

# PUBLIC INCENTIVES FOR DEVELOPMENT: RESPONDING TO FISCAL CONSTRAINTS

by Stephen B. Friedman, CRE

While state and federal governments seek to drastically cut back spending on community and economic development, local governments continue to have a responsibility to foster economic activity. Curtailed federal and state aid, in fact, exacerbates the pressure on local governments to foster development. When the state and federal governments were more generous with development programs (e.g., Community Development Block Grants, CDBG, school aid formulas based on tax effort and general aid such as the former general revenue sharing program), local governments had some help in meeting their needs by tapping broadly based taxes of higher levels of government. As federal and state resources decline, individual communities are forced to seek development to maintain their own fiscal stability. Ironically, in some states there are also efforts to curtail local government incentives.

The overall impact of this reality may not minimize overall governmental spending, encourage efficient location of development or otherwise contribute to an overall public good, but commercial and industrial development become essential to survival. In localities without commercial and industrial development, and with heavy reliance on property taxes, there is virtually no way to meet responsibilities for schools, police, fire and other basic services within a reasonable tax rate. Little wonder then that communities compete with each other for commercial development.

The tools communities use vary from state to state but generally include tax incremental financing, special service taxing districts and tax abatement for some period. Larger communities continue to have CDBG funds available and smaller communities can obtain these funds from county or state agencies. Transportation-related funds may also be used for transit-oriented developments. In addition, many localities have surplus real estate which can sometimes generate greater returns if the locality is a development participant rather than just a seller.

In the current climate, it is very important that the government make good business decisions that minimize the investment of public incentives and maximize the returns to the public sector. For the taxpayer, it should no longer be acceptable to assist private development projects without careful

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evaluation of the need for help and without knowing if the funds can be recovered in the future. For the developer seeking assistance, more judicious use of incentives may help preserve their availability for when they are really needed. The following key issues should be considered in evaluating public financial participation in public development projects:

- What is the public purpose being served and will the project occur anyway?
- Is the project fundamentally viable?
- What is the competitive incentive situation regarding such a development?
- What is the financial gap that needs to be filled to achieve economic feasibility and attract private financing?
- How can assistance be structured to maximize public benefit?

#### **What Is The Public Purpose Served And Will The Project Occur Anyway?**

Commercial development not only enhances the tax base of a community, but it balances residential development which is more costly in direct demands for public services, such as schools. While this is an important reason to seek commercial development, it is not a sufficient reason to justify public investment. Public investment should be considered when a project provides overwhelming benefits and achieves important public policy objectives. A project should be reviewed in terms of such objectives, costs and benefits and whether it would occur without assistance (the *but for* test).

**Public Revitalization Objectives.** Assisted developments should contribute to achieving objectives established by the community. These may include enhancing the local tax base, job creation, efficient use of public facilities or other measurable benefits. More intangible benefits should also be considered such as historic preservation, deconcentration of low income housing, enhancement of transit/air quality improvement, esthetic contributions, etc.

**Cost Benefit Analysis.** The benefits of projects can be partially quantified. Direct revenue generation from taxes and fees can be readily estimated. Broader economic impacts from job creation and attendant secondary fiscal benefits can also be quantified. Averted public service costs from use of an infill location can also be considered, among other measurable benefits. The overall benefits serve as a probable upper limit of assistance, but not a budget. Similarly costs can be considered. These include extraordinary project costs, such as environmental remediation of an infill site, infrastructure, required services and the direct costs of incentives offered.

**The "But For" Test.** Even if the project provides overwhelming benefits, assistance is justified only if the project would otherwise not proceed. This is partially measured by evaluating the financing gap including both structural and return on investment issues. It may also be the result of competitive pressures created by business climate and incentives offered in other locations.

#### **Is The Project Fundamentally Viable?**

If a project appears to provide positive long term benefits and is unlikely to occur without assistance, it is important to review whether the project is fundamentally viable. A number of interrelated issues are involved, which are critical in determining the level of assistance needed. These include market factors for commercial real estate type projects, site location fundamentals for single user facilities, environmental issues and construction costs.

