
TOD VALUE CAPTURE

FINANCING TRANSIT-ORIENTED DEVELOPMENT THROUGH VALUE CAPTURE STRATEGIES

SEPTEMBER 26, 2013

Kevin Dwarka, Ph.D.

Dwarka Land Use & Economic Consulting

Introduction

In the early 1900s, William Wilgus, the Chief Engineer of New York Central Railroad imagined a new Grand Central Terminal on the east side of Midtown Manhattan. The proposed terminal and its sunken bi-level rail yards promised the city a grand architectural statement, greater terminal capacity, and electrification of the system. No public financing was required under the engineer's ambitious plan. North of the existing terminal were open air rail yards also owned by New York Central Railroad. Wilgus surmised that decking over the yards and selling the air rights above them could be used to repay the debts for the new terminal. The idea worked. The new Grand Central Terminal opened in 1913 and within 20 years, a thriving district known as "Terminal City" grew up around it with luxury apartment houses, hotels, and offices lining a fashionable new roadway called Park Avenue. Today, Wilgus' idea is known as "value capture", the idea that transportation infrastructure can be financed by capturing the appreciation in land value that results from enhanced access and locational advantage.

Throughout the United States, transit agencies, municipalities, and economic development groups are increasingly exploring value capture as a way to offset the public costs of transit infrastructure and channel new development to areas within walking distance of a transit station. Presented below is a description of the most widely considered value

capture strategies and examples of the ways they have been enlisted to catalyze TOD.

Tax Increment Financing

A widely used redevelopment tool is tax increment financing ("TIF"). TIF programs are often used to promote economic development in areas where a high number of distressed or vacant properties cripples the city's capacity to recover its ongoing operating costs through property taxes. By capturing the value of future land appreciation, a TIF program aims to heighten the level of public services in a given area while also helping a city become fiscally solvent. When paired with TOD planning, TIF offers a strategy for financing the transit infrastructure necessary to attract developers to vacant or underutilized parcels are ripened for transit-oriented development.

Under a TIF program, a municipality designates a part of the city as a TIF district. The city then finances infrastructure improvements within this district by selling bonds that are repaid by the higher property taxes that will be collected in the TIF as a result of the improvement. However, not all of the property taxes of a given property in a TIF are used to service the debt on the bonds. The city repays the bonds only with the incremental increase in property tax that accrues after implementation of the infrastructure improvement. The baseline amount of property tax that was collected prior to the improvements is essentially frozen and continues to flow to the city's

general revenues. Upon expiration of a TIF program, which can last as long as 20 to 30 years, the total amount of property tax assessed within the district goes back to the general revenues. In this way, the benefits of the TIF program are not simply limited to the TIF district but eventually serve to expand the tax base for the entire city.



A large-scale example of using TIF to finance transit-oriented development is Atlanta's Beltline Redevelopment Plan. Aiming to redress decades of suburban sprawl and rising traffic congestion, the \$2.8 billion Beltline project envisions a new 22 mile looped rail corridor that would serve almost 30,000 new housing units, 1.3 million square feet of retail space, and 5.2 million square feet of industrial space in a 6,500 acre redevelopment district. To fund the rail line along with a host of other amenities including parks and trails, the Atlanta City Council approved the sale of bonds that will be repaid from the incremental property tax collected from the new development in the Beltline redevelopment area. Fifteen percent of the bond funds must be

used to finance a housing trust fund that will help finance more than 5,500 units of workforce housing. The financing mechanism will stay in effect for 25 years after which all of the property taxes in the redevelopment area will be channeled back into general revenues and split between the city, county, and schools.

It is also possible to use TIF monies to finance smaller changes including minor upgrades and repairs to transit facilities. In Chicago, for example, TIF monies have been used to upgrade Chicago Transit Authority's rail stations including relatively modest improvements to station entrances, lighting fixtures, and platforms.

PILOTS

Payments in Lieu of Taxes (or "PILOT") is a financing mechanism similar to tax increment financing. PILOT programs vary from TIF programs in two fundamental ways. First, the revenue collected is not property tax per se but a substitute fee. In essence, the PILOT property becomes tax exempt but subject to a tax equivalency payment that is lower than the amount the developer would have paid as a property tax. As such, the PILOT is as much a tool for infrastructure finance as it is an incentive for developers. Second, and more important, the total amount of the PILOT revenue is used to repay the bonds. Under a TIF arrangement, only the incremental increase in property tax is captured for the purposes of infrastructure financing.

