sophisticated procedures. As a private corporation, it is not subject to the controls and restrictions, like the debt limit, under which a municipal corporation operates. It is a facade that exists solely to facilitate what in economic reality is the installment-purchase of a capital improvement by a local entity—without popular approval.[55] In validating such financing, the courts have simply elevated form over substance.[56]

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51. A nonprofit corporation may be formed by three or more persons simply by the execution of articles of incorporation and their subsequent filing with the Secretary of State. *See* CAL. CORP. CODE §§ 9200, 9304, 9305 (West 1977).

52. *See* Rev. Rul. 20 (TIR-442), 1963-1 C.B. 24.

53. *Id.* at 25.

54. CAL. CORP. CODE § 9502 (West 1977) provides:

> Unless otherwise provided in the articles or by-laws, any vacancy in the board of directors caused by death, resignation, or any disability shall be filled by a majority of the remaining members thereof, though less than a quorum.

55. The Jarvis-Gann initiative will sharply curtail this mode of financing because it decreases the ability of a local entity to fund rental payments unless a sublease of the facility, perhaps to a sports franchise, is contemplated. *See* text accompanying note 178 *infra*.

56. Curiously, the California legislature has focused on the substance of the transaction in providing that 60% of the aggregate rentals over the term of the lease must be factored into the calculation of the county's statutory debt limit. CAL. GOV'T CODE § 25371 (West 1966). For a discussion of statutory debt limits see note 12 *supra*.

C. Obligations Payable From a Special Fund

The special fund doctrine authorizes other means of circumventing the requirement of two-thirds voter approval of long-term debt to finance capital improvements. It facilitates borrowing to construct a revenue-producing enterprise, such as a sewer system, as long as the local entity pledges only user charges or other revenues from the enterprise to the repayment of the debt.

> An obligation which is payable out of a special fund is not an "indebtedness or liability" of a governmental body within the meaning of [article XVI, section 18] of the Constitution if the governmental body is not required to pay the obligation from its general funds, or by exercise of its powers of taxation, should the special fund prove insufficient.[57]

The rationale for the doctrine was clarified in an early case[58] where the court noted that since moneys for the purchase and construction of the facility were not to be taken from the ordinary revenues of the city, "to that extent it may be said that the city's credit was not involved in the incurring of the indebtedness."[59] Within the meaning of the constitutional provision, a debt is created only if the general fund supported by the taxing power of the local entity is pledged to the repayment of an obligation. This interpretation appears to conform to the constitutional drafters' intent—the protection of the property taxpayer from burdensome debt. In many instances, however, user charges are not purely voluntary; they are tantamount to a property tax. For example, it is of little concern to the homeowner whether a property tax is levied or a monthly service charge is imposed for the privilege of sewer service; the homeowner must pay for the service in either

57. City of Oxnard v. Dale, 45 Cal. 2d 729, 737, 290 P.2d 859, 863 (1955). In *Dale,* the city had previously constructed a sanitary sewer system financed by general obligation bonds. In order to finance certain additions to that system, namely interceptor sewers, the city proposed to issue revenue bonds, the principal and interest of which were to be paid exclusively from revenues of the entire sewer system. Because of the limitation in sources of repayment, the court held the debt limit inapplicable, *id.*, even though the financing raised the problem of the extent of the special fund doctrine. For a discussion of the defects in the doctrine see text accompanying notes 71-72 *infra.*

58. Mesmer v. Board of Public Service Comm'rs, 23 Cal. App. 578, 583, 138 P. 935, 937 (1913). In *Mesmer,* the board proposed to acquire property and erect a building thereon. Since the money for the purchase of the lot and construction of the building was not to be taken from the ordinary revenues of the city, the court held the constitutional debt limit was inapplicable to the transaction. *Id.*

59. *Id.*

event, regardless of its denomination. Therefore, the special fund doctrine is most appropriately employed as a means of circumventing the debt limit when it is used to sustain the financing of optional use facilities—zoos or sports stadia, rather than sewer systems or waterworks—but neither the courts nor the legislature have so limited its application.

By the enactment of the Revenue Bond Law of 1941,[60] the legislature established a formal procedure for the implementation of the special fund doctrine. It formulated a technique whereby local entities, such as general law cities and counties, may borrow to finance the construction of revenue-producing enterprises for certain enumerated purposes, such as sewer and garbage collection and treatment, and public transportation.[61] The procedure is somewhat analogous to the issuance of general obligation bonds. The local governing board must adopt, by majority vote,[62] a resolution calling an election at which the electors may approve the issuance of revenue bonds to finance the construction of a specific enterprise.[63] A simple majority vote of the electors is required for approval of the borrowing.[64]

The two-thirds vote requirement of article XVI, section 18 is inapplicable to the financing because, in reliance on the special fund doctrine, the legislature has specifically provided in Government Code section 54431 that "the principal of and interest on the bonds and any premiums upon the redemption of any thereof

60. CAL. GOV'T CODE §§ 54300-54662 (West 1966).

61. *Id.* § 54309. Chartered cities need not adhere to the procedures of the Revenue Bond Law of 1941. Pursuant to their charters and the grant of home rule, they have full power over municipal affairs and, therefore, the power to issue bonds for municipal purposes subject only to the limitations imposed by charter or the Constitution, including the debt limit. CAL. CONST. art. XI, § 5. In brief, chartered cities can issue revenue bonds without any voter approval. The special fund doctrine exempts the issuance of such bonds from the debt limit requirement of two-thirds voter approval. Their charters exempt the issuance of such bonds from the statutory requirement of majority voter approval. For an excellent discussion of home rule see Sato, *"Municipal Affairs" in California*, 60 CALIF. L. REV. 1055 (1972).

General law cities and all counties, because they lack the home rule power, require the express statutory authorization of the Revenue Bond Law of 1941 to engage in such borrowing and must conform to the procedures specified therein, including the requirement of a majority vote. *See* City of Redondo Beach v. Taxpayers of Redondo Beach, 54 Cal. 2d 126, 352 P.2d 170, 5 Cal. Rptr. 10 (1960); City of Oxnard v. Dale, 45 Cal. 2d 729, 290 P.2d 859 (1955); City of Santa Monica v. Grubb, 245 Cal. App. 2d 718, 54 Cal. Rptr. 210 (1966).

62. CAL. GOV'T CODE § 54381 (West 1966).

63. *Id.* § 54380.

