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TO: Economic Development Committee's Subcommittee on TIF
FR: Aaron Olver
RE: TIF Policy Items for January 29, 2013
DT: January 22, 2013

Overview

This memo summarizes the issues associated with "Pay-As-You-Go" or "Developer-financed" TIF and Affordable Housing.

PART 1: PAY-AS-YOU-GO TIF

Background & Definitions

In making TIF awards[1], the City usually borrows the amount of the award - typically on a ten year repayment schedule - using the strength of the City's credit. Since the City can usually borrow at rates below those available to the private sector and borrows over a shorter period (ten years vs. perhaps twenty-five), this practice minimizes interest costs and helps close TIDs faster. The City has used a variety of agreements to transfer the TIF award to developers, but these funds are typically available to the developer on the front end of the project's life. For the purpose of this memo, I'll call this the "traditional method."

"Pay-As-You-Go," also known as "developer-financed TIF" is another TIF financing technique. Instead of the City making an upfront award to the developer, the City promises to pay the award amount to the developer over time as the development generates increment (hence the name Pay-As-You-Go). In this case, the developer goes to the private debt and equity market to raise all of the funds, helped by the City's pledge of increment (hence the name "developer-financed").

Here's a simple way to think about the difference: In the traditional method, the City determines the amount of the TIF award and borrows this amount on behalf of the developer. In Pay-As-You-Go, the City determines the amount, but the developer borrows that amount on top of the rest of the funds they have to raise.

Current Policy

Current TIF policy does not prohibit Pay-As-You-Go, though in practice, we have not used the tool recently. Here is the relevant language from current TIF Policy:

> **"Pay-As-You-Go" Financing Method.** So-called "Pay As You Go" or "developer-financed" TIF is a variant of traditional methods to finance TIF assistance wherein the municipality agrees to a "moral obligation" of tax increment to repay a portion of a developer's bank loan. Under this method, the municipality agrees to incur higher interest and fee costs at longer terms in comparison to municipal borrowing. The municipality must budget the amount of debt service owed to the bank each year as part

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[1] We typically refer to TIF loans, not awards. However, to avoid confusion about who is doing the paying or repaying, I'm using the term "TIF award" in this memo to mean the funds that the City wishes to invest in a development project by using TIF.

of its annual capital budget process and has the option, with penalties, to forego repayment in any year. Such borrowing may be considered on a case-by-case in comparison to the other methods indicated above. The City of Madison reserves the right to choose the option that is in the best interests of the taxpayer. In all cases, a project using the Pay As You Go method must comply with all other aspects of TIF Law and TIF Policy, including but not limited to the "but for" standard and the 50% rule.

How a Pay-As-You-Go Deal is structured

There are four major quantitative terms that must be negotiated to structure a Pay-As-You-Go deal:

1. The **award amount**
2. The **percentage of increment**
3. The **interest rate**
4. The **length of time**

In a sentence: Under Pay-As-You-Go, the City allows the developer to use a **percentage of increment** generated by their project for a certain **length of time** to recover up to a maximum **award amount** plus interest based on a negotiated **interest rate.** Let's look at each element in turn.

Award Amount

In Pay-As-You-Go, the City is essentially issuing an I.O.U. to the developer. The maximum amount the developer can recover (excluding interest) must be determined. The City can (and should) apply the same underwriting technique to determine the amount of TIF to be invested (regardless of financing method).[2]

Percentage of Increment

A Pay-As-You-Go TIF award allows the developer to use a portion of the increment to pay themselves back. Or in other words, the City pays down the I.O.U. toward zero by appropriating a portion of increment the development generates each year to the developer. This portion must be negotiated. For example, one deal may use 50% of increment; the next deal might use 75%.

Interest Rate

The City and developer must agree on what interest rate will apply to the award amount (or the I.O.U. balance). The developer will want an interest rate that reflects their borrowing costs (or better yet, cost of capital). The City will prefer an interest rate reflecting our own cost of borrowing. The negotiation must settle this issue.

Length of Time

The City will pay the developer a percentage of the increment each year up to a maximum number of years specified by an agreement. The agreement terminates when the developer has recovered the award amount (plus eligible interest) or after a set number of years. If the developer has not recovered the award amount (and the interest they are entitled to) by then, the agreement typically terminates with no further obligation from the City.

