

Welcome to a new endeavor by Development Strategies to inform our clients, friends, and professional colleagues about the kind of services we provide. Replacing our paper version of Development Strategies Review will be periodic, single-article emails that can be read quickly or deeply, depending on your tastes. Authors will be our own principals and staff writing on topics that reflect the high levels of insights and analysis that you have come to expect from us. Our first article is below. We look forward to your reactions and questions when you are so inclined. Please enjoy!

Determining the Fiscal Need for Public Intervention in Redevelopment

By Bob Lewis, AICP, CEcD Principal

Communities are often barraged with requests for “development incentives” when proposed projects just do not seem to earn a sufficient rate of return. How do public officials figure out which projects deserve incentives?

Any site can be placed on a continuum that indicates the relative balance between the value of the land (i.e., ignoring improvements on the land) and the value of the improvements (i.e., ignoring the land). Almost all property taxing jurisdictions distinguish between the two—land is valued separately from what’s on the land. It’s possible to use the ratio of land-to-improvements value in evaluating incentive requests.

Ideally, the relationship between land value and improvements value will be balanced in a fully thriving community. As the economy is manipulated by the invisible hand toward equilibrium, so says the theory, all real estate values will achieve an appropriate balance. This doesn’t mean that land value is equal to building value, but that there is an appropriate balance that is effectively expressed in the “rents” that the property generates—sufficient income to pay all operating and maintenance expenses, debt service, and a competitive rate of return to the owners.



We all know, however, that a perfect balance for all properties all the time never happens. To one side of the equilibrium continuum, therefore, would be sites where the ratio of improvement value to land value is too high. To the other side would be sites where the ratio of improvement value to land value is too low.

Properties that have perfect balance do not need public intervention because the economy is operating as it should. Likewise, properties on the “stimulative” side of the continuum do not need public intervention because the underlying value of the land is a strong enough incentive for

property owners to develop or redevelop in order to “capture” that value through higher economic rents. That is, if the land value is so strong, then high paying tenants will want to occupy the location, so the property owner needs no economic incentives to, say, build a bigger or better building and attract such tenants.

Where intervention might be necessary is on the “blight” side of the continuum. This is where the value of the improvements is high, but the location value is relatively low. For example, there might be a very expensive building on the site, but the site is too poorly located to attract tenants willing to pay rents that reflect the value of the building. So the building remains underutilized, probably with poor maintenance, and can become a blight in the community.

All cities have experienced varying degrees of these conditions. The corner of "Main and Main" in a vibrant downtown, for example, represents a site either in balance or in a stimulative condition. But a formerly successful shopping center on a major arterial road might no longer be well located because major retailing has moved to the interstate highway interchange. Demographic and household income shifts also change the location value of shopping centers.

In any event, this equilibrium concept can be an effective indicator of properties needing public incentives and those that shouldn't need such incentives. Public officials need to marshal resources as carefully as the private sector, so the use of such statistics can guide better decision-making.

'Blighted' might be too strong a word in some cases, but there are properties that are clearly blighted while others we tend to call "marginal" because they show early signs of imbalance favoring the value of the improvements. For whatever reasons, the value of the land is diminishing relative to the operating costs and value of the building. In such cases, there is technically no economic incentive for the property owner to improve the property to a higher value. Stronger rents cannot be achieved at that location. Thus, the building is effectively allowed to deteriorate to a value more in balance with the value of the land—and rents will inevitably decline.

Ridding that blight requires improving the value of the land and/or reducing operating costs. A city government might work harder to reduce crime, increase the quality of the utilities, or re-pave the street to increase the site's location value. Indeed, these are useful intervention techniques for properties just beginning to go out of balance on the blight side of the continuum.

More drastic measures, however, are required for more advanced stages of blight. Thus, cities often offer to buy the land and turn it over to a developer at no cost, thus reducing the new property owner's exposure to the rate-of-return imbalance. Or substantial public infrastructure investments might be made to increase the location value. Tax increment financing is often an appropriate tool in this case because higher values, triggered by the "new" infrastructure, should generate "new" taxes, some of which can be siphoned off to pay for the needed improvements. Tax abatements, tax credits, direct payments, etc., may also reduce the property owner's exposure to the improvement/land imbalance and/or to increase the location value of the site.

What defines "balance," however? In most communities, a simple indicator could be the aggregate value of all land divided by the aggregate value of all improvements (or vice versa). This is, in effect, the average for the entire community. Individual property ratios that significantly deviate from this ratio can be identified as opportunities for higher value development (stimulative) or opportunities for public intervention (blighted). Multi-year measures of this aggregate balance can be utilized to minimize statistical variations year-to-year.

Perhaps even better is to determine the equilibrium ratio using a much larger geographic area, say a county-wide or metropolitan-wide measure. A central city might have its own balance, but that ratio might not be the same as, say, the adjacent suburban county. Thus, a metro average might be a more appropriate "goal" though it could mean that a disproportionately high number of central city properties fall into the blighted end of the continuum while the suburban properties are more weighted in the other direction.

The premise of this article is drawn from a panel session on Spatial Economics at the 2009 national conference of the American Planning Association. Panelists were Steven Shwiff, who heads the Department of Accounting, Economics and Finance at Texas A&M University; Robin McCaffrey, who is a principal with Mesa Design Group in Dallas; and Carissa Cox, an associate with Mesa Design Group. Interpretations of the panel's presentation in this essay are entirely the author's, however.

