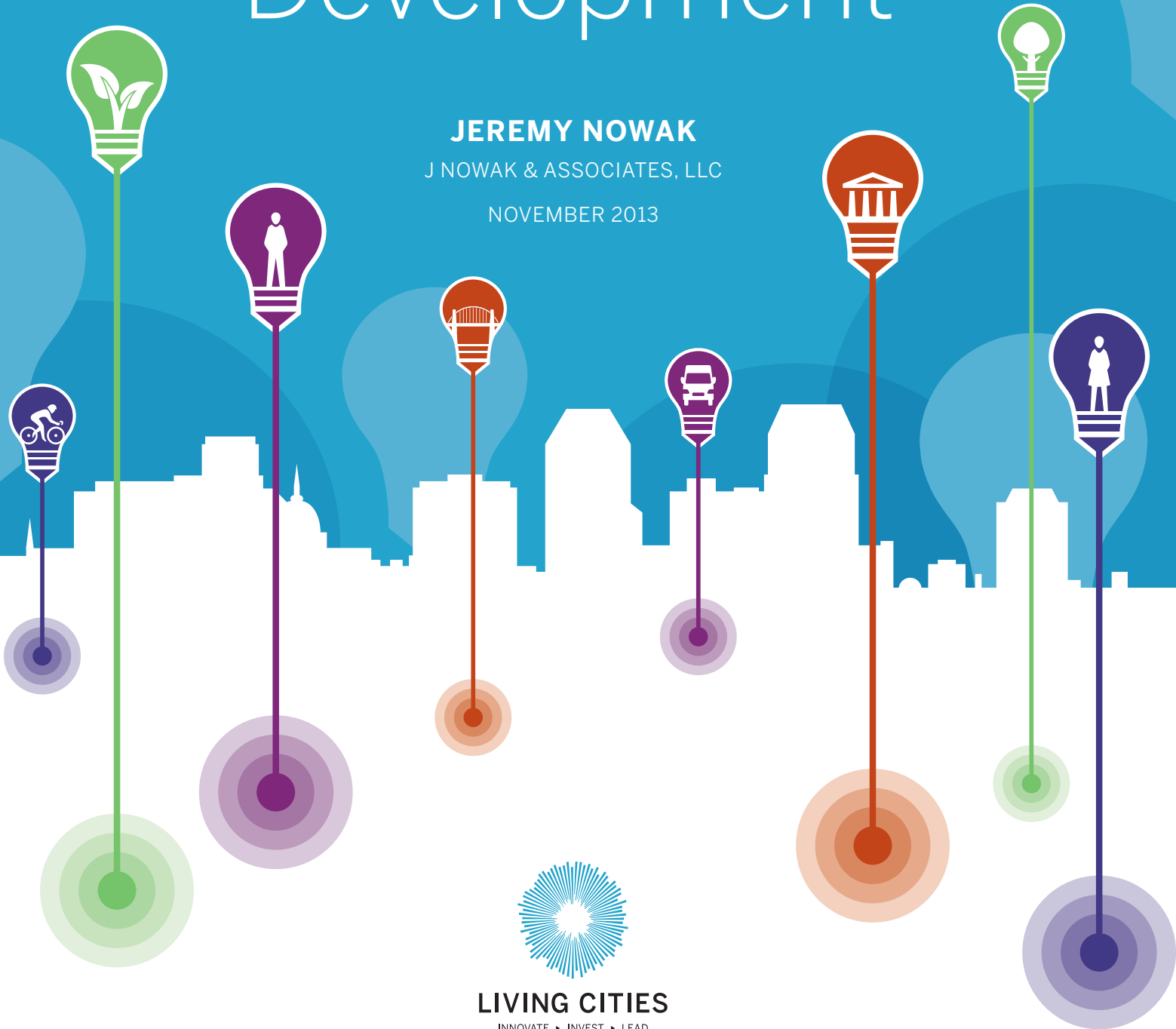


Smart Subsidy in Community Development

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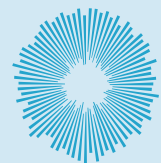
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Smart Subsidy in Community Development

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LIVING CITIES

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The goal of community development is to bring low-income people and low-wealth places into the economic mainstream through targeted financial investments, real estate development, social service and human capital interventions.

From the earliest community development corporations and community action programs to recent tax-incented investment policies, public and private subsidies have played important roles in the field.

Yet there has been relatively little written about the use of subsidy in our field apart from observations about market failures and the costs incurred by public-private partnerships organizing place-based revitalization. And very little of what has been written reflects the experience of practitioners. Most practitioner conversations about subsidy revolve around advocating for the preservation or expansion of particular programs and how to best translate program guidelines into viable projects. That should be no surprise. Advocacy and the explication of regulatory mechanics are common to any industry that uses public resources and is subject to public regulation.

The lack of reflection on subsidy in community development is, however, in contrast to its extensive use in the field. The core institutions of community

development are supported by both public subsidy and private philanthropy and the majority of real estate projects undertaken in support of low and moderate-income communities utilize some form of subsidy. Community development financial institutions are launched with subsidized capital and make extensive use of subordinated debt and various credit enhancements to facilitate conventional capital flows.

This paper is a practitioner's reflection on subsidy, particularly as it relates to place-based real estate development and financing. I define subsidy as non-market capital allocation that does not receive a conventional return on its investment, assists in creating market returns for other (conventional) capital sources, and/or is permanently embedded within a project's cost without potential for recapture or re-circulation.

I define social inclusion as maximizing economic participation and capacity in line with agreed upon cultural norms.

My purpose in writing this paper is to open a conversation about subsidy as a way to improve community development practice. I believe that this is particularly important during a period of budget cutbacks at the local and federal levels. The paper argues three things:



The rationale for subsidy in community development is largely the same as the rationale our nation uses in economic development practices more broadly with one additional factor at play: community development's explicit concern with social inclusion. Because community development is a bridge between catalyzing economic growth and facilitating social inclusion, there are additional costs to consider. I define social inclusion as maximizing economic participation and capacity in line with agreed upon cultural norms.



An efficient use of project level subsidy must adhere to one or more of the following principles:

- a) project level subsidy is best when it is limited and least intrusive;
- b) subsidy ought not exacerbate or obscure existing operating inefficiencies;
- c) subsidized capital – where possible – should have a market-building time horizon or expiration date; and
- d) it is best to use subsidy to arrive at the most direct route to achieve an intended outcome. While this is by no means an exhaustive list, these four principles are useful starting points to frame a conversation.



A focus on **smart subsidy** (*subsidy that is efficient and appropriate to the task*) requires analytical tools to support those practices. In the absence of strong analytical tools and the standards they generate, it is harder to distinguish between better or less desirable uses of subsidy.

Subsidy in Community Development Practice



To illustrate these issues I use examples from the portfolio of The Reinvestment Fund (TRF), a community development financial institution that has provided more than a billion dollars of financing in some of the poorest urban communities in America. TRF also provides data and policy analysis, specializing in spatial-statistical models to portray development trends. From its inception in 1986 until 2011 I was the CEO of TRF.

Using examples from TRF is not an argument that TRF did a better job at deploying or financing projects through smarter uses of subsidy than did other organizations. Sometimes TRF did a good job on that account and at other times the organization participated in relatively high subsidy and low efficiency projects.