The PILOT funds are used to finance the project itself or its supporting infrastructure. A PILOT district can be created so that new development in a given area is designated as a special financing district where real property tax revenue is channeled to service the bond debt acquired to finance area improvements.

The Hudson Yards Financing District (HYFD) is an especially ambitious example of using PILOTS to finance transit-oriented development. In 2005, the New York City Council approved a redevelopment plan for Manhattan's far west side. Integral to the proposed development is the extension of the #7 subway line to a terminal station on 11th Avenue. The Hudson Yards plan entails the sale of development rights for the area above active open air rail yards as well as infill development throughout the surrounding area. To finance the subway extension as well as other public realm improvements in the redevelopment area, a newly created development corporation, the Hudson Yards Infrastructure Corporation (HYIC), sold \$3 billion in bonds with one issue of \$2 billion in 2007 and another \$1 billion issue in 2012. As part of a complex financing program that also includes considerable city support from New York City's general revenues, PILOTS will eventually be used to repay these bonds. In order for an office building to qualify for inclusion in the PILOT program, it must be 1 million square feet in size, dedicate 75 percent of its usable space to Class A office space

or other commercial uses, and utilize 90% of its allowable floor area ratio. The first building to meet these qualifications will be an office tower built by the Related Company on the eastern side of the rail yards. Based upon the current construction schedule, it will take another four or five years before the building generates PILOT revenue.

PILOTS can also be used to finance smaller scale TOD projects. For example, the Village of Farmingdale in Long Island is contemplating the use of PILOTS for Bartone Plaza. At buildout, this 3½-story mixed use project would provide 154 units of housing and almost 20,000 square feet of retail space all proximate to a Long Island Rail Road station (which one?). Once authorized by the Nassau Industrial Development Agency, the PILOTS will provide the developers with a tax abatement or reduction. However, this initial project could also catalyze further development around the station, thus leading to a long-term expansion of the village's tax base.

District Improvement Funds

The success of TIF and PILOT programs are contingent upon the real estate market. If the market is sluggish or land value increases are overestimated, then the public sector may end up having to dip into its general revenues in order to service debt incurred. An alternative value capture approach that does not involve this type of risk to the public entity is the District Improvement Fund (DIF). Under a DIF program, developers contribute to a special fund in exchange for the right to build new projects at a greater density than would be permissible under the existing zoning code. The revenue that accumulates in the fund is then used for improvements such as transit and pedestrian infrastructure to accommodate the increased densification resulting from the upzoning.

Along with PILOTS, DIF is another financing strategy enlisted for Hudson Yards. Under the 2005 rezoning for the area, developers were authorized, as an incentive to build additional floor area space and community facilities, if they contributed to a DIF. This incentive enables the construction of taller building heights, an especially valuable premium for the sale of top floor luxury apartments. The cost for participating in the Hudson Yards DIF program was initially set in 2005 at \$100 dollars a square foot but has since risen to \$120 per square foot in accordance with annual increases in the consumer price index. So far, the HYIC has collected more than \$88 million in revenue through the DIF program.

One drawback of the DIF approach is that the revenue is acquired incrementally instead of up-front as in a bond issuance. Also, unlike the recurring flow of revenue provided by a TIF program, a second drawback of a DIF is that it provides a city only a one-time injection of revenue from a given developer. On the other hand, the DIF concept can also be used to support far more modest densifications than those proposed for Hudson Yards. Density bonuses purchased in exchange for contributions to transportation funds can be

used to finance minor pedestrian improvements, transit shelters, and lighting improvements on a more localized basis.

A DIF is also proposed as part of the planned rezoning of Manhattan's East Midtown, including the area between East 39th Street to the south, East 57th Street to the north, Second and Third Avenue to the east, and Fifth Avenue to the west. Currently winding its way through the city's land use review process, the proposed rezoning would enable the replacement of the area's older office buildings with larger floor-plate Class A office buildings built at a higher scale than permissible under the current zoning resolution. Developers would pay \$250 per square foot for the additional air rights that would be made available on certain qualifying sites as of right or by special permit depending on location and the degree of density bonus. The sale of the air rights presumes the demolition of existing buildings and their replacement with new taller buildings rather than the construction of rooftop additions.