EXAMPLE: An agreement with ACME Development might allow ACME to recover up to $2 million (plus 4% interest) by using 66% of the increment their project generates over a period up to 18 years. If ACME generates enough increment to payoff $2 million (plus interest) before 18 years, everyone is happy. If 18 years comes and goes and ACME has not recovered the $2 million, ACME is on the hook for the remaining balance.

Role of Pay-As-You-Go.

Pay-As-You-Go TIF is not a magic TIF bullet that will instantly solve all TIF-related issues. Like any tool, it has advantages and disadvantages. Depending on the situation, employing Pay-As-You-Go may be advantageous to the City. Below, I will discuss why Pay-As-You-Go might be attractive to the City, what it's real and perceived disadvantages are, and in which types of situations it may be the most useful.

Potential Advantages for the City

Here are the primary advantages of Pay-As-You-Go TIF relative to the traditional method from the City's Point-of-View:

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[2] The City may wish to retain some flexibility to address the time value of money, though the negotiated interest rate implicitly addresses this issue.

1. Transfers Risk to Developer
2. Create Incentives for Development
3. Avoid Incurring Debt
4. Reduce the possibility of distressed TIDs

Transfers Risk
When the City borrows funds to make a TIF loan, the City is assuming some risk associated with the possibility that a project will fail to generate the projected value that the City based its underwriting on. This could happen for a variety of reasons. The City attempts to deal with this risk by requiring increment and personal guarantees from developers (and sometimes through other devices such as performance bonds). Pay-As-You-Go is another way of transferring the risk that a project creates less increment than projected from the City to the developer.

Creates Incentives
Because developers are assuming the risk that a project may fall short of projections, using Pay-As-You-Go creates two desirable incentives. First, it discourages developers from overvaluing their project to make the TIF award amount seem more feasible. Second, it creates a powerful incentive for the developer to actually complete all of the development they anticipate. This is especially useful for multi-component or multi-phase projects where uncertainty exists (see below).

Avoid Incurring Debt
Because the City is not doing the borrowing under Pay-As-You-Go, the City is not incurring additional debt. For municipalities nearing their debt limits, this could be an advantage. For Madison, this is not a major concern right now.

Reduce the Possibility of Distressed TIDs
TIDs become distressed when the increment generated over its normal lifetime (typically 27 years) is not sufficient to retire its obligations. By paying out no more than 100% of actual increment generated, the City can guarantee that a TID will not become distressed because of that particular development project.[3] A TID could still become distressed, but only because of other spending under municipal control, such as that on infrastructure.

Potential Disadvantages for the City
Here are the primary disadvantages of Pay-As-You-Go TIF relative to the traditional method from the City's Point-of-View:
1. Longer TID lifespans are probable
2. Higher Interest costs
3. Lower returns (as a result of larger lifespan and interest costs)

Longer TID Lifespans Probable
TIDs are required to close when they have generated sufficient increment to retire their obligations (unless some contractual agreement keeps the TID open). Closing a TID allows taxpayers and our partners to benefit from the increased value a TID has generated. Pay-As-You-Go agreements are likely to extend TID lifespans beyond what would probably happen under the traditional model.

In the traditional method, we are used to discussing a percentage of increment a particular project will receive. For example, we might say a project will be awarded $3.4 million, or 59% of the increment, requiring an exception to our current 50% rule. Using language like "59% of the increment" is an underwriting convention that measures how risky a project is and how much excess increment a project will generate for other public purposes. In practice, however, the City applies 100% of a particular projects increment, as well as the increment being generated across all property in the TID, toward retiring all of the obligations in that TID. This often allows us to close a TID faster than we would if all TIDs were actually single-purpose TIDs built around one project. In other words, while we underwrite on a project-by-project basis, in practice, we comingle all increment in the TID to our financial benefit.

[3] If the City awarded more than 100% of the increment generated for some reason, this advantage would obviously disappear.

Under Pay-As-You-Go, the City really would be creating a segregated stream of revenue to repay a TIF award amount. Unless (and probably even if) the City made a practice of allowing 100% of the increment to be used to pay down the I.O.U., the lifespan of TIDs with Pay-As-You-Go deals is likely to be longer than TIDs with traditional TIF deals (all else being equal). There is an inverse relationship between the percentage of increment annually appropriated to the developer and the number of years required to fully recover the TIF award amount. Lowering the percentage of increment available to developers under Pay-As-You-Go will tend to extend the length of the deal.[4]

The City does have strategies available to help mitigate this potential downside. First, the City can reserve the right to prepay the I.O.U. with increment accumulated in the TID and close the TID faster. Second, the city could amend to the TID's boundaries to partially close the TID (perhaps leaving only the parcels subject to Pay-As-You-Go arrangements). This could return property tax base to the rolls faster and increase the return to the City while the City continues to enjoy the reduced risk benefit of a Pay-As-You-Go agreement.