TRF, like all organizations of its kind, exists within a particular community of practice and responds

to projects and capital deployment opportunities within the confines of that practice. In fact, lenders sometimes like high subsidy projects to the extent to which it diminishes the amount of required debt and offers greater protection for their loans. But TRF did develop a perspective on subsidy that drove aspects of the organization's lending and public policy. My comments reflect that attitude and perspective.

The Rationale for Subsidies



Community development is a fifty year-old place-based approach to poverty reduction and economic inclusion. Public policy distinguishes between people- and place-based approaches. A people-based strategy treats individuals in abstraction from a community context by offering benefits that travel through the household, labor market, or other non-local relationships. Place-based interventions travel through a specific spatial context. In practice, place and people approaches lose much of their distinction as people-based strategies are often pursued through place-based institutions and place-based institutions expand program coverage well beyond their earliest organizing geography.

The use of subsidy in community development assumes a broader policy and philosophical perspective regarding how we balance the roles of markets, the public sector, and civil society; as well as our approach to poverty alleviation. All modern societies have operating assumptions regarding the role of public investment in support of economic

growth and poverty reduction. These assumptions change over time. American history exhibits shifting perspectives in its emphasis on market-oriented versus public solutions, from periods of significant public regulation and investment to periods of high levels of deregulation and greater market autonomy.

The use of subsidy in community development during the past five decades largely reflects the general rationale for subsidy in economic development as it relates to three categories of investment:



Investing in Physical Infrastructure



Providing Intangible Public Goods Linked to Human Capital and Public Safety



Addressing Market Failures Related to Business Formation



In addition, community development adds a fourth rationale to these three; the expansion of social inclusion.

Physical Infrastructure



Most people agree on the importance of public investment in support of basic economic infrastructure such as highways, bridges, water and sewage systems, and utility connections. The public goods that comprise economic infrastructure reflect what we believe culturally to constitute a commons, as well as our understanding of what prohibits public goods from being produced privately (market failure). The logic of public infrastructure is rooted in the cultural priorities of universal access and the fact that the cost of creating a public good to any individual firm exceeds its ability to be repaid given the assumptions of universal use and the requirements of a reasonable investment return horizon.

Of course, the notion of public infrastructure as it is commonly used in economic development strays far beyond streets, highways, utilities, or even public facilities like schools, recreation centers, parks, and municipal centers. The modern American city subsidizes – often at great levels – investments into stadia, cultural venues, convention centers, and other facilities defined by some as foundational to economic competitiveness. There are arguments pro and con regarding the use of such subsidies, largely revolving around the public return or economic impact of the investment. But the point is that the popular meaning of *infrastructure* expands or contracts based on historical context and ideas about economic growth and public spending.

Public infrastructure investments in community development are often linked to the re-purposing of older assets to create new housing or commercial developments. The infrastructure investments into older, often former industrial sites may involve re-use and remediation costs that are greater than the costs associated with virgin land development in suburban green fields. These legacy costs often require expensive boutique design and development solutions due to existing land use patterns. When the cost of re-use cannot be done on a market basis, public investments, such as brownfield remediation, become essential. Legacy costs to redesign, re-purpose, and upgrade sites can either be incurred by conventional development and investment (but only if the returns can justify the expense) or they require a public investment to *normalize* the opportunity.

Expanded notions of public infrastructure common to all manners of city building are also important parts of neighborhood revitalization efforts. Public spending on cultural centers and a variety of other public and privately owned (usually nonprofit) amenities is commonplace. The extent to which civic institutions with a public purpose ought to receive public resources for physical plants and operations is often debated. These neighborhood subsidies often pale in comparison to the public subsidy showered on a stadium or convention center. But the substance of the debate is the same.

Intangible Public Goods



Intangible public goods essential to economic growth include education and the maintenance of social order. Many of these functions are partially privatized (e.g., private education, private security) and also organized by civil society; but they remain a pre-condition to a thriving economy. Indeed it is clear that the advantages enjoyed by the U.S. over the past century had a great deal to do with our early adoption of universal public education and our capacity to maintain stable political institutions that allow for the orderly processing of market activity. Some today question our ability to remain economically dominant in the absence of sweeping changes in schooling.

Effective investments into human capital and public safety are critical redevelopment levers for low-income communities; school performance is positively

correlated with real estate values; and the assumption of public order expands opportunities for business growth by increasing retail hours, creating easier access for consumers, and lowering the operating costs of businesses through lower insurance premiums and the like.

Practitioners involved in rebuilding low-income places are often forced to go beyond the ordinary system of public education and policing to identify novel civic arrangements able to foster higher expectations. Thus community-based policing and the creation of more than 6,000 charter schools in the United States has become an important part of community development. Similarly business improvement districts in downtowns or neighborhood commercial districts reflect the need to offer amenities not provided by ordinary public sector mechanisms.

Other Market Failure Related to Business Formation



There are also other market-making public investments apart from large-scale physical infrastructure or intangible public goods. These interventions address an actual or perceived market failure; that is, the inability of normal market mechanisms to produce goods or services and hence allow for business formation or growth in an efficient manner. A market failure can be caused by a number of things including information asymmetries, relatively high market entry costs, and financing risks that cannot be managed by conventional credit intermediaries. There is a great deal of debate in economics regarding what causes market failures and whether government intervention is always the right solution.

Public investments designed to overcome market failure can be place-based (e.g. specific areas impacted by some extraordinary local cost); sector specific incentives (e.g. early stage research and development in the computer chip industry); or, related to the stage

of a firm's development (e.g. higher risk, start-up companies). Place-based cost issues are common in community development, but there are also a variety of sector-specific issues germane to development in low-income areas. And of course, many of the business or enterprise investments in community development have start-up risks or face other barriers to expansion and viability.

Information asymmetries have received a great deal of attention in community development research, particularly related to retail location. It should be noted, however, that solving the information problem does not in and of itself make cost disparities disappear. Quality information is a necessary but not sufficient basis upon which markets can be catalyzed in distressed areas. It is one thing to demonstrate to retailers that there is more income in an inner-city area than they may have understood; but it is another thing to understand the extra costs involved in that location and then devise ways to manage those seemingly inherent disadvantages.

Social Inclusion



A fourth category of public spending, largely absent from most economic growth conversations involves social inclusion.

The assumption within most community development work is that their projects cost more because their mission is to provide services and subsidize income in ways that conventional developers do not. This is often clearly justified by the mission and products that are created. A great many residential and commercial real estate developments financed by community development organizations involve specialized subsidies in areas as diverse as childcare,

healthcare, elderly housing, and supportive housing for special needs or homeless families.

As with other public spending, the use and value of various social inclusion expenditures can still be subject to wide debate. There are obvious impact considerations in terms of cost versus benefits and there are always issues of the kinds of incentives embedded within the projects. How, for example, do subsidies incent or dis-incent people from entering the labor market, competitively choosing goods and services, developing skills, and expanding social networks?

The difficulty of community development derives from its dual role dealing with conventional market failure while also trying to maximize value for the most marginal participants in the economy. Community development's balancing of market imperatives and social inclusion is the source of its creativity but it can also be a source of its marginality economic growth policy, as it represents a service-oriented notion of city building.

The Value and Efficiency of Subsidy



Subsidy comes in different forms, ranging from market-oriented incentives to direct public grants. The closer a subsidy is to functioning like a market instrument; the less it is thought of as subsidy. Consider tax-exempt bond financing.