64. *Id.* § 54386.

are *not a debt* of the local agency."[65] The general fund of the local agency is not liable for the payment of the principal or interest on the bonds.[66] Additionally, the credit or taxing power of the local agency is not pledged as security for the bonds.[67] Rather, the revenues of the enterprise, together with the interest thereon, constitute a trust fund for the security and payment of the principal and interest on the bonds.[68]

In keeping with the theoretical basis for the special fund doctrine, the legislature has authorized a local entity to pledge other funds as additional security for the bonds, provided such funds are not tax proceeds.[69] But in *Garrett v. Swanton,*[70] the court severely limited the exercise of that power by focusing on the ultimate effect of the pledge of other funds, namely, a consequential increase in taxes to compensate for the loss of income to the general fund. In *Garrett,* the city proposed to borrow in order to finance the installation of a pumping plant, an addition to a water system plant that had been financed by general obligation bonds that were still outstanding. The security for the new borrowing was to be the revenues derived from the entire system. The court recognized that the proposed financing would deplete or encumber the general fund of the city by the amount of money attributable to revenues of the existing facility which were previously unencumbered. In fact, the revenues of the existing facility might well have been the source of the payment of principal and interest on the outstanding general obligation bonds.[71] Since those revenues would no longer be available, it would have been necessary to levy a tax to meet the debt service requirements on the earlier bonds. The court held the special fund doctrine inapplicable to the transaction; a debt was created because the revenues of the original system were encumbered and "the taxpayers became directly liable to pay the amount thereof."[72]

The *Garrett* reasoning strictly adheres to the purpose of the constitutional drafters to protect the property taxpayer. Yet, it

65. *Id.* § 54431 (emphasis added).
66. *Id.* § 54428.
67. *Id.* § 54429.
68. *Id.* § 54223.
69. *Id.* § 54478. The pledge of tax proceeds would defeat the application of the special fund doctrine. *See* notes 57-59 *supra* and accompanying text.
70. 216 Cal. 220, 13 P.2d 725 (1932).
71. *See* note 12 *supra.*
72. 216 Cal. at 230, 13 P.2d at 729.

was rejected by later courts,[73] perhaps because it was viewed as a bar to financing additions to capital improvements by means of revenue bonds. In most circumstances, it is practically impossible to apportion revenues between an existing facility and newly financed improvements thereto. When this practical difficulty is absent, the courts have more carefully monitored the attempts of local entities to pledge funds other than revenues derived directly from the enterprise. For example, in *City of Palm Springs v. Ringwald*,[74] the court held that the special fund doctrine was inapplicable to the pledge of future sales and use taxes as part of the security for bonds issued to finance the construction of parking lots and meters.[75] It found the pledge to be in direct conflict with the notion that the special fund doctrine is only applicable if "the governmental body is not liable to maintain the special fund out of its general fund, or by tax levies, should the special fund prove insufficient."[76] The *Ringwald* court reasoned that sales and use tax revenues were simply a part of the general fund; an increased property tax levy would be required in order to compensate for the loss of future tax proceeds to the general fund.

The city might have argued in *Ringwald* that the increased sales and use tax revenues were directly attributable to the enterprise. That is, sales volume, and consequently tax proceeds measured by that volume, would increase because of the greater accessibility to stores afforded by the existence of the parking lots and the turnover generated by timed parking meters. In a sense, increases in the general fund directly attributable to an enterprise are a kind of windfall. A property taxpayer cannot claim to be injured if that windfall is pledged to the repayment of debt incurred to finance the very enterprise that generated it. Therefore, one might reasonably contend that such debt is outside the policy of the constitutional drafters.[77] However, in light of the court's holding in *City of Redondo Beach v. Taxpayers of Re-*

73. *See, e.g.*, City of Oxnard v. Dale, 45 Cal. 2d 729, 290 P.2d 859 (1955), *overruling in part* Garrett v. Swanton, 216 Cal. 220, 13 P.2d 725 (1932).

74. 52 Cal. 2d 620, 342 P.2d 898 (1959).

75. *Id.* at 626, 342 P.2d at 902, *quoting* City of Oxnard v. Dale, 45 Cal. 2d 729, 733, 290 P.2d 859, 861 (1955).

76. *Id.* at 624, 342 P.2d at 900.

77. An analogous argument has been accepted in connection with the issuance of redevelopment project bonds. That portion of property tax revenues generated by the increase in assessed valuation of the real property in the project area, a kind of windfall attributable to the existence of the project, are pledged as security for the payment of the bonds issued to finance the redevelopment. CAL. CONST. art. XVI, § 16.

dondo Beach,[78] such an argument is destined to fail. In *Redondo Beach,* the city attempted to pledge as additional security for the repayment of revenue bonds "that part of the sales, use and license tax revenues resulting from . . . the additional business in that area attributable to the construction of the harbor project."[79] Eighty-six percent of the electors approved the issuance of the revenue bonds. Their validity was challenged on the theory that the pledge of the increased tax proceeds exceeded the scope of the special fund doctrine. The court agreed because "the asserted relationship of such funds to the harbor project during the entire life of the bonds is too indirect and too intangible to effectively remove what are ordinary general funds from that category."[80] Nevertheless, the court validated the issuance of the bonds because they had been authorized by a two-thirds majority vote of the electorate—albeit pursuant to revenue bond, rather than general obligation bond, proceedings.[81]

The most serious objection to the special fund doctrine as employed by the courts is its failure to recognize the practical realities inherent in the financing of municipal improvements. The doctrine is based on the assumption that the general fund has not been pledged to the repayment of the debt.[82] While a local entity is not contractually bound to make contributions from the general fund to the revenue bond redemption fund in the event of deficiencies in revenues, there is a strong economic and practical necessity which may compel the local entity to make such contributions if the special fund should prove to be inadequate. The entity's existing investment would be lost to the bondholders upon default.[83] Furthermore, a default might impair the entity's credit rating so that it might not be able to obtain future loans at advantageous interest rates. The special fund doctrine is therefore an illusory concept; in reality, the general fund *is* pledged to the repayment of revenue bonds. Nevertheless, the courts continue to adhere to the doctrine, reasoning that although there may be economic compulsion, the local governing board is subject

78. 54 Cal. 2d 126, 352 P.2d 170, 5 Cal. Rptr. 10 (1960).