**Market Factors.** While financial assistance, such as a low interest loan, may help overcome a soft market, the market fundamentals must still be present. Whatever the land use, are the rents sufficient and market occupancy levels strong enough that the project has some fundamental strength? Can an anchor lease be complemented by enough market driven smaller leases? Is the competitive position of the site reasonably strong, and is there a market niche in the face of competition? Market factors for each land use and specific project are, of course, unique, but they need to be carefully reviewed. The assumptions derived from the market will drive the financial analysis. If occupancy and rents are understated, the need for public assistance will be improperly overstated. If occupancy and rents are overly optimistic, the project may not be able to survive at all and, at the very least, will end up undercapitalized and result in either further demands for public assistance or a workout situation.

**Site Location Fundamentals.** Particularly for single user and industrial facilities, what are the site fundamentals? Are accessibility and visibility appropriate? Are the labor market and transportation conditions such that this is a good long-term location for a particular type of firm? Are educational and telecommunication requirements met? Some factors cannot be anticipated, and business conditions may change: deregulation of trucking and increased energy costs have rendered locations uncompetitive which previously were successful. Telecommunications and other technology are continually changing the competitive position of an area. Nonetheless, an honest competitive analysis can help identify both where to target

incentives and whether the project has good long term prospects.

**Environmental Issues.** We have become increasingly aware of environmental issues at a site specific level. While they can be addressed and often are justification for public financial assistance, it is critical to understand their magnitude and cost prior to committing to a project and agreeing to provide incentives. Typically this would require a Phase 1 Environmental Assessment followed by a Phase 2 study with reasonably complete cost estimates for remediation.

**Construction Costs.** Cost estimating for new projects is difficult. Even if the design is fairly straightforward there may be soil conditions or other issues to address, and often the project sponsor is seeking preliminary commitments before more than conceptual design is completed. In rehabilitation projects, cost estimating is very difficult. Few rehabilitation projects are planned with the building in such condition that behind-the-wall and under-floor situations can be fully assessed. A detailed assessment by specialists and a greater degree of preliminary architectural analysis is called for so that the magnitude of the project is fully known prior to initial commitments.

### **What Is The Competitive Incentive Situation Regarding Such A Development?**

One of the most common circumstances in which incentives are sought is to match the competitive incentives from another locality. A community may face this issue in trying to retain a firm as well as in attracting new development. This is usually related to the move of a specific user, but can also occur if two communities are vying for the attention of developers in a small or tight market. Incentives may include free land, infrastructure, job training, financing, etc., the entire menu of whatever is available. However, in state-to-state and metro-to-metro competition, real estate costs, tax structures (business and personal), cost of living, costs of transportation, labor force quality, wage rates and quality of life factors may all play a role in the competition. Analysis should include both the specific incentives that might be available in the locality's tool kit and business climate/location fundamentals. There may be issues on which one's geographic area simply is not competitive at the time. For example, certain levels of telecommunications needed to support telemarketing are not available in all rural areas. There may be other issues to immediately address including tailored training programs through vocational/technical systems to address labor issues; housing or transportation improvements to support labor availability, etc. Careful research of

both financial and locational issues allows a community to focus on winnable competitions and resources and sharply target assistance against the competitor's advantages. In community-to-community competitions, this is the most fundamental issue.

### **What Is The Financial Gap That Needs To Be Filled To Achieve Economic Feasibility And Attract Private Financing?**

In real estate development projects, including shopping centers, hotels, office buildings, business parks and residential projects, the most critical basis for public financial assistance is the financing gap. This is the amount of capital required after all the possible private debt and equity have been raised in private markets. Based on the cash flow of the project and the current underwriting standards for debt and equity, the supportable private financing can be estimated. This is illustrated in Figures 1 and 2.