Bond investors take market risk, and bond ratings are based on market criteria. Pricing may be reduced due to tax savings or a public guarantee. This represents a type of subsidy. Still tax-exempt bond markets are established enterprises that utilize a full array of market intermediaries, are subject to market pricing fluctuations, and are organized through predictable systems of exchange, valuation, and liquidity.

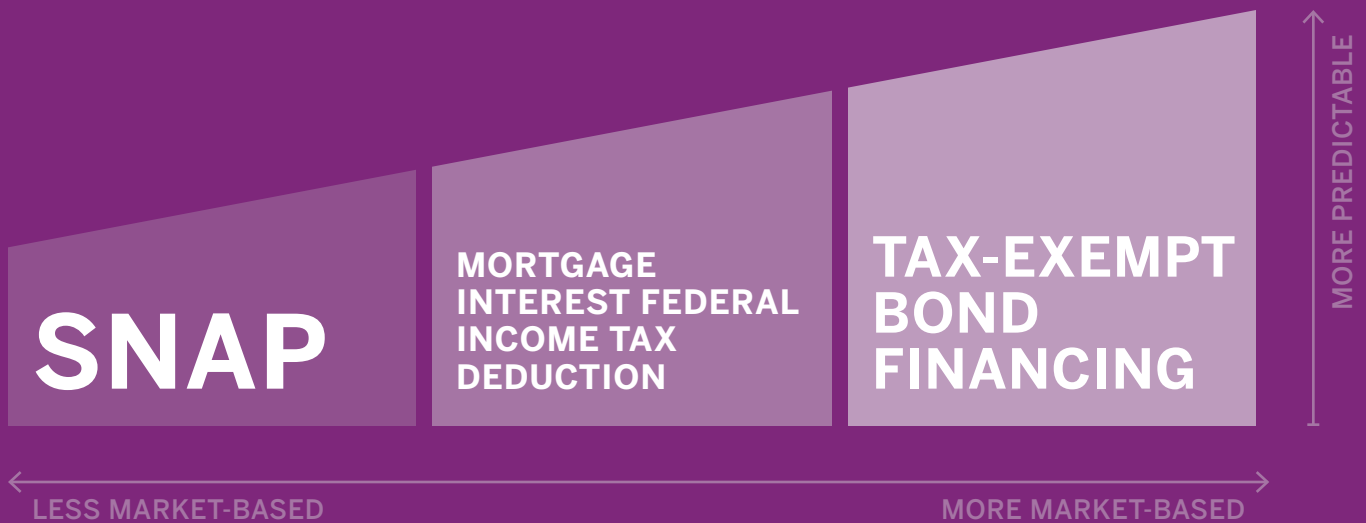
Another market-oriented subsidy is the mortgage interest Federal income tax deduction we take for granted in every homeownership transaction. This is such an integral subsidy that we do not think of it as such and yet it represents the largest annual public investment in housing in the nation; backed politically by every market-oriented sector of the home building industry.

Contrast tax-exempt bonds and the deduction on mortgage interest rental income vouchers and food stamps (SNAP). Cash grants for rent and food have more of the characteristics we assume when we hear the term subsidy. While they also facilitate market participation (in housing investment or the support of local food retailers) and have accepted economic multipliers, they are thought of differently. Unlike bonds they cannot be bought and sold by the public at large and they are dependent on annual public budget allocations. And unlike mortgage interest deductions, they are explicitly income targeted.

The value of market-based subsidy instruments has to

do with its greater supply and predictability because it has self-organizing incentives for origination, purchase, and trading. A cash grant may have flexibility because it does not have investors in the formal sense, but it is constrained by the uncertainty of supply and other public regulations and allocation systems. The same is true with philanthropic subsidy; it can range from extreme flexibility to high levels of restriction depending on the contractual agreement between the grantee and grantor. But even when it is most flexible, its value is constrained by its limited supply and lack of predictability.

In either case – market-based subsidy or a grant allocation – the value of subsidy is also determined by its project-level efficiency. The issue is not whether subsidy is necessary in a generic sense; it has an important role and that is one of the assumptions this paper makes. The question for community development practitioners is how to use subsidy in ways that maximize social value and market leverage. Below I outline four guidelines or rules for thinking about more efficient uses of subsidy.



RULE #1:**Project level subsidy is most efficient when it is limited and least intrusive.**

The most efficient subsidy is often the least subsidy or that subsidy which interferes least in the development process. Anyone who has financed a project or developed a piece of real estate knows that development is most easily implemented if the sources of funding and regulations are kept to a limit, particularly through the construction process.

If optimal market conditions are at play in single-family housing development, developers use their working capital or a loan for land acquisition and then they obtain a construction loan to build the units. Each unit repays the construction and land cost through a mortgage obtained by the buyer. Few sources of finance are required. What is required is the ability to understand the market. If you get the cost of development, the level of market demand (absorption rate), and the sales price right, you make money. If not, you can lose money.

In contrast, if a unit requires subsidy, the sources of financing and their attendant regulations are layered on top of each other. As necessary as the subsidy may be, its use can slow a development time line, increase project costs, and distort the normal pricing mechanisms.

All things being equal in terms of social value (the quality of the units produced and the incomes of those that buy or rent the unit), developers able to deliver housing and commercial real estate units without subsidy or at lower levels of subsidy should be given priority in terms of public assistance, including the sale or provision of vacant units or land.

Most examples of non-or limited subsidy development occur outside of the community development industry and are not known to low-income housing agencies

and private philanthropy. They are often carried out by small-scale developers familiar with local markets but out of sight of public agencies. A shortcoming of community development is that we have not spent more effort identifying those developers and nurturing their business growth, including connecting them to supportive civic institutions.

Many housing and commercial real estate projects require subsidy due to the difference between development costs and real estate values or the difference between development costs and what a typical renter or buyer in that market can pay. One solution to this problem is to simply allow the market to determine the consequences; which will mean that nothing will be built until values and incomes shift; or some new demand (by income or use) emerges. In fact in cities that have lost significant population during the second half of the twentieth century, long-term vacancy is the default solution most of the time. But if we decide to develop despite market constraints, subsidy will be required. If the policy decision (and it is a policy decision) to build is pursued, it is still possible to give preference to subsidies in ways that create more efficiency.

One strategy is to create enough mixed income (subsidized and non-subsidized) product that it is possible to cross-subsidize within the project and therefore not as deeply from external sources. Internal subsidy is always more efficiently used than external subsidy. Anyone who has worked in an organization or business where certain lines of business are subsidizing the start up costs or losses of another line of business knows that budgeting can be a tense time for decision making, forcing people to come to terms with cost efficiencies.

Another strategy is to use forms of subsidy that arrive after the project is finished and therefore limit regulatory costs added to the construction process. This is most commonly done through tax abatements to homeowners, or direct rehabilitation grants to prospective homebuyers. These forms of subsidy widen demand for the product without interfering with the development and construction processes.

The first and most basic principle of subsidy allocation ought to be that we prioritize and incent projects that utilize the least subsidy for the greatest social value.

This is why employer-assisted housing subsidies have often been effective. They incent a market through loan guarantees and sometimes cash rehabilitation grants without transforming the process of development into a subsidized housing project. For instance, the University of Pennsylvania's housing program has used a range of programs including mortgage guarantees, enhanced forgivable loans, and closing cost reductions to avoid public subsidy requirements. Simplicity is always a virtue in these cases but it requires either the right market conditions or the right balance sheet to enable the transaction.