Higher Interest Costs

Developers are almost never able to borrow as inexpensively as the City. In addition, while the City typically borrows over ten years, most Pay-As-You-Go deals will be longer. Theoretically, the City could negotiate an interest rate on the I.O.U. equal to City's borrowing costs and cap interest at the amount amortized over ten years. In practice, though, the developer is raising more debt and/or equity and facing real costs. There will be pressure and reasons to agree to an interest rate and period longer than that available to the City. A deal structured as Pay-As-You-Go will usually wind up dedicating more increment to paying interest costs than a traditionally structured TIF deal.

Lower Returns

When the City makes a TIF award, there is a stream of future benefits and future costs associated with the award. These streams could be collapsed into a single number that shows the net benefit of the deal to the City in today's dollars (we call this a net present value). Taken together, the longer lifespan of the TID and the higher interest costs will tend to reduce to net present value of a Pay-As-You-Go deal compared to a traditional deal (It will remain positive, though).

In summary, when the City uses Pay-As-You-Go, we are essentially agreeing to a lower return on our investment in exchange for lower risk and the creation of incentives.

Perceived Disadvantages

There are several other arguments against Pay-As-You-Go TIF that I do not find as compelling as those above. Here are some additional perceived disadvantages and the reasons I don't find them as compelling:

> **Pay-As-You-Go is Always a Worse Deal**
>
> Some will argue that Pay-As-You-Go should never be used since the City can usually borrow at a lower interest rate. As noted above, higher interest costs can be a real downside. However, Pay-As-You-Go has other benefits that may justify its use. Trading higher returns for lower risk is often a good deal. In other words, the story is little more complex than simply the relative borrowing costs of the City and a prospective developer.
>
> **Pay-As-You-Go Voids the "But For" Test**
>
> The argument here is that if a developer is capable of financing the entire project cost, no gap exists, and therefore the project doesn't meet the "but for" test. There are two problems with this argument. First, the TIF statute doesn't require the City to make a "but for" finding for each project. The statute assigns the responsibility to the Joint Review Board to make a "but for" finding when they initially create the TID. Second, the developer is likely to be using the City's pledge of increment to help raise either their debt or their equity (or both). A lender may be willing to make a larger loan if there is a pledge of increment from the City. Similarly, an equity investor may be able to justify a larger investment based on this stream of projected increment. In other words, the fact that a developer is able to privately finance a project based

[4] Obviously these terms are all subject to negotiation.

on the assumption that increment will be dedicated through a Pay-As-You-Go arrangement is not grounds to assume that they can also finance the project without any TIF increment.

Pay-As-You-Go Uses 100% of the Project Increment
This is completely negotiable. It may be in the City's interest to allow the developer to recover the TIF award amount as fast as possible (in order to minimize interest costs and improve the City's return). But if the City wishes to generate increment for other purposes (such as infrastructure), the City can negotiate a lower amount.

Synonymous with Tax Abatement
This argument suggests that Pay-As-You-Go TIF is somehow more like tax abatement (which is prohibited by the uniformity clause in the Wisconsin Constitution) than traditional TIF. In both cases, the property owner is required to make property tax payments like any other property owner. In cases where the City uses the traditional TIF method, they make an appropriation to a developer upfront. In cases where the City uses Pay-As-You-Go, the City makes an annual appropriation to a developer for a period of time. I'm not aware of any reason to suppose that one method of appropriation is less likely to pass constitutional muster. If anything, both the courts and the legislature have expanded the interpretation of the TIF statute, already having found, for example, that the TIF statute does not violate the uniformity clause or public purpose doctrine.[5]