In this example, a downtown inn is to be rehabilitated to historic rehabilitation standards. Because of the perceived level of risk associated with a hotel and restaurant, a relatively high debt coverage ratio would be applied by the primary lender. To attract equity, relatively high returns are required. The result is a capital shortfall of 15 percent to 20 percent of estimated costs. A participating second mortgage structured to be paid from 50 percent of cash flow is used to fill the gap. Weak initial cash flow improves over time with ultimate return to the second mortgage at a rate well in excess of the public sector's cost of funds.

There are many reasons why an otherwise viable project may present a financing gap, including:

- redevelopment land costs/site assembly
- weak market conditions
- construction costs/special site conditions
- special public facilities (e.g., public meeting facilities)
- rehabilitation/historic building restoration costs
- unusually high market interest rates
- financing market structural issues (e.g., high equity requirements)

Assistance can be provided by the public sector paying directly for costs that would otherwise be incurred by the developer, such as relief from infrastructure or impact fee requirements. Assistance can also be provided by further reducing project costs through land acquisition and write-down. There are a number of sources for such funds, including tax incremental financing, general obligation capital funds (for infrastructure), and revolving funds created from paybacks of past loans.

**FIGURE 1**

Hypothetical Historic Rehabilitation—  
Downtown 25 Room Inn & Restaurant  
Development Cost Summary

Uses Of Funds	1995
<b>Land/Building Acquisition</b>	
Building	\$ 360,000
Other Acquisition Costs	4,000
Other Acquisition Costs (Legal, etc.)	2,000
Taxes During Holding Period	10,000
<b>Subtotal, Acquisition</b>	<b>\$ 376,000</b>
<b>Building Rehabilitation</b>	
Construction Costs	\$1,500,000
Contingency	150,000
<b>Subtotal</b>	<b>\$1,650,000</b>
<b>Equipment and Supplies, Including Restaurant</b>	
<b>Subtotal</b>	<b>\$ 330,000</b>
<b>Soft-Costs</b>	
Architecture and Design Fees	\$ 178,200
Other Professional Fees, Insurance, etc.	20,000
Soft-cost Contingency	19,820
<b>Subtotal, Soft Costs</b>	<b>\$ 218,020</b>
<b>Financing Costs</b>	
Loan Fees	\$ 40,120
Syndication Fees	38,500
Other Financing Cost	5,000
Construction Period Interest	129,031
<b>Subtotal, Financing</b>	<b>\$ 212,651</b>
<b>Pre-Opening Costs</b>	
Advertising & Marketing	\$ 25,000
Salaries and Management Fee	75,000
Working Capital	100,000
<b>Subtotal, Pre-Opening</b>	<b>\$ 200,000</b>
<b>Capitalized Operating Losses</b>	<b>\$ 0</b>
<b>Total Development Costs</b>	<b>\$2,986,671</b>
<b>SOURCES OF FUNDS</b>	
Equity	\$ 550,000
First Mortgage	2,006,000
GAP/TIF Loan Needed	430,671
<b>Total Development Funds</b>	<b>\$2,986,671</b>
<b>Construction Period Interest</b>	
Acquisition Hard and Soft Costs	\$2,244,020
1/2 Out Average, Months	\$ 129,031
12	11.50%

Source: S. B. Friedman & Company

**How Can Assistance Be Structured To Maximize Public Benefit?**

Once it is determined that assistance is justified and the sources are identified, the financing structure should be considered. In general, the form of assistance should address the fundamental problems of the project. In the example provided, the cash flow second mortgage responds to the weak cash flow in the early years but creates the potential to obtain a higher overall return in exchange. To the extent that provision of public facilities can be used to assist the project, tax exempt debt may be used to reduce interest costs. Often however, the levels of assistance will exceed public improvements and adjunct help such as training, transit, etc. In such cases direct financial assistance is needed. Depending on circumstances, two of the best methods of involvement are participating ground leases and loans.