Not surprisingly, the most complex subsidies are often linked to very low-income rental housing. Rental income is often subsidized by income vouchers; credit risks may be managed by everything from tax exempt bond financing to subordinated debt from specialized credit intermediaries; equity investments come from tax credit incentives, and so forth. Moreover, some programs employ direct grant allocations. Subsidy is used to lower debt burdens that cannot be supported by real estate values, to increase operating income, and to facilitate private investments, and/or subsidize the risk and cost of capital.

It is not uncommon for low-income rental projects to have three or four kinds of subsidy (or more) on a single project along with private debt. Moreover, housing development for a special-needs population may use additional operating subsidies linked to ongoing social support programs. This is the cost of an additional social inclusion strategy.

Real estate subsidy is also used to create early stage product premiums (embedded in the price and/or the qualities of the product) that the market could never produce by itself. And in fact there may be a longer-term market rationale at work here. To rebuild a distressed market, the new housing product must represent a premium not found in the existing market. This builds the market trajectory in terms of longer-term values and it draws broader consumer demand (i.e., from outside the community) than might be available by adding the same housing product back into the market. It represents a bet on the longer-term direction of the area. Bets on the future are always present in real estate investments that developers and consumers make, but sometimes with far greater certainty.

If we accept the idea that subsidy must be used in certain housing developments, we can still build a case for using the lowest amount of subsidy necessary. The first and most basic principle of subsidy allocation ought to be that we prioritize and incent projects that utilize the least subsidy for the greatest social value. We do not want to lower the level of subsidy to a point where product quality is compromised and hence further degrades the market, but with that important caveat there are choices to be made.

While this seems obvious on a project basis, it is often not adhered to or explicitly valued either by developers or the allocators of subsidy. If we follow the principle of limits, we would agree that the less project subsidy the better, in that there would be more subsidy to use for other projects and there would be a greater level of private market leverage attracted to the projects.

CASE STUDY

Let me cite an example, however, where there was a long-term historical resistance to low levels of subsidy use. The Reinvestment Fund has provided debt financing in West Philadelphia for nearly 1,000 units of scattered site rental housing sponsored by a private company called Neighborhood Restorations (NR). NR had a very simple but effective business model. They bought privately owned housing units with lines of credit provided by TRF and other lenders and then financed the units using equity investments incented by the Low Income Housing Tax Credit (LIHTC) and private debt. In contrast to how most LIHTC projects were done in Philadelphia and in other parts of Pennsylvania, NR used almost no subsidy outside of the LIHTC (although most of their tenants came with Section 8 income vouchers not attached to the project).

Similar rental projects in Philadelphia most often coupled LIHTC with federal and state grant subsidies, as well as some private philanthropy. In fact, it was common for the State Housing Finance Agency (PHFA) to insist on deeper subsidies, in part, because it had early experience with rental projects that were too thinly subsidized and ran into problems later. From their port-folio experience, the deeper the subsidy, the lower the private debt, the safer the property was from default. It was an understandable logic on the part of the agency.

NR development costs and operating costs were significantly lower than most comparable projects in part because they were effective developers who knew their market and were able to manage construction costs effectively, and, in part, because they did not have the extra costs driven by additional subsidy compliance issues in low-income housing. Moreover, their profit incentives were based on bringing projects in at as low of a cost as possible, while still keeping

them in demand for tenants who had other choices (including higher subsidy unit choices).

They were remarkably market-oriented in a heavily subsidized arena that often seemed to discourage private leverage. But rather than being valued by the policy environment, they were regarded with suspicion by some public officials, other nonprofit developers, and some philanthropists. The conventional wisdom was that there had to be something wrong. It was too good to be true and so it must not be.

The chief critiques were that NR's construction quality or property management was below the standards of other developments. TRF never found this to be true (although their new construction was not at the highest standards in the portfolio in terms of amenities) and, as the scale and civic influence of NR's portfolio of units expanded, the developer was accepted by some of their earlier critics. Sometimes this only happened after public agency audits of NR's rental management were undertaken.

Still NR or others were never able to get a preference in tax credit allocation based on their low development costs and lack of external subsidy (outside of LIHTC). The value of limits was not explicitly preferred through the allocation system and yet it would clearly make public policy sense to make such considerations part of a competitive scoring system.

There were two reasons why this preference was not affirmed: 1) fears of non-sustainability and 2) the culture of local development.

The fear of non-sustainability is the more rational of the two reasons. The cheapest in the short term is certainly not necessarily the best or the cheapest in the long term. In a situation where you are trying to finance assets in a distressed community, building down to the market in a shoddy way is problematic. And overloading projects with debt that is not ultimately sustainable can have terrible long-term consequences. We have all learned that lesson. Thus the suspicion of low costs was a suspicion regarding community value and asset viability. While this could be largely refuted, and was often couched in generalized suspicion of for-profit developers and motives, the suspicion was understandable, even when it proved to be wrong.

The culture of local development is more vexing. Any community of practice creates norms regarding how things are done. In subsidized housing development, where cost containment is not always a factor in profitability, the community of practice creates a consensus around a non-competitive cost. A higher cost is covered by more public subsidy, as long as it is available. In the most extreme cases – when the public sector becomes the developer – cost containment is easily ignored because the subsidy bank and developer have no reason to hold each other accountable. Many public housing developments are ground zero for this kind of inefficiency.

If the culture of expectations becomes too distorted, demonstrating lower costs for comparable units

causes embarrassment to other developers and the development community reacts predictably; it tries to de-legitimate efficiencies that would be valued and imitated in a more competitive market.

The rule of limits – as long as it can be shown to provide high-value construction and management in keeping with longer-term sustainability and development – ought to be affirmed as the major principle of smart subsidy. Where it is not affirmed, the social value of a limited pool of subsidy will decline.

RULE #2:

Subsidy should not mask avoidable cost inefficiencies.

Rule number two of smart subsidy requires that we do not use subsidy to mask or reinforce cost inefficiencies. There are many reasons why a product's cost can vary by region. In real estate development cost variation reflects material costs, land values, environmental remediation requirements, labor costs, and local regulatory issues. While cost variation is unavoidable, there are costs that can be avoided which are sometimes masked by subsidy.

These avoidable inefficiencies can be placed into two primary categories: 1) process costs and 2) monopoly costs.

Process costs have to do with the ways in which the public sector provides the basic services of development, from land assembly and zoning to licensing and approvals. Many cities are ill equipped to respond to development, in large part because they have spent so much time managing decline. The existing processes are slow and unpredictable and this increases risk. A developer is more likely to tolerate process inefficiency in a market where the end product will compensate for added transaction costs. But if the end product is only marginally profitable or has risk of non-profitability, then process uncertainties are barriers to entry and limits to production.

CASE STUDY

In Baltimore, TRF's real estate development company (TRF-DP) works with a citywide coalition of congregations to redevelop sections of East Baltimore. The land assembly process was slow despite the best efforts and intentions of several public sector managers and elected officials, with whom TRF-DP and the congregations have strong working relationships.

In the early stages of development TRF-DP paid market prices for publicly owned land through a competitive bid and was willing to pay for the city's initial legal costs for the transfer of title and cleaning of the liens. But even so, the process took more time than any entrepreneur without a social motive would be willing to incur. Thus only a social entrepreneur with adequate working capital could enter the market; others make a rational choice to stay out.