The already existing congestion and cost of reconstruction for Midtown East's transit facilities and pedestrian infrastructure have raised concerns, however. The DIF may not generate enough funding and fast enough to cover the costs of the improvements necessary to support the area's increased density. The DIF proposed for the Midtown East project will be the subject of a more comprehensive article this fall.

Special Assessment Districts

Another way that municipalities might think about recovering the infrastructure costs associated with TOD programs would be through the creation – with the support of affected property owners — of a Special Assessment District (SAD). In a SAD, a city assesses a tax on properties receiving a direct benefit from a certain infrastructure improvement. The amount of the special assessment (sometimes called a betterment levy) corresponds with the degree of benefit that accrues to a certain property. What distinguishes special assessment districts from traditional impact fees is that they are created with the support of the property owners themselves. As a result, SADs do not trigger the thorny legal questions that often arise for municipalities contemplating impact fees. The enabling legislation for SADs typically requires that a certain percentage of property owners in the SAD district agree to be taxed in order to reap the benefits of a proposed public improvement.


A large-scale example of a SAD is the Dulles Metrorail expansion in Washington D.C. The 23-mile extension of the Metrorail system to serve the rapidly growing Dulles Corridor is being financed in part by a special assessment against commercial landowners along the corridor. The SAD was created because a sufficient percentage of landowners

petitioned the Virginia Board of Supervisors to assess the tax, which rises to as much as 22 cents per \$100 dollar of assessed property value. These revenues, expected to total \$400 million, not only help to service the debt acquired to finance the extension but also to serve as the required local match for securing federal funding.

The SAD concept can be used to finance less capital intensive infrastructure. For example, cities including Portland, Tampa, and Charlotte have used SAD to finance streetcar and light rail systems. Maryland's Montgomery County is exploring the possibility of using SAD to finance a new 160-mile, county-wide bus rapid transit network. Meanwhile, numerous cities throughout the country have long used a variation of SADs, Business Improvement Districts (BIDs), to help finance street beautification and landscaping programs along main commercial streets. Increasingly, these organizations of business owners are more receptive to financing not only aesthetic improvements but also the "complete streets" interventions and transit services that are essential to TOD. In New York City, for example, the Flatiron 23rd Street Partnership assumed financial responsibility for a pedestrian plaza that not only offers a public amenity but also facilitates safer pedestrian movements around a key transit node in Manhattan. In Washington DC, BIDs have played an active role in planning, extending, and financing the DC Circulator bus service that helps connect workers to job centers and link up rail stations.

Conclusion

Value capture strategies are not risk-free nor are they necessarily simple to design or easy to gain acceptance. Before embarking upon a value capture approach to TOD finance, cities need to research their statutory authority and to make difficult projections about future land use values. These projections are always subject to the inherent volatility of real estate markets no matter how conservative may be the assumptions that underlie them. Value capture strategies also introduce political tensions related to the diversion of public revenue from general budgets to ear-marked programs. Given public concerns about ensuring the availability of funding for city-wide expenditures, including schools and utilities, municipalities need to carefully assess the short and long-term implications of channeling value capture funds to particular TOD investments. On the other hand, value capture is as much of a conceptual planning framework as it is a financing strategy. Simply by examining the possibility for financing transit through land use appreciation, cities not only uncover possible funding sources but also arrive at new ways of tightening the linkage between transit investment and land use planning.



Kevin Dwarka, Ph.D. is an urban planner and policy analyst with 15 years of experience in transportation and land use planning in the United States and Israel. He has served as a Senior Planner at New York City Transit and a Senior Research Fellow at the Israel Union for Environmental Defense. He was a Senior Associate at Nelson Nygaard Consulting Associates and opened up the firm's New York City office. Dr. Dwarka is also an Adjunct Professor at Baruch College, where he teaches a suite of courses in land use, environmental policy, and economic development. He also serves as a Senior Fellow at the Land Use Law Center at Pace Law School.

This article is available online at: <http://bit.ly/KDValueCapture>