79. *Id.* at 130, 352 P.2d at 172, 5 Cal. Rptr. at 13.

80. *Id.* at 133, 352 P.2d at 174, 5 Cal. Rptr. at 14.

81. *Id.* at 134, 139, 352 P.2d at 175, 178, 5 Cal. Rptr. at 15, 18.

82. *See* notes 57-59 *supra* and accompanying text.

83. *See, e.g.,* Garrett v. Swanton, 216 Cal. 220, 13 P.2d 725 (1932), where the court reasoned that "as a practical matter the installments will have to be paid from the general fund in order to protect the investment already made." *Id.* at 234, 13 P.2d at 731.

to no legally enforceable obligation to make up deficiencies in the revenue bond redemption fund.[84]

Indeed, it is clear that the special fund doctrine has met with legislative, as well as judicial, approval.[85] In the Joint Exercise of Powers Act,[86] the legislature authorized local governmental units sharing a common power to join in the formation of a new govern-

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84. *See, e.g.*, City of Oxnard v. Dale, 45 Cal. 2d 729, 290 P.2d 859 (1955), which expressly rejected the theory of practical economic inducement articulated in Garrett v. Swanton, 216 Cal. 220, 13 P.2d 725 (1932). Although the court did not consider the issue, there may be some doubt as to whether the local entity can in fact cover debt service deficiencies in light of the constitutional prohibition against the gift of public funds. CAL. CONST. art. XVI, § 6.

The additional argument that the legally binding covenant created by the issuance of the revenue bonds may impair the future integrity of a governing board's decision-making process has found little favor with the courts. *See, e.g.*, Shelton v. City of Los Angeles, 206 Cal. 544, 551, 275 P. 421, 424 (1929). In *Shelton*, an injunction was sought against the issuance by the board of water and power of short-term notes to be secured by revenues of that body. The court denied the injunction, holding that the board was not an entity subject to the constitutional debt limit. *Id. See* text accompanying notes 125-26 *infra*. Furthermore, the fact that the local governing board must periodically approve rates to be charged customers for services provided by the new enterprise did not negate the application of the special fund doctrine.

> It may be conceded that upon the incurring of the proposed indebtedness, a strong moral obligation, which the city could not well avoid, would rest upon the city council and mayor to approve a schedule of rates theretofore fixed by the board sufficient to discharge the principal and interest as the same might become due. But this obligation or "liability" as the latter term is used in the constitution, is not a financial one in default of which the city would be required to disburse the general funds of the city or other monies derived from taxation. The argument that the obligation of the legislative body of the city to safeguard the credit of the city by approving adequate water rates would amount to a "liability" within the constitutional section is not persuasive.

Id. In City of Glendale v. Chapman, 108 Cal. App. 2d 74, 238 P.2d 162 (1951), the city council of a chartered city formally covenanted to fix rates to be charged customers of the city waterworks system so as to provide sufficient revenues to meet the payment on the revenue bonds as they became due. The court held that such a covenant did not constitute a debt of the city. In addition, the court pointedly remarked that the notion that the city must either feed the special fund or lose its investment "is based upon fear or suspicion! . . . The application of the special fund doctrine . . . cannot fairly be deemed 'only a subterfuge to subvert the constitutional limitation' or a 'trick and device to avoid submitting the proposition of the electorate . . . .' " *Id.* at 83, 238 P.2d at 167. *See* note 61 *supra*.

85. The executive has exercised greater restraint. In vetoing a measure that would have authorized the issuance of revenue bonds for the payment of insurance bills, Governor Brown remarked: "Those cities in the east which have yielded to the temptation of paying current expenses by floating bonds have reaped a whirlwind of fiscal chaos. That is not what I want for California." CALIFORNIA JOURNAL, November 1977, at 385.

86. CAL. GOV'T CODE §§ 6500-6514 (West 1966).

mental entity, separate from the public bodies that are the parties to the agreement.[87] The new entity is empowered to issue revenue bonds to finance the construction of certain enumerated projects, such as exhibition buildings, sports stadia or public recreation areas.[88] Demonstrating a rather arrogant disregard for the policies underlying the constitutional debt limit, the legislature has provided that such borrowing is not subject to voter approval—except by means of a referendum.[89]

D. Special Assessment Bonds

The next artifice to be considered, the special assessment bond, is a variation on the preceding three theories. A local entity that chooses to finance the cost of a public improvement by means of special assessments must follow the procedures set forth in the Special Assessment Investigation, Limitation and Majority Protest Act of 1931.[90] In general, the local entity must prepare a report on the proposed project[91] and hold a noticed hearing on the report.[92] If protests are made by the owners of more than one-half of the land area proposed to be assessed for the cost of the project, the proceedings must be abandoned and cannot be reinitiated for at least one year.[93] If the requisite protest is not made, the local entity may proceed with the project, which will be financed by the levy of assessments against property to be benefited from the improvement.

Special assessments are commonly used in the development of subdivisions to finance, for example, the paving of streets.[94] The cost of the improvement must be allocated on the basis of benefit,[95] which, in real terms, may be translated into front footage. The benefited landowners can elect to pay the cost allo-

87. *Id.* §§ 6500, 6502, 6507.

88. *Id.* § 6546. *See generally* Beebe, Hodgman & Sutherland, *supra* note 1.

89. *Id.* § 6547; Cal. Elec. Code § 3751.7 (West 1961).

90. Cal. Sts. & Hy. Code §§ 2820-2830 (West 1969). However, the majority protest provisions are not applicable to a chartered city or county if its governing board determines by a four-fifths vote that "the public convenience and necessity require such improvements or acquisitions." Cal. Const. art. XVI, § 19.

91. Cal. Sts. & Hy. Code § 2824 (West 1969).

92. *Id.* § 2850. The due process clause of the Federal Constitution has been held to mean that a property owner is entitled to a noticed hearing on the issues of benefit to his land and on the consequent amount of assessment to be levied against his particular parcel. *See, e.g.*, People v. Sacramento Drainage Dist., 155 Cal. 373, 103 P. 207 (1909).

93. Cal. Sts. & Hy. Code § 2930 (West 1969).

94. *Id.* §§ 5101, 8570, 10100.