I could cite similar examples in other cities where the transaction cost cannot be justified by the profitability of the end product. The question that must be asked is to what extent is the provision of subsidy a way of defraying unnecessary process costs? And can subsidy create a rationale for keeping inefficient processes from being reformed? After all, why change if someone is willing to pay to keep the status quo in operation?

The second category of avoidable inefficiencies is monopoly costs, which can have dramatic consequences. Monopoly here refers to a variety of things: limitations on developers and contractors involved in a specific field or limitations on the supply of materials, labor, or technology. In Philadelphia, the greatest cost of monopoly has to do with building trade labor and the ways it has determined the cost and technology of building. No development of any significant size can be undertaken in Philadelphia if it is not done through contractors that use the local building trade unions. This creates a cost monopoly reflected not only in higher labor costs, but also in specific restrictions regarding technology and materials.

A particularly bizarre example of these material restrictions involved the insistence by the plumber's union in Philadelphia that no PVC piping be used as a replacement for the more expensive copper and cast iron pipes. In perhaps the most comical of monopoly cost dramas, the plumber's union allowed a brand new skyscraper (The Comcast Center) to be built in downtown Philadelphia with environmentally friendly waterless urinals, only under the condition that piping used that would have been fitted out in traditional urinals. They were able to use their political power with the zoning board and the political class to install pipes to nowhere.

Union labor through the building trades generally is of a very high quality in terms of the product they deliver. After all, the building trades are craft unions with their own apprenticeship programs. But there is a dramatic difference between the meaning of that premium to contractors and developers versus the value of the premium as calculated by the building trades.

CASE STUDY

More than a decade ago, TRF was asked by Mayor John Street (then Mayor of Philadelphia) to build a cost model for constructing the same housing unit using different development scenarios. The table below demonstrates the four scenarios that we used. In each scenario we excluded the cost of land and we held the cost of capital constant. We concentrated only on the hard and soft costs of development. Remember that these prices are quite old and would be out of date today.

AN ANALYSIS OF NEW CONSTRUCTION RESIDENTIAL DEVELOPMENT COSTS

| COST | UNSUBSIDIZED | | | SUBSIDIZED |
|--|------------------|---|-----------------------------|------------------|
| | SUBURBAN | CITY WITH COMPETITIVE UNION AND NON- UNION LABOR MIX | CITY WITH UNION LABOR | CITY |
| Year | 1998 | 1999 | 2001 | 2001 |
| Square Feet | 2,150 sq. ft. | 2,150 sq. ft. | 2,150 sq. ft. | 2,150 sq. ft. |
| Unit Size 4 BR / 2.5 BA | 4 BR / 2.5 BA | 4 BR / 2.5 BA | 4 BR / 2.5 BA | |
| Number of Units in Development | 183 Units | 78 Units | 71 Units | 50 Units |
| Average Sale Price | \$230,000 | \$230,000 | \$230,000 | \$55,000 |
| Hard Costs | | | | |
| Land Remediation | \$200 | \$8,200 | \$8,200 | \$8,200 |
| Infrastructure | \$7,500 | \$9,750 | \$9,750 | \$0 |
| Labor and Materials | \$79,410 | \$83,586 | \$113,566 | \$164,456 |
| Building Permits | \$1,058 | \$1,509 | \$1,509 | \$1,500 |
| Total Hard Costs | \$88,168 | \$103,045 | \$133,025 | \$174,156 |
| <i>Adjusted for Inflation to 2001</i> | \$94,428 | \$107,785 | | |
| Soft Costs <i>includes Professional Services, Builder Overhead, Financing Costs, etc</i> | \$39,100 | \$39,100 | \$39,100 | \$39,913 |
| TOTAL DEVELOPMENT COST | \$127,268 | \$142,145 | \$142,145 | \$211,069 |

Scenarios one and two were taken from actual developments in 1998 and 1999 that were identical in terms of housing size and materials. In scenario one, the housing unit was built in an open shop, largely non-union environment in suburban Philadelphia. In scenario two, the housing unit was built in Philadelphia with a combination of union and non-union labor, with the unions providing their most competitive rates. In scenario three, the housing unit was built with the full rate of the building trades unions. In scenario four, the house was built with the full rate of the building trades unions plus the costs incurred by the use of other forms of development subsidy and managed by a local community development organization.

The first scenario resulted in a cost of \$127,000; the second a cost of \$142,000; the third a cost of \$172,000, and the fourth a cost of \$211,000. Scenarios one and two were similar models built

around the same time (1998/1999). Scenarios three and four were abstracted from developments two years later (2001) where we modeled the differences in design and square footage to get to the best approximation of the earlier units. The two-year difference represents some increase in labor and materials but not a significant enough difference to result in the cost delta from the 1998 and 1999 models. The first three housing units were sold for approximately \$230,000 and the subsidized units (scenario four) were sold for \$55,000, thus requiring a huge public grant.

The variation is dramatic from scenarios one to four. Even if we were committed to using all building trade union labor, it is clear that the right circumstances can get us a dramatically lower cost, which should increase housing affordability and decrease the level of subsidy utilized.

Monopoly costs also relate to the limited capacity that exists in non-competitive markets. The competition between developers and an economy of scale that would allow developers to negotiate better terms with contractors and materials vendors are not available in a smaller niche market. This is not just a matter of the development size of a particular project but the differences in total development that a company is undertaking at any one time.

In the most extreme examples of monopoly costs in a city like Philadelphia, we have a housing market with two segments: a relatively high-end market where the costs can be justified by the anticipated future returns and a low-income market where the added costs can be subsidized by the public. In fact, subsidy is often used in both segments of the market; tax abatements are used to spur development at the higher end (largely a way to make up for an outmoded and non-competitive wage tax) and subsidies drive

the low end. In this environment, the prospect for middle-income new housing development is relegated to suburban developers or in areas in the early stages of gentrification, where prices have increased enough to justify development but not so much as to limit the scope of market demand.

RULE #3:

Subsidy should have a market-building time horizon.

A third category for smart subsidy is the capacity to choose places or products with a market-building rationale.

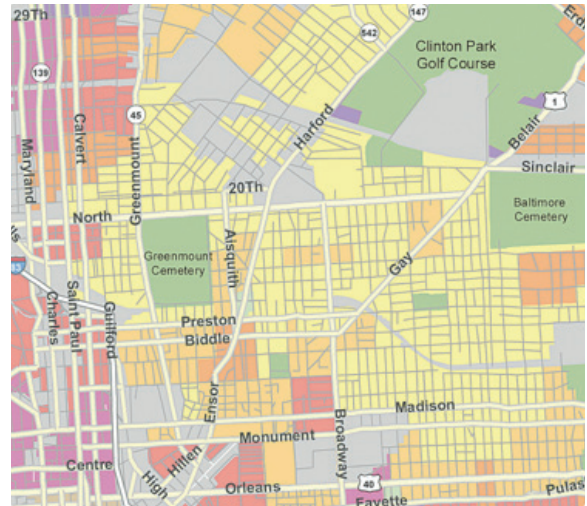
In Baltimore, the community TRF Development Partners was trying to rebuild was in a significantly distressed area called Oliver, that we thought had future market viability due to its locational advantages (proximity to transportation and institutional assets). While the original interest in working there came through a relationship with a group of congregations (Baltimore BUILD), the methodology for thinking about the best way to intervene had to do with an analysis of the market ecology within which the community existed, as well as the patterns of market value within the community itself.