"Moral Obligation" Realities Eliminate Any Perceived Risk Reduction
When a municipality enters a Pay-As-You-Go arrangement, it typically issues a tax increment revenue bond promising a defined increment stream to the developer. Though the municipality has a moral obligation to appropriate the future revenues it promises, the municipality does not necessarily have a legal obligation. Because the consequences of defaulting on a moral obligation to pay its bills are potentially significant, however, many developers are comfortable relying upon the moral obligation as they don't view default as a viable option for the municipality.[6] Even if the municipality were to commit to an increment schedule with defined dollar amounts, the moral obligation would not force the municipality to appropriate the funds defined in the schedule so long as the documents are clear that the municipality's obligations are contingent on the increment the development actually generates. Instead of committing to a schedule that lists specific annual dollar amounts (as we ask of developers in our guarantees), municipalities can structure the agreement and commit to a percentage of the actual increment generated. For example, a Pay-As-You-Go agreement might create a moral obligation for future Common Councils to appropriate 50% (or some other percentage) of the increment a particular parcel or parcels generates, it does not create an obligation to appropriate any more than 50% of what is actually generated.

Situations Where Pay-As-You-Go May Benefit the City

In general, most developers would prefer the traditional method of TIF financing (all else being equal). It's a better deal for them to 1) get their money up front, 2) use the City's credit and borrowing power to drive down interest costs, and 3) share the project risk with the City. The City also likes it because it minimizes interest costs and helps closes TIDs faster. Risk is managed with the help of the increment guarantees we require.

However, there are some situations where Pay-As-You-Go may be a superior arrangement on balance. The two most likely situations are for major projects and for complex or multi-phase projects.

Major Projects

Let's say the City wants to do a project that requires a substantial portion of projected increment (maybe 75 to 100%). This situation could reasonably occur, for example, if the City wanted to support pioneering infill development in an area where the market was unproven. Such a situation might increase the risk the project wouldn't hit projections. It might also require a larger than typical TIF award leaving less margin for error. This level of increased risk to the City could threaten an otherwise desirable deal. While the City could choose to do such a deal through the traditional method, we would be leaning heavily on the increment guarantee. The City

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[5] See *Sigma Tau Gamma Fraternity House v. City of Menomonie,* 93 Wis. 2d 392, 288 N.W. 2d 85 (1980)
[6] In light of the Debt Ceiling debate, perhaps it's more accurate to say default is not perceived as a ***good*** option.

could be left holding the bag if something unexpected occurred. Doing the deal as a Pay-As-You-Go shifts the increased risk to the developer (in exchange for the City stretching the amount of TIF it might otherwise allocate). While such a deal would likely lower the return of the project itself, the stimulation of pioneering development coupled with the dramatic reduction in risk might make the trade off worthwhile. After all, the big "get" may be the catalytic impact the development will have and not the initial project itself.

Complex or Multi-Phase Projects
A complex project is one where multiple entities share an element. For example, a parking structure might be shared between an apartment building, an office building, and some retail space. A multi-phase project is one where a developer plans to construct multiple buildings (say three office towers) over time. The exact timing of the phases is unknown because market forces cannot be accurately forecast.

In these cases, the traditional method of TIF financing can be impractical. First, the various components are almost always owned by different entities. Lenders and investors almost universally require real estate assets to be developed as single-purpose entities, such as LLCs. These entities often have different groups of investors. Residential investors (or lenders), for example, may not finance commercial space and vice versa. To secure the City's TIF award, both a personal guarantee and an increment guarantee is required. But with multiple owners and entities, securing these guarantees is complex at best and can threaten otherwise desirable deals. After all, if the City wants to encourage urban, transit-bike-pedestrian-friendly, multi-use, infill development, we are asking developers to bring us deals with multiple components or phases.

Second, these deals often have unpredictable elements. Developers can't necessarily predict how fast the market will absorb their proposed project and when they can complete it. At the same time, the City doesn't want to risk half-completed projects. Or see surface parking persist in an area planned for structured parking. Setting an arbitrary timeline based on assumptions and providing penalties is one way we could deal with this situation. It's a pretty blunt instrument, though, and difficult to negotiate. In these cases, though, Pay-As-You-Go might offer a very elegant solution.

The City can underwrite a Pay-As-You-Go deal assuming that all elements or phases will be completed. The agreement with the developer can make an assumption about when the project might be completed. To the degree the developer is able to move faster, they reduce their own risk. To the degree the development is slow to materialize, it is the developer who takes that risk. This creates a powerful incentive for the developer to complete all phases of the project. While the City will never be able to mandate development, Pay-As-You-Go can be used to create strong and appropriate incentives in some cases.