95. *Id.* § 6091.

cation in a lump sum or in installments.[96] Since benefited landowners usually choose the latter alternative, construction costs are financed through the issuance of special assessment bonds by the local governmental entity. The bonds are secured by a levy of assessments against the real property benefited by the improvement.[97] Thus, assessments are very similar to property taxes—each is a charge against the land—but assessments differ from property taxes in that they are fixed in amount over time and are directly related to the benefit to the underlying property.

There is, however, a critical distinction between special assessments and property taxes. The levy of a property tax to finance a capital improvement requires two-thirds voter approval, whereas the levy of a special assessment does not. California courts have held almost uniformly that the creation of indebtedness by means of special assessment bonds does not come within the constitutional debt limit on the theory that the taxing power is not pledged.[98] A potential conceptual difficulty in so evading the debt limit arises because of the local entity's statutory obligation upon failure of the landowner to pay assessments under the Improvement Bond Act of 1915.[99] Under the more commonly used assessment bond procedures, the local entity has no obligation to the bondholders other than to pass along money paid by property owners on account of the assessment. However, under the Improvement Bond Act of 1915, if property owners fail to pay assessments and thereby cause deficiencies in the bond redemption fund, the local entity is required to make up the shortage by a transfer from the general fund.[100] If the money in the general fund is insufficient to make up such a shortage, the local entity must levy a tax of up to ten cents per hundred dollars of assessed valuation to make up any deficiency.[101] The local governmental unit then has the right to foreclose on individual delinquent par-

96. *Id.* §§ 6421, 8680.

97. *Id.* §§ 6400, 8570.

98. *See, e.g.*, San Francisco Sulphur Co. v. County of Contra Costa, 207 Cal. 1, 276 P. 570 (1929). In *San Francisco Sulphur Co.*, an injunction was sought against the levy and collection of assessments on the basis of a violation of the constitutional debt limit. The court held that no debt or liability was incurred by the county in the assessment proceedings because the cost was to be borne by the property benefited by the improvement. *Id.* at 5, 276 P. at 572. In effect, the levy of a *tax* on property requires a two-thirds vote of the electorate; the levy of an assessment on property does not.

99. CAL. STS. & HY. CODE §§ 8500-8851 (West 1969).

100. *Id.* § 8809.

101. *Id.*

cels.[102] The court in *American Co. v. City of Lakeport*[103] held that the obligation of the city to feed the redemption fund in such circumstances was outside the scope of the constitutional debt limit, since it was both an obligation imposed by law as well as a contingent obligation.[104] While the former conclusion is clearly suspect in light of *Arthur*[105] because of the local entity's discretion to undertake assessment proceedings, the existence of the condition is indisputable.

Not all attempts to evade the debt limit have been so successful, however. A California court outlawed one of the more brazen schemes in *City of Saratoga v. Huff.*[106] A special assessment district, composed solely of lands belonging to a community college district, was formed within the city. The court held that the issuance of assessment bonds to finance improvements to the college campus was a violation of the debt limit because the college district was required to levy a property tax in order to pay the assessments, just as it would have had to levy a property tax to repay general obligation bonds.[107] The court properly concluded that the special assessment proceedings were a mere subterfuge designed to avoid the requirements of a school bond election:

> The purpose of [article XVI, section 18] of the Constitution is not to interfere with the city's exercise of its discretion in determining for what objects of public convenience and welfare its power shall be exercised or for which money may be appropriated. It is designed to afford the people who are required to pay the cost of providing such objects of public convenience and welfare an opportunity to express their approval or disapproval of a long-term indebtedness. The constitutional provision does not prohibit the legislative body of the city from spending any or all of its current income

102. *Id.* § 8830.

103. 220 Cal. 548, 32 P.2d 622 (1934) (per curiam). In *Lakeport,* a mandamus action was brought because the city had failed to transfer city funds into the bond redemption fund or levy a tax to pay delinquent assessments levied under the Improvement Bond Act of 1915.

104. *Id.* at 558, 560, 32 P.2d at 626-27.

105. 175 Cal. 216, 165 P. 698 (1917). For a discussion of *Arthur* see text accompanying notes 23-24 *supra.*

106. 24 Cal. App. 3d 978, 101 Cal. Rptr. 32 (1972).

107. *Id.* at 1000, 1003, 101 Cal. Rptr. at 49, 51.

> for whatever it deems proper or necessary objects of public convenience or welfare. It simply provides that the legislative body may not encumber the general funds of the city beyond the year's income without first obtaining consent of two-thirds of the electorate.[108]

Apart from whether an assessment bond creates a contingent obligation or is utilized as a mere subterfuge, judicial analysis seems oblivious to more fundamental objections to exempting assessment bonds from the constitutional constraints of article XVI, section 18. The determination that the taxing power has not been pledged is another example of the judiciary's elevation of form over substance. A property owner finances a capital improvement through the payment of a charge against the land, regardless of how the charge is characterized. Yet, there is a critical distinction between the procedures which are required in order to authorize the imposition of property taxes, as opposed to special assessments, to finance a capital improvement. The constitutional debt limit provision mandates two-thirds voter approval before a local entity can levy a property tax; no such voter approval is required prior to the levy of a special assessment. Furthermore, the majority protest provision,[109] even when it is available, cannot really be compared with the election requirement of article XVI, section 18, because of the different majorities required and the different voting units—people as compared with acres affected. In the extreme, the majority protest provision means that one voter owning more than fifty percent of the benefited property may burden any number of voters with a charge on their land for an improvement which they do not desire. Hence, special assessment financing, like revenue bond and nonprofit corporation financing, undermines the policies of the constitutional drafters.

E. Obligations of a Special District

Special districts can be created for a variety of governmental purposes, ranging from mosquito abatement[110] to sewer service[111] to recreation.[112] Many such districts have been formed to provide

108. *Id.* at 989-90, 101 Cal. Rptr. at 41-42, *quoting* City of Palm Springs v. Ringwald, 52 Cal. 2d 620, 627 342 P.2d 898, 902-03 (1959).

109. *See* note 90 *supra*.

110. Cal. Health & Safety Code §§ 2200-2360 (West 1970).

111. *Id.* §§ 4700-4858.