When TRF began to work with the local community, it carried out a citywide survey of market conditions. The map below is a TRF-Market Value Analysis (MVA) of the city of Baltimore based on a statistical cluster analysis using variables such as sales data, mix of residential and commercial properties, vacancy rates, housing tenure, and foreclosure activity.¹

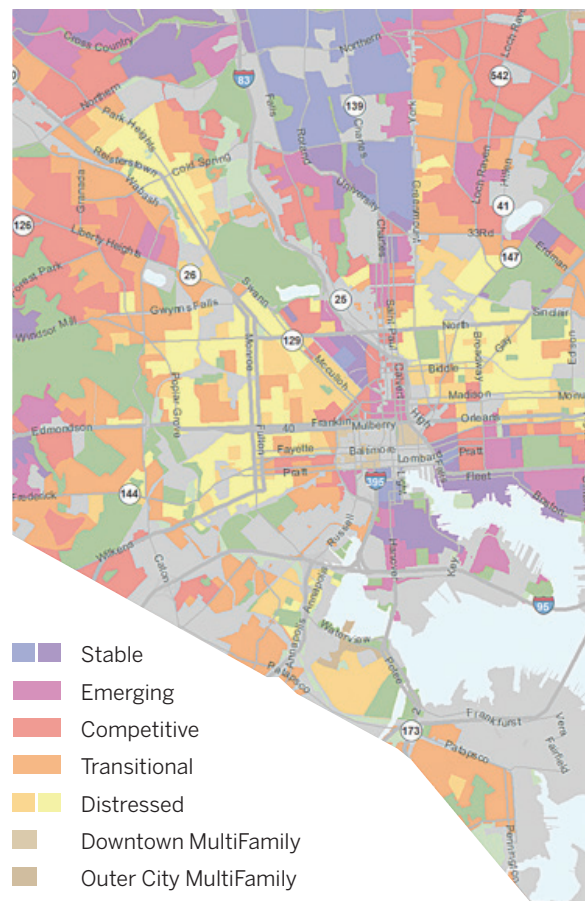
If we look at the city's MVA the areas in yellow are the lowest performing in the city whereas areas in blue and purple are the highest performing. The second map is a close up of Oliver, the project area, using the same analytical tool. TRF-DP work in Oliver has possibilities because of its proximity to the stronger markets and peripheral market strength at the edges. The important questions are where do you start development? And how much is necessary to catalyze change?

The original strategy was not to redevelop the abandoned units in the worst areas but to first concentrate on the relatively stronger areas. Moreover, TRF-DP decided to price the units in such a way as to manage a process that requires less and less subsidy over time. The Oliver development project assumes a relatively high level of subsidy in its early years and a declining level of subsidy in the future, until a price point is reached that will allow for an entirely market-based development project. As in many projects of this sort, the

1. The Market Value Analysis was created by Dr. Ira Goldstein, the Director of Policy at TRF, who deserves credit for developing the product. In the city of Baltimore, Sean Closkey and Graciela Cavicchia from TRF's real estate development subsidiary (TRF-DP) deserve credit for using the work of the MVA as a tool to help them decide where, what, and how much to develop.



DETAIL OF OLIVER MARKET VALUE ANALYSIS



- Stable
- Emerging
- Competitive
- Transitional
- Distressed
- Downtown MultiFamily
- Outer City MultiFamily
- Non-Residential Blockgroup
- Other Non-Residential (Over 1M sqft)
- Parks/Recreational/Green Space
- Undeveloped
- Water

Even in a dramatically distressed community, there may be ways to limit subsidy allocation over time if you make smart choices regarding where you invest first and the rates of ongoing investment over time.

Oliver development also assumes that the development organization not only will have to build a premium into the first units, but also take on projects in the short term that make no immediate or short-term market sense, although they may help to maximize long-term value.

For example, TRF-DP bought out a liquor store that was a source of criminal activity and got rid of the liquor license rather than selling it to another vendor. They paid a higher price for the store than it was worth on the market; it was simply worth more to TRF-DP to get rid of than it would be worth to others who would want to have it for the same use. This should eventually lead to an increase in values in the community, but it is not something that TRF-DP could immediately capture in a housing price in any significant way.

Even in a dramatically distressed community, there may be ways to limit subsidy allocation over time if you make smart choices regarding where you invest first and the rates of ongoing investment over time. Residents must get the signal that there will be predictability to the upward movement of values. This helps to create better decisions regarding investing in local properties by existing and new owners.

Just as a place-based development scenario can project a time horizon of diminishing subsidy, sector specific investments can be approached with the same market building perspective. Two examples in this regard with which TRF has had an extensive

financing background are urban charter schools and supermarkets in underserved areas.

An important area of TRF financing involves facilities and working capital financing for a variety of education, health care, and social services. The devolution of public agencies has opened up new opportunities for social enterprises and businesses that provide these services in the same communities where organizations like TRF have always financed housing and commercial developments. The largest TRF portfolio in that regard is charter schools. As of December 2012 TRF had provided \$250 million in financing to 76 schools, resulting in new school opportunities for 36,000 children.

From the perspective of capital markets, the significance of this portfolio was its quick transition from the highest-risk, most boutique product into something that functioned more like a predictable commodity. This shift demonstrates the dynamic quality and capacity of capital markets and the role of early stage subsidy, at least prior to the financial crash of 2008.

The first charter school transactions were difficult to underwrite. The schools were start-up businesses subject to novel public policies. The charters required re-certification after the first five years and could be revoked at any time. Moreover, because TRF financed working capital, construction debt, and mortgage debt for their facilities, they were working with start-up companies in an area that few schools understood

very well: real estate. In the first years of charter school financing it was clear that there would be no external source of liquidity; no other lenders were going to purchase the loans. In the most distressed areas of Philadelphia, facilities options were limited and it was often difficult to make the loan to value ratios satisfy even the most flexible lenders.

TRF subsidy came in the form of the pricing of debt (a debt return for an equity risk), a willingness to take very risky positions without being adequately compensated for that risk. TRF and many other CDFIs were incurring the cost of early-stage information and market building: understanding a new sector, building relationships with investors who had an interest in the sector, and creating underwriting criteria where there was very little to work with prior to CDFI entry.

After five years of making these loans, TRF developed a solid underwriting model that ensured (as much as possible) financial and program viability. That underwriting capacity enabled TRF to structure larger pools of debt dedicated to long-term charter school financing. The structured debt pools were a signal of gradual market acceptance and recognition of TRF's ability to lever their experience into an agreed-upon, standard underwriting box. At this point, the lending had moved in part from boutique transactions to something more commodity-like.

At the same time, other lenders were now financing projects directly or buying loans shortly after origination or after a specified period of maturity. Other investors were now in the market and ad hoc forms of liquidity were appearing. This meant that the notion of charter school risk was being activity priced and there was even some competition for the best schools – those that had proven their operational longevity through recertification and expanded into multi-school charters.

Five years later, TRF and other community development financial institutions (CDFIs) had competition for the best loans not only from other portfolio lenders, but also from banks offering tax-exempt bonds against which CDFI pricing and terms could not compete.

These banks saw these facilities through the same underwriting lens with which they viewed nursing homes or health care facilities, to which they also offer bond financing.