Summary

Pay-As-You-Go TIF is not a magic bullet. It is commonly used by other municipalities. Some even specify that only Pay-As-You-Go TIF deals will be considered. It's important that policymakers understand the advantages and disadvantages relative to the traditional method the City uses to make TIF awards. Ideally the policy would leave either option open and, if desired, provide guidance on the types of situations where one method or the other should generally be preferred. The policy could be written to encourage consideration or preference of Pay-As-You-Go in the cases of major projects, complex projects, or multi-phase projects.

PART 2: AFFORDABLE HOUSING

Current Policy

Current TIF policy contains the following language about affordable housing:

> (6) **Affordable or Workforce Housing** (rental or owner-occupied)
>
> (a) TIF Assistance for Affordable **or Workforce** Housing. Affordable or workforce housing projects may apply for conventional TIF assistance provided they demonstrate "but for" to the City's satisfaction.

(b) 10% TIF Set-Aside. In each TIF district involving residential use created after October 1, 1999, at least 10% of the anticipated district-wide increment shall be reserved to assist in the development of affordable or workforce housing within the TIF District under program parameters and guidelines adopted by the Common Council. In cases where the gap is greater than 50% of the present value of tax increments generated by the project ("i.e. the 50% Rule"), the City may provide funds from the set-aside to fund the gap.

(c) Dane County Median Income. The affordable housing units shall be made available to income certified households at or below 80% of the Dane County median income, adjusted for family size for rental housing and 100% of Dane County median income for owner-occupied housing. By adopting this income standard, it is the intent of the Common Council to encourage the development of mixed-income affordable housing, which should include housing units at low and very low-income levels.

And:

Repayment Through Increment. Non-profit affordable housing projects must generate sufficient tax increment to cover or repay only the TIF contribution that is not provided by the Affordable Housing Set-Aside Fund.

On one hand, the policy calls for setting aside funds in some TIDs to support affordable housing. On the other hand, the policy states that a project must demonstrate that they pass the "but for" test to the City's satisfaction. The "But For" section states:

TIF assistance will be utilized as gap financing.

Challenges for TIF & Affordable Housing

There are two potential challenges for TIF and Affordable Housing: gap analysis and value.

First, the current language regarding "gap financing" sets up a potential catch-22. Affordable housing, almost by definition, requires some form of subsidy in order to achieve below-market rents. The most often looked to source are federal Low Income Housing Tax Credits, which are administered in Wisconsin by WHEDA (the Wisconsin Housing and Economic Development Authority). While the scoring protocol changes from time to time, projects can typically score higher if they have local participation (usually in the form of TIF). However, the credits are valuable enough that projects that receive may not exhibit a gap. So on one hand, the projects don't necessarily need TIF as a form of gap financing. On the other hand, projects may not attract the tax credits without a pledge of TIF.

The second challenge with affordable housing is that property values tend to be low (which means the amount of increment an affordable housing project generates is often low). Lower rents lead to less income which reduces the value relative to market rate projects.

Taken together, it's conceivable the City will face situations where a reasonable and otherwise desirable affordable housing project will request a TIF award that exceeds both the financial gap and possibly 50% of the increment that the project generates.

Policy Considerations

Here are a few ways that policymakers might wish to deal with affordable housing in the TIF policy:

1. Affirmatively state that Madison has a goal of developing a range of housing options, including affordable and workforce housing. In addition, make it the policy of the City to work with both for-profit and not-for-profit developers to attract subsidized investment in affordable housing, including that backed by tax credits, low-interest debt, and other public programs.

2. Consider either eliminating the 10% set aside or crafting additional guidance to make it work. While an analysis of the set aside is beyond the scope of this memo, I think most watchers would agree it has not produced the desired result. While I believe it could be made to work as intended, I think there may be a simpler alternative.
3. Possible Alternative to the 10% Set Aside Language:
    a. Approve TIF awards to affordable housing projects based on demonstrating they pass the “but for” test by either:
        i. Gap analysis, or –
        ii. Demonstrating that other funding (such as LIHTC) is likely to be contingent on City participation through a vehicle such as TIF
    b. Underwrite TIF awards for affordable housing projects based on either:
        i. The net present value generated by the project, or –
        ii. If the TID is sufficiently healthy, provide a TIF award appropriate to the project based on the strength and/or youth of the district (In other words, consider treating affordable housing like a hybrid of private development and public infrastructure when the TID is financially healthy)
    c. Anticipate the provision of TIF for affordable housing (in accordance with guidance above) in the development of TIF project plans when affordable housing is consistent with adopted plans for the area included in the TID.