112. Cal. Pub. Res. Code §§ 5780-5788.13 (West 1972).

urban services in unincorporated areas. Some have been created to solve problems extending over the geographical territory of several local entities. Others have been established as a means of evading financial restrictions, such as the debt limit[113] and tax rate limitations.[114]

The statutory guidelines for formation of a special district are set forth in the District Organization Law.[115] Proceedings are initiated by the filing of a petition with the board of supervisors of the county in which the proposed district is located.[116] Preliminary and final hearings are held.[117] The proceedings will terminate if the owners of real property having an assessed valuation greater than one-half of the assessed valuation of the proposed district offer oral or written protest.[118] If the requisite protest is not made, an election is held within the proposed district to establish whether there is majority approval of its formation.[119] But the statutory model set forth in the District Organization Law is not the only means of forming a special district. Many special

113. *See* text accompanying notes 125-26 *infra.* The existence of the statutory and constitutional debt limits added to the complexity of the local government scene by stimulating the proliferation of special districts—a trend which has been drastically reduced in recent years. Thus, in the five years between 1962 and 1967, 206 special districts were formed in California, for a net increase of approximately 10%. MOODY'S MUNICIPAL & GOVERNMENT MANUAL at a6 (1976) [hereinafter cited as MOODY'S]. However, in the following five years, between 1967 and 1972, only 55 new special districts were created. *Id.* In large part, the decline may be attributed to the legislature's creation in 1965 of special administrative bodies, local agency formation commissions (LAFCO), whose approval is a prerequisite to the initiation of proceedings for the formation of a special district. *See* CAL. GOV'T CODE §§ 54790-54799.2 (West 1966). One aim of LAFCO is to simplify the increasingly complex local governmental picture. Circumvention of the debt limit is clearly not one of the factors to be considered favorably in the review of a formation petition under Government Code section 54796.

114. Historically, tax rate limitations in California were formulated for general categories of local entities. For example, former Government Code section 43068 authorized all cities to levy a maximum tax rate of $1 per $100 of assessed valuation. Such tax rate limitations were repealed with the passage of SB 90 that provided for a unique tax rate limit for each individual local entity. *See* text accompanying notes 134-38 *infra.* Before the enactment of the tax reform measure, a city could evade tax rate limits by the formation of a special district, a new entity having an entirely different—and additional—taxing capacity.

115. CAL. GOV'T CODE §§ 58000-58200 (West 1966).

116. *Id.* § 58030.

117. *See id.* §§ 58060, 58090.

118. *Id.* § 58103. The constitutionality of the landowner protest provision is doubtful in light of Curtis v. Board of Supervisors, 7 Cal. 3d 942, 501 P.2d 537, 104 Cal. Rptr. 297 (1972). In *Curtis,* the court held that the statute allowing landowner protest to bar an annexation election was a denial of equal protection's mandate of one person-one vote. *Id.* at 965, 501 P.2d at 553, 104 Cal. Rptr. at 313.

119. CAL. GOV'T CODE § 58130 (West 1966).

districts, such as the San Francisco Bay Area Rapid Transit District, have been created by the state legislature.[120] The legislature has also provided separate enabling statutes for the formation of various kinds of special districts, and in most instances, the District Organization Law has not been adopted or incorporated by reference into the specific statutory procedures.[121] Indeed, procedural variations from the model are not the exception, but the rule. For example, proceedings for the formation of a county sanitation district are not initiated by a petition, but rather by the adoption of a resolution of intention by the board of supervisors.[122] Protests by two percent of the voters within the proposed district mandate either termination of the proceedings or an election on the issue of formation.[123] Absent the requisite protest, the board of supervisors may form the district without consulting the electorate.[124]

The impetus to form a special district to evade debt limits is twofold. First, the statutory debt limit is imposed upon a type of entity, rather than upon the underlying geographical territory. Accordingly, a city that has reached its statutory debt limit as measured against assessed valuation may nonetheless engage in the desired borrowing by means of a newly formed entity, a special district having a geographical territory substantially similar to that of the debt-laden city. Second, the debt limit only applies to those local governmental entities specifically mentioned in the constitutional provision—counties, both chartered and general law cities,[125] and school districts.[126] A special district, an entity

120. CAL. PUB. UTIL. CODE § 28600. (West 1973).

121. There are currently 55 different types of special districts in California. CALIFORNIA CONTROLLER'S DEPARTMENT, 1975-76 ANNUAL REPORT, FINANCIAL TRANSACTIONS CONCERNING SPECIAL DISTRICTS OF CALIFORNIA at vii.

122. CAL. HEALTH & SAFETY CODE § 4710 (West 1970).

123. *Id.* § 4715.

124. *Id.* § 4717.

125. *See* note 61 *supra*. In City of Santa Monica v. Grubb, 245 Cal. App. 2d 718, 54 Cal. Rptr. 210 (1966), a mandamus action was brought against the city clerk of a chartered city to compel the publication of a public notice inviting bids for the sale of water revenue bonds. The court held that the power of a chartered city to issue bonds for a municipal purpose is subject to the limitations imposed by its charter and the state constitution, including the debt limit. *Id.* at 725, 54 Cal. Rptr. at 215. Nevertheless, the debt limit was held inapplicable to that particular financing, *id.* at 726, 54 Cal. Rptr. at 216, because of the special fund doctrine. *See* text accompanying notes 57-59 *supra.*

126. The constitutional debt limit has been held to be inapplicable to a number of other kinds of local governmental units. *See* Shelton v. City of Los Angeles, 206 Cal. 544, 275 P. 421 (1929) (city board of water and power); Robertson v. Board of Library Trustees, 136 Cal. 403, 69 P. 88 (1902) (county library governing board); *In re* Bonds of Madera

that is not named in the provision, may borrow without being subject to the constitutional requirement of two-thirds voter approval. Although in most instances the specific enabling statutes require a two-thirds vote before a special district may incur bonded debt,[127] the statutory two-thirds vote requirements do not fully coincide with the constitutional debt limit since they do not refer to other forms of debt, like long-term contractual obligations, that the special district may wish to create.[128] For example, in *Vanoni v. County of Sonoma,*[129] the court upheld a long-term contract between the federal government and a flood control district whose boundaries were coextensive with the county. The contract provided for financial aid to the district in exchange for a ten million dollar commitment by the district over a fifty-year period. The court decided that no election to approve the contractual obligation was required because a flood control district is not specifically named in the constitutional debt limit provision.[130] Furthermore, stated the court, "[b]ecause Sonoma County neither assumed any obligation for the district's contractual obligation to the United States nor controlled the district's decision to incur that obligation, the constitutional limitation on indebtedness does not apply to the indebtedness of the district."[131]

Again, the court has elevated form over substance. In many instances, the relationship between a city or county and a special district is quite close, as demonstrated by the fact that they often share the same officers.[132] Moreover, the property taxed to meet the cost of the capital improvement is the same, whether the levy is made by the city or county or by the special district. However, the distinction is a critical one in terms of procedure. A city or county must secure two-thirds voter approval to levy a property tax to finance a capital improvement. A special district must secure such voter approval only if the financing is in the form of

Irrigation Dist., 92 Cal. 296, 28 P. 272 (1891); Eastern Municipal Water Dist. v. Scott, 1 Cal. App. 3d 129, 81 Cal. Rptr. 510 (1969).