This relatively quick progression from boutique high-risk transaction to standardized debt through structured finance and finally to the tax-exempt bond market demonstrates, through a small example, the scaling capacity of capital. At each stage of evolution there was a new point of risk and market acceptance and hence new financial instruments could be used to provide liquidity to the market.

But the market-building initiative came from community development finance and its willingness to incur very high levels of risk in the early stages of product evolution. The CDFI subsidy was through concessionary pricing when evaluated against the actual risk of the project. This is not to say that many of the individual charter schools did not raise significant levels of private philanthropy and public subsidy in support of the schools. But the market could not have moved to anything approaching scale without debt being credentialed in the market place. And the credentialing process required an incubation period of high-risk, boutique lending.

But the market-building initiative came from community development finance and its willingness to incur very high levels of risk in the early stages of product evolution. The CDFI subsidy was through concessionary pricing when evaluated against the actual risk of the project.

TRF had to find new ways to extract financial value from the very innovations they incubated at various points in the market's development. This is an extraordinarily important point of sustainability for institutions such as TRF. They cannot only be in business of taking high levels of credit risk and early entry positions, unless they are able to monetize some of their success at a later stage. In this instance it came from selling information or providing letters of credit or subordinating their debt in larger bond deals. Development institutions that subsidize early costs must identify ways to recover those costs at a later stage of market growth.

This evolution was moved back to square one at the point of the financial crisis in 2007 and 2008 when once again organizations such as TRF became the primary market intermediaries. As capital markets stabilize, the re-entry of investors and products re-calibrates.

A similar developmental horizon for another sector involves the financing of supermarkets in low-income communities. In partnership with the Commonwealth of Pennsylvania and a nonprofit advocacy group called

The Food Trust, TRF launched an initiative to increase the supply of fresh food retailers in low-income communities. While everyone understood that the demand existed for these markets, it became clear there were market entry costs that dissuaded the best operators from locating in those communities.

According to entrepreneurs, the higher costs in the early years were related to at least three things: the cost of recruiting and training workers, particularly the high turnover costs in the first two years; the extra costs related to capital investments in safety and security; and the cost and uncertainty of land development. There were also issues of capital access for the smaller entrepreneurs that were just growing into multi-store operators with more extensive finance relationships.

The high cost of labor recruitment and the cost of managing turnover in the city were particularly striking. One entrepreneur (who now operates seven supermarkets in Philadelphia) told us that while he expected to spend \$75,000 in year one for labor recruitment and training in the suburbs, his cost in the city could easily exceed \$400,000. With the first

EVOLUTION OF CHARTER SCHOOL CAPITAL MARKETS



store TRF financed for him, it took 4,000 applicants to identify 250 qualified workers. Turnover in year one was astounding – about three times higher than the turnover rates in the operator’s non-urban stores.

In order to test the proposition of higher market-entry costs, TRF teamed with the Commonwealth of Pennsylvania to develop the Fresh Food Financing Initiative. The State provided \$30 million in grant funds to be used for up-front subsidies for the businesses. TRF raised \$90 million in private capital to finance the equipment, working capital, and real estate of many of the stores that had no other financing alternatives. Since the advent of the program, TRF has played some role in financing 120 food retailers and has created increased competition for retail entry into these communities. As the environment begins to respond to the demand for workers and sites, the subsidy cost requirements ought to diminish.

As with financing housing in a neighborhood where the price increase gradually allows for lower levels of subsidy, the advent of charter school and supermarket financing are examples where subsidy has an early stage role (often through subsidized debt) but eventually it is hoped that the market accepts the viability of those developments and eliminates some of the need for subsidy.

RULE #4:

Subsidy should take a direct route to solving the problem.

The fourth rule of subsidy is to take as direct a route as possible to solve the problem you want to solve. As the old adage goes, “solutions are easy; the hard part is asking the right questions.”

A common problem that developers face when working in distressed housing markets is that real estate values are too low to justify the amount of debt financing

needed to buy and rehabilitate a unit. Thus even if demand for the units exists, real estate assessments will not allow for the entry of appropriate levels of credit. The solution is usually some form of subsidy to write down the amount of private capital needed.

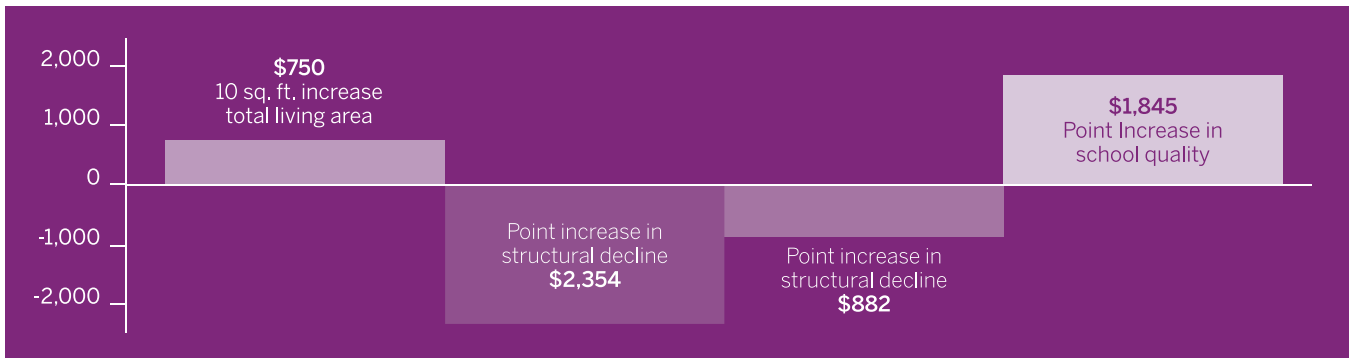
In a neighborhood that has this problem, the general option open to developers is to seek a subsidy of some sort – a direct grant and/or subordinated debt. If they are persistent enough over time, as with our Baltimore example, housing values may go up and the subsidy requirements decline. But there are other feasible options. We know for example that certain place-based amenities – public safety, quality transportation, good retail access, and quality schools have a significant impact on real estate values. If the problem we are trying to solve is low real estate values, it may make more sense (even in the short term) to focus resources and attention in addressing other issues.

One TRF study measured multiple impacts on neighborhood residential real estate prices in Philadelphia: structural decline (abandonment, code violations, etc.), school performance, and public safety. For each, TRF built indices based on multiple data sources, using a rich spatial database to examine impacts in very small geographical areas.²

In the analysis every block group in the city was given a numerical value connected to three factors: the performance of local schools, crime rates, and what we termed structural decline, which encompassed issues such as housing vacancies, code violations, and related issues. Below are some of the initial results of our assessments of net financial impact on property values based on shifts in school quality, public safety, and structural decline.