If the public sector has the land or must acquire it by eminent domain, then an opportunity for a ground lease exists. Sale lease backs of land could also be used. Such situations also include potential joint ventures for reuse of surplus public facilities. Participating ground leases with escalations linked to changing conditions can be structured to enhance some projects and provide long term public benefit. Important provisions include the basis for participation (gross revenue, sales, inflation or reappraisal), subordination to allow financing of structures and rights to cure.

It is also critical to include provisions to prevent sandwich subleasing situations. Ground leasing has been used with such diverse sites as school board properties, airport hotels and research parks. Disadvantages of ground leasing include potential problems with financing structures since some lenders will not finance ground leases. Other problems include reduced property taxes from the development, end-user attitudes and limitations on condominium development in states requiring land to be owned for condominiums. In addition, there are often problems structuring the adjustment clauses and enforcing them.

Loans can be readily structured to respond to the project's cash flow. Typically structured as a second mortgage, cash flow above that required for minimal debt and equity returns can be directed to service the second mortgage. Low rates can be used which are linked to the public sector's costs of funds (taxable bonds). Often a tax incremental financing district is used to raise funds for such loans, and the tax increment secures the bonds. Repayment is still desirable however, and the loan can be structured with contingent interest based on performance. Such loan structures have been used on residential, office, retail and mixed use projects.

**FIGURE 2**

Hypothetical Historic Rehabilitation—  
Downtown 25 Room Inn & Restaurant

OPERATING ESTIMATES		1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Net Operating Income		\$250,000	\$300,000	\$309,000	\$318,270	\$327,818	\$337,653	\$347,782	\$358,216	\$368,962	\$380,031
Debt Service											
First Mortgage (High Risk) DCR	1.30	230,769	230,769	230,769	230,769	230,769	230,769	230,769	230,769	230,769	230,769
Cash Available for Equity and Gap Debt Service		\$ 19,231	\$ 69,231	\$ 78,231	\$ 87,501	\$ 97,049	\$106,883	\$117,013	\$127,446	\$138,193	\$149,262
RETURN ON EQUITY											
Share of Cash Flow	50%	\$ 9,615	\$ 34,615	\$ 39,115	\$ 43,750	\$ 48,524	\$ 53,442	\$ 58,506	\$ 63,723	\$ 69,096	\$ 74,631
Tax Credit		\$300,000									
Total Return on Equity	Equity (\$550,000)	\$309,615	\$ 34,615	\$ 39,115	\$ 43,750	\$ 48,524	\$ 53,442	\$ 58,506	\$ 63,723	\$ 69,096	\$721,882
Cash-on-Cash Return	Cumulative	262.23%	56.29%	6.29%	7.11%	7.95%	8.82%	9.72%	10.64%	11.59%	131.25%
Percentage of Residual	50%										
Internal Rate of Return		19%									
GAP FINANCING											
Debt Service—Share of Cash Flow	50%	(\$430,671)	\$ 9,615	\$ 34,615	\$ 39,115	\$ 43,750	\$ 53,442	\$ 58,506	\$ 63,723	\$ 69,096	\$721,882
Nominal Interest Rate	0.085										
Percentage of Residual	50%										
Overall Return (IRR)		13%									

Source: S. B. Friedman & Company

In one case, a residential and retail project benefiting a private university received such a loan with cash flow split between the loan and the university's patient equity in the project.

**Conclusion**

It is critical that the public sector structure as much assistance as possible on a repaying or ongoing return basis. Not all projects will succeed. If these were developments of ordinary risk there would be no justification for assistance. Future sources of funds for development purposes are uncertain. Recapturing investments through loan repayments or leases provide a future stream of economic development investment resources under the control of localities relatively safe from changes in state and federal legislation. The broad parameters underlying public financial assistance include:

- The project should make a significant contribution to the locality.
- The project will not proceed "but for" assistance.
- Financial assistance to the project will be based on financial need.
- Assistance should be structured to provide ongoing return to the locality.

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