127. *See, e.g.*, CAL. HEALTH & SAFETY CODE § 4786 (West 1970).

128. Senate Constitutional Amendment No. 35 (1977) would remedy this by expressly including special districts within article XVI, section 18.

129. 40 Cal. App. 3d 743, 115 Cal. Rptr. 485 (1974).

130. *Id.* at 748, 115 Cal. Rptr. at 488.

131. *Id.* at 751, 115 Cal. Rptr. at 490.

132. *See, e.g.*, CAL. HEALTH & SAFETY CODE § 4730 (West 1970). The governing board of a county sanitation district is composed of members of the local city council and board of supervisors. *Id.*

bonded debt.[133] If such debt is in the form of a long-term contractual obligation, as it was in *Vanoni*, no voter approval is required.

Recent tax rate limitations, popularly known as SB 90,[134] should negate much of the debt limit advantages that have accompanied the formation of a special district in the past. In general, SB 90 restricts the tax levy of all local governmental entities to the highest rate imposed in one of two fiscal years, 1971-72 or 1972-73.[135] The electors may authorize a higher tax rate by majority vote at a tax-override election.[136] For special districts created after fiscal year 1972-73, majority approval of the voters will be required to impose any tax rate at all.[137] Therefore, tax rate limitations effectively operate as a debt limit on special districts as well, mandating majority voter approval of obligations which cannot be financed from tax revenues that are either nonexistent or limited in amount because of a frozen tax rate.[138]

III. ECONOMIC AND POLITICAL DILEMMAS

A. Fiscal Fallout of Devices Which Evade the Debt Limit

In light of the availability and variety of devices capable of evading the application of the debt limit, it is not surprising that the constitutional provision has been less than effective in meeting its stated purposes. The magnitude of local government debt is overwhelming. In California, the amount of state and local debt increased by a factor of forty between 1919 and 1975.[139] In fiscal year 1975-76, 3.5% of California's city expenditures was devoted to servicing outstanding bonded debt, the amount of which was nearly $4 billion.[140] The debt service requirements amounted to a property tax rate of $.23 per hundred dollars of assessed valuation.[141]

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133. *See* text accompanying note 127 *supra*.

134. Property Tax Relief Act of 1972, Cal. Rev. & Tax Code §§ 2260-2267 (West Supp. 1977).

135. *Id.* § 2262(1)-(2). Any property tax levied to meet debt service requirements on voter approved bonds is excluded from the calculation. *Id.*

136. *Id.* §§ 2265, 2286.

137. *Id.* § 2286 (a).

138. The effectiveness of SB 90 in limiting the spending of existing special districts was diminished by dramatic increases in assessed valuation. *See* text accompanying notes 168-69 *infra*. The Jarvis-Gann initiative's limitation on property tax revenues and its restriction on the ability of local governments to replace lost revenues should negate any remaining debt limit advantage that attends the formation of a special district. *See* text accompanying notes 170-74 *infra*.

139. ACIR, *supra* note 12, at 24.

140. California Controller's Department, Annual Report of Financial Transactions Concerning Cities of California, Fiscal Year 1975-76, at xi [hereinafter cited as 1975-76 Cities Report].

141. *See id.* at xii.

Commentators generally agree that statutory or constitutional restrictions on debt are somewhat effective in curbing the absolute growth of long-term borrowing.[142] But the very existence of debt limitations has induced the growth of a type of debt that is more dangerous than that which is restricted. The most startling statistic is not the increasing volume of local government debt, but rather the increasing proportion of nonguaranteed debt, that is, debt which is not secured by the taxing power of the issuing entity. In 1961, it was estimated that approximately one-third of all outstanding local debt was outside the scope of constitutional or statutory debt limitations.[143] By 1975, the ratio of nonguaranteed to guaranteed debt in California was almost one-to-one.[144] Seventy-one percent of the cities' bonded debt outstanding as of June 30, 1976, was in the form of revenue bonds.[145] Unmatured assessment bonds issued through city procedures totaled an additional $330 million.[146] Finally, the monetary value of leases in effect in connection with the cities' lease-purchasing financing, if continued to termination, amounted to $726.6 million.[147]

In essence, then, a history of the operation of the debt limit is a study in evasion. Such duplicity not only thwarts the clearly enunciated purposes of the drafters, but is costly as well. Because of the increased risk, the interest rate on nonguaranteed debt is generally between .5 and .6% higher than on debt secured by the taxing power of the issuing entity.[148] Given recent interest rates, this amounts to an increase of well over 10% in the annual cost of debt repayment. Yet, because of the election requirement of the present debt limitation, local entities may contend that they have had little choice other than to attempt evasion and to pay the increased cost. In 1969, only 40% of all state and local bond elections were approved by national voters;[149] in the presidential

142. "Debt restrictions have probably restrained the total volume of local government debt to some extent, but the extent to which this is true cannot be measured." ACIR, *supra* note 12, at 3. *See also* A. HEINS, CONSTITUTIONAL RESTRICTIONS AGAINST STATE DEBT 33 (1962), on the effectiveness of state debt limits.

143. ACIR, *supra* note 12, at 35.

144. MOODY'S, *supra* note 113, at a7.

145. *See* 1975-76 CITIES REPORT, *supra* note 140, at xi.

146. *Id.* at xii.

147. *Id.* at xi.

148. ACIR, *supra* note 12, at 55.

149. THE BOND BUYER 208 (1976).

election of 1976, approximately 50% of such bond issues passed.[150] Thus, in many instances, popular control of debt creation would mean no borrowing, regardless of the merits of a proposed project.