2. The analysis was led by Dr. Ken Gross, formerly of TRF (currently a colleague of mine at J Nowak Associates), and Dr. Ira Goldstein from TRF. The following journal article contains detailed information on the development of the structural decline index: Gross, K.S. & McDermott, P.A. (2009). Use of City-Archival Data to Inform Dimensional Structure of Neighborhoods. *Journal of Urban Health*, 86, 161-182. Available: http://cml.upenn.edu/PDFfiles/Gross_McDermott%20Neighborhood%20Factor%20Scores%20study.pdf

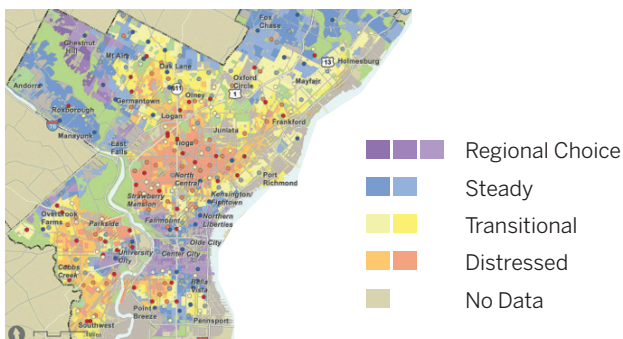
NET FINANCIAL IMPACT ON PROPERTY VALUES



In Philadelphia neighborhoods (on average) a slide down the structural decline index of one point will result in a loss of \$2,354; an increase of crime on our index by one point would result in a loss of \$882 and an increase in school quality by one point gives back \$1,845 of value. Controlling for housing type and size allowed TRF to build a framework for any geographical area and see what the role of each variable is in depressing or promoting values. Thus you can plot, for example, schools against real estate values and show where schools are outperforming or underperforming their sales market. A similar thing could be done with the other variables.

This allows us to ask other questions about interventions in the real estate market. The map below shows TRF’s Market Value Analysis (MVA) for Philadelphia. The map adds some school locations to this MVA (represented by dots). In the Philadelphia map, the stronger real estate markets are purple and blue and the weaker ones are orange; the middle markets are yellow. Each school dot is colored to reflect the tier of quality it is within, blue being the highest and red the lowest.

SCHOOL QUALITY AND MARKET VALUE ANALYSIS³



This map allows us to ask targeting questions, such as the importance of dealing with a red colored school in a yellow area. The yellow area is a middle market that could move up or down the pricing scale based on relatively small changes. You would want to do everything you can from a community development perspective to work on those ‘red dot’ schools. We could ask lots of questions about any of this, but the key is to have a data-rich framework from which intervention decisions can be developed.

This kind of data also begs an important policy question. If there are easier roads to get to an outcome that are not being taken now; how do we re-think public policy incentives and systems to pursue the best outcomes. In part, this is a question of having integrative approaches and in part, this is a matter of unhooking resources from strict categorical uses.

As a thought experiment, ask the question of how to best maximize social mobility and economic growth through public subsidies. How can high quality data help us redesign the use of those resources? And to what extent would this redesign require shifts in the present silos of subsidy allocation? Smart subsidy should ultimately force us to ask questions about the meta-systems of government we take for granted; the way allocations are segmented make it easy to lose a sense of the ultimate mission.

3. The Reinvestment Fund. Schools in the Neighborhood: Are Housing Prices Affected by School Quality? <http://www.trfund.com/wp-content/uploads/2013/07/Schools-and-Housing-Prices.pdf>



A Smarter Community Development



The rules for smart subsidy discussed in this paper are derived from my policy and practitioner experience. This discussion focused on aspects of place-based real estate development.

These observations may not resonate with all community development practitioners, particularly those who work in communities where there are fewer problems with low real estate values. The most distressed markets are quite affordable in comparison to many other cities in the U.S., but all too often those communities sit on degraded infrastructure with demand that is income limited. Deteriorated neighborhoods in cities that have lost significant populations and changed their base industries over the past several decades lead to significant development challenges both for the most affected communities and for contiguous areas as well.

As necessary as subsidy is, its manner of use can define the culture of development practice in such a way that we lose our capacity to measure its true value and the trade-offs it brings.

As necessary as subsidy is, its manner of use can define the culture of development practice in such a way that we lose our capacity to measure its true value and the trade-offs it brings. To avoid this, community development has to engage the subsidy issue directly. Our hesitation to do so is often based on an understandable defensiveness about public policy alternatives and possibilities. The fear is that if we discuss inefficiencies, we may lose the political battle for any subsidy. Given the disagreements over the role of government in recent years this is understandable, but ultimately short sighted. In the long run we are better off building an argument about the roles and efficiencies of subsidy within a strategic and data-informed framework.

To move the quality of practice forward we need richer, comparative case studies to drive best practices. The case study data cannot just be at the project level but also must reflect what we know about local market contexts: How are costs comparable from subsidized to non-subsidized projects? What are the cost drivers of those differences? What do we know about different approaches that will yield a development horizon that reduces subsidy costs? Do we have examples of various interventions yielding results at different rates, as might be the case with the example of real estate values and school performance? The data we collect must not only be comparative but also represent enough time depth to yield a clear picture of impact and trade-offs.

The collection and use of data will lead to applied analytical tools that can guide future public and private investment. To do this, however, it has to be embraced by the allocators of subsidy. It is one thing to think about the use of data to develop rational models, and another thing to deal with the problem of change on the ground; particularly if change is linked to tough political issues related to long-term inefficiencies and commonly accepted methods of doing things. There are ways around this issue that go to the heart of how we ought to allocate public money. If subsidy masks cost inefficiencies, then public funding initiatives should include carrots and sticks to force the issue, whether related to regulatory, capacity, or monopoly costs.

If we know that it is more effective to use different tools to affect the same problem, then at the very least we ought to be able to build integrated funding strategies that demonstrate the dynamic interactions of the interventions. We should use this information to challenge the way government programs are organized. We talk about comprehensiveness in this field but we have not moved far from poetic imagery in this regard. Imagine a federal housing bill that would only provide subsidy to neighborhood investment if it could be shown that school reform, public safety, and structural decline issues were also being addressed. There are elements of this thinking in the Obama Administration's Promise Neighborhoods and Sustainable Communities work, but much more can be done. What if housing investments were accompanied

with agreed-upon data metrics that allowed us to measure the relative impacts of various efforts? It is short sighted to invest money into a real estate market – subsidized or otherwise – if these other issues are not simultaneously addressed. But, we allow public policy to do precisely that.

Change at the point of public allocation is not just a matter of incentives and integration, but is related to the ability to negotiate deals at the point of project delivery. Expertise, political will, and program flexibility must exist to enforce efficiencies without creating so many regulatory barriers that nothing can move forward. The best way to do this is often to use quasi-public agencies or local private development intermediaries that know the business and still have a public purpose in sync with the public allocator. TRF's supermarket program in Pennsylvania involved the public sector giving up some of its direct allocation role; but in return the Commonwealth got a more effective and rapid disbursement system that stimulated rather than followed development.

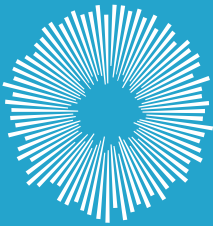
Finally, there is the matter of community development institutions themselves. What is their role in all of this and how can they benefit? They have to be willing to embrace new analytical tools – indeed they have to help create them – and then they have to work to establish or implement the deliver of those tools. These entities too have to be willing to make some new choices based on good information and alternative routes to solving problems. This involves risks. We sometimes learn how to do a good job in a dysfunctional environment; we learn the system to deliver a product and we are unwilling to make change unless we can be sure that the alternatives will lead to something besides publications and conferences.

At this critical moment in American history, when we are working to recover from a dramatic credit and housing crisis, there is no better time to get it right. Our capacity to use the best technology and data to build market recovery models and apply those models to the allocation of capital and the implementation of change has never been better. Community development practitioners have an opportunity to help lead this change.

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J. Nowak and Associates specializes in providing counsel to nonprofit organizations, for-profit businesses, and innovative government agencies dedicated to the renewal of American cities.

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