B. ATTEMPTS AT REFORM

Because of the manifest reluctance of voters to approve local bond measures, some commentators have advocated a repeal of the debt limit altogether, preferring to rely on the wisdom and political responsiveness of local governmental officials to make appropriate borrowing decisions using the full ambit of available techniques.[151] Thus far, no state has adopted this approach. A report of the Advisory Commission on Intergovernmental Relations (ACIR) took a more moderate position, recommending a permissive, as opposed to the traditional mandatory, referendum.[152] That is, borrowing decisions would be made by the local governing board and would be subject to voter approval only upon a petition of the electorate. Such a proposal, while not so drastic as the abolition of the debt limit, nonetheless strikes at the theoretical underpinnings of the debt limit, for the constitutional drafters believed that decisions to incur debt were so fundamental that they vested the decisionmaking power in the electorate. Nevertheless, with the notable exception of certain bonded indebtedness, virtually all governmental decisions are made by public representatives. The people remain the ultimate reservoir of power, in the sense that they are able to vote out or recall elected officials[153] and to prevent the effectiveness of proposed legislation through the referendum.[154] Apparently persuaded by this rationale, several states have followed the recommendation of the ACIR.[155] For example, in North Carolina, local borrowing decisions must be approved by a statewide commission and are subject to voter approval by permissive referendum only.[156] In Pennsylvania, there is no restriction on the amount of voter-

150. The Wall Street Journal, Nov. 10, 1976, at 18, col. 1.

151. See A. HEINS, *supra* note 142, at 85.

152. ACIR, *supra* note 12, at 65.

153. *See* CAL. ELEC. CODE §§ 27000-27346 (West 1977).

154. *See* CAL. CONST. art. IV, § 25; CAL. ELEC. CODE §§ 4050-4061 (West 1961).

155. Idaho, Kentucky and Missouri are not among such states. Along with California, they are the only four states requiring two-thirds voter approval of debt creation. *See* IDAHO CODE § 50-1026; KY. CONST. § 157; MO. CONST. art. 6, § 36(b).

156. *See* N.C. GEN. STAT. § 159-52 (1976). *Cf.* California District Securities Law, CAL. WATER CODE §§ 20000-20107 (West 1956), relating to bonded debt of irrigation districts and other special districts whose purpose is the development or distribution of water. The local entity may apply for certification by a state commission that such bonds are legal

approved borrowing;[157] nonvoted borrowing is subject to a permissive referendum.[158] Hopefully, the effect of this kind of legislation will be to remove artificial stimuli to higher-cost, nonguaranteed borrowing, thereby allowing governmental officials to exercise the full range of borrowing options.

The trend in California, however, appears to be toward greater voter involvement in debt creation. In particular, recent ballot propositions in California indicate the voters' unwillingness to cede any of their power in borrowing decisions. Attempts to lower the two-thirds vote requirement to a simple majority have been notably unsuccessful.[159] In June, 1976, state voters rejected a proposal that would have authorized lease-purchase agreements between school districts and the state subject to simple majority, as compared with the traditional two-thirds, voter approval for more contentional school district borrowing.[160] In November, 1976, San Francisco voters expanded their power over debt creation by approving a proposition requiring a referendum on revenue bond financing, as well as on all future "lease-financing agreements" or nonprofit corporation borrowing.[161] The San Francisco proposition undoubtedly reflects increasing voter frustration with local legislators who undertake projects that the voters are unwilling to support with their property taxes. For example, the bond proposition for a county courthouse in *County of Los Angeles v. Byram*[162] was defeated twice at the polls; the measure for construction of a music center in *County of Los Angeles v. Nesvig*[163] was rejected by the taxpayers three times. Both projects were subsequently undertaken through nonprofit corporation financing. More significantly, the City and County of San Francisco has incurred $266 million in nonprofit corporation debt

investments for certain institutions because the proposed project is economically sound and feasible, and adequate funds are available for the payment of principal and interest on such bonds.

157. *See* 53 PA. CONS. STAT. ANN. § 6780-51 (Purdon 1977-1978).

158. *Id.* § 6780-101. In addition, *id.* § 6780-52, when considered in conjunction with *id.* § 6780-2(c)(3), provides that the debt be measured against all revenues of the issuing entity, not just the issuer's assessed valuation. *See* note 12 *supra*.

159. *See* note 11 *supra*.

160. The proposal appeared on the June 8, 1976 statewide ballot as Proposition 1.

161. The proposal was submitted to the voters of San Francisco on November 9, 1976, as Proposition P.

162. 36 Cal. 2d 694, 227 P.2d 4 (1951).

163. 231 Cal. App. 2d 603, 41 Cal. Rptr. 918 (1965).

in the past twenty years.[164] Portions of that debt represent the financing of improvements to the municipal transportation system and construction of downtown parking garages, proposals which earlier had been rejected by the voters.[165]

The ability of local entities to disregard the popular will has now been tempered. It was anticipated that legislative reform aimed at property tax relief[166] would ultimately mandate majority voter approval of most long-term financing of capital improvements. By freezing the tax rate, the legislature seemed to have redefined debt to include all obligations that might be payable by resort to the taxing power. For example, because property tax proceeds would be required to fund rental payments to a nonprofit corporation on a school building lease, majority voter approval of such financing would be required at a tax-override election[167] unless a surplus of tax revenues were on hand. However, since the debt on a stadium is self-liquidating, in the sense that construction costs could be repaid from user charges or subleases, a local entity's rental obligation to a nonprofit corporation would remain free of the requirement of voter approval.

At last, the legislature reaffirmed the principle of the constitutional drafters to protect the property taxpayer and appeared to have restored a modicum of viability to the concept of voter approval of debt. But it was not to be. Under SB 90, property tax rates declined while overall property tax revenues increased because of dramatic increases in the level of assessed valuations. For example, in fiscal year 1974-75, the assessed valuations in California's cities increased by 9.4% over the preceding fiscal year;[168] in fiscal year 1975-76, the assessed valuations jumped an additional 18.3% over the previous year.[169] Even a frozen tax rate, when applied to an increased base, generates substantial additional revenues. As long as increases in assessed valuation continued to outpace inflation, a cushion of increased property tax revenues remained available for the repayment of debt that had not

164. The Progress (San Francisco), Apr. 2, 1976, at 12, col. 1.
165. *Id.*
166. *See* notes 134-38 *supra* and accompanying text.
167. CAL. REV. & TAX CODE §§ 2265, 2286 (West Supp. 1977).
168. 1975-76 CITIES REPORT, *supra* note 140, at xiii.
169. *Id.*

been approved by the electorate. Property tax reform proved only an illusory limitation on the amount of property tax revenues and on the power of a local governmental entity to evade the constraints of the constitutional debt limit.

Finally, with the passage of Proposition 13, the Jarvis-Gann initiative, in June, 1978, the people were successful—in their third attempt in the last ten years—in imposing a constitutional limit on the amount of property taxes that could be collected by local governments as well as in restricting the growth of the assessed valuation of the property subject to taxation.[170] In brief, the measure limits property taxes to one percent of a property's full cash value as reflected initially in the 1975-76 assessed valuation.[171] As long as the property is neither sold nor transferred, the fair market value base may be increased by a maximum of only two percent a year.[172] The proposition also prohibits any new state tax on the sale or value of real property.[173] Finally, before local governmental units may impose "special taxes," those not based on the sale or value of real property, a two-thirds vote of the "qualified electors" is required.[174]

The potential impact of the Jarvis-Gann initiative is enormous.[175] Commencing with fiscal year 1978-79, property tax reve-

170. ASSEMBLY REVENUE AND TAXATION COMM., FACTS ABOUT PROPOSITION 13, THE JARVIS-GANN INITIATIVE 7 (1978) [hereinafter cited as 1978 TAX STUDY]. The measure appeared as Proposition 13 on the June 6, 1978 statewide primary ballot.

171. CAL. CONST. art. XIII A, §§ 1(a), 2(a).

172. *Id.* § 2.

173. *Id.* § 3.

174. *Id.* § 4. The term "qualified elector" raises one of the many ambiguities of Proposition 13. It is defined in CAL. ELEC. CODE § 17 (West 1961) as "any person who is a United States citizen eighteen years of age or older and a resident of an election precinct at least twenty-nine days prior to an election." It is questionable if two-thirds of all eligible electors—whether registered or not—have ever voted in an election.

Other ambiguities exist in the directive of section 1 that property taxes "be collected by the counties and apportioned according to law to the districts within the counties." At present, there is not state law that would provide for the distribution of these revenues. Furthermore, cities and counties are not technically "districts," and it is therefore unclear how they would participate in the division of property tax revenues. One can scarcely dispute the conclusion of California's legislative committee: "[I]n several instances the exact meaning of language used in this measure is not clear." 1978 TAX STUDY, *supra* note 170, at 26.

175. In addition to the difficulties discussed at note 174 *supra*, certain constitutional questions remain unresolved that may delay—or defeat altogether—the implementation of Proposition 13. For example, CAL. CONST. art. II, § 8(d) provides that "an initiative measure embracing more than one subject may not be submitted to the electors or have any effect." It is arguable that property tax limitation, the supermajority requirement for

nues will be cut by approximately sixty percent or seven billion dollars annually.[176] That initial reduction, as well as the limitation on future property taxes and other alternative revenue sources, will have a pronounced effect on the operation of the debt limit and the techniques of municipal borrowing. Indeed, the norm of financing envisioned by article XVI, section 18 has been jeopardized; although general obligation bonds can still be issued with two-thirds voter approval, no new property taxes can be levied to finance them.[177] The proposition's effect on other financing devices is equally profound. For example, the lease-purchase financing technique employed by nonprofit corporations is seriously impeded because the Jarvis-Gann initiative cuts back the ability of a local entity to make payments on its leases from limited revenues.[178] Even the back-up security for 1915 Act assessment bonds, the ten cent property tax levy, is eliminated.[179] And although revenue bonds can be issued, resort to the general fund for repayment can no longer be anticipated.[180] With the advent of Jarvis-Gann, a new era in municipal finance has begun. The financing devices developed over the past century in response to the constitutional debt limit have become, for the most part, outmoded. Two-thirds voter approval will at last be required for most debt creation—not to authorize the levy of a property tax but rather to permit the resort to additional revenue sources for repayment.[181]

increases in state taxes and the limitation on a city or county's power to impose "special taxes" constitute three subjects rather than one denominated under the broad category of tax reform.

Procedures for assessment increases pose additional constitutional difficulties. Under Proposition 13, two properties of equal value may have markedly different tax bills. If one parcel were sold after the base assessment year, it would be assigned a new assessed valuation of full cash value at the time of sale. The other property's assessed valuation would lag behind, having been increased only two percent a year over its 1975-76 assessed valuation. The resulting disparity in tax burdens may well violate the equal protection clauses of both the Federal and State Constitutions.

176. ANALYSIS BY LEGISLATIVE ANALYST, CALIFORNIA VOTER'S PAMPHLET, PRIMARY ELECTION JUNE 6, 1978, AT 60.

177. CAL. CONST. art. XIII A, § 4 precludes citizens from voting to increase or levy a property tax. Prior general obligation bonds are not endangered, however, as the local entity may exceed the one percent tax limit to fund them. *Id.* § 2(b).

178. Proposition 13 has succeeded where SB 90 failed. *See* text accompanying notes 167-77 *supra*.

179. *See* notes 101 & 171 *supra*.

180. *See* text accompanying notes 82-84 *supra*.

181. CAL. CONST. art. XIII A, § 4. The imposition of any "special taxes" contemplated by that provision requires express statutory authorization—at least for general law cities. *See* note 61 *supra*. Such legislation is yet to be devised.

CONCLUSION

In response to the rigidity of the debt limit and its negative impact on economic growth, courts narrowed its application by refashioning a definition of debt. Yet, such well-meaning judicial interpretations fostered the very abuse the constitutional provision was enacted to prevent. Lack of popular support for various capital improvements has not prevented borrowing, but rather stimulated the creation of complex borrowing techniques at higher costs. Municipal borrowing has occurred without two-thirds voter approval, and indeed without any vote at all. Non-profit corporation bonds, special assessment bonds, revenue bonds of chartered cities and joint power authority revenue bonds were all traditionally exempt from the voter requirement. Only revenue bonds of general law cities required prior voter approval, and then, a simple majority vote sufficed.

In short, the debt limit simply failed to fulfill its promise of protecting the property taxpayer through popular control of local debt creation. By means of Proposition 13, the Jarvis-Gann initiative, the people have attempted to secure that objective themselves. Yet, Proposition 13's validity is in doubt, its implementation unclear and its effect problematic. At least its supporters can assert that the seed of restraint planted by the constitutional drafters has, after four generations, been brought to germination.