Building the Ideal Financing Toolbox

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Economic developers require a comprehensive set of financing tools to support their work. From debt tools such as industrial development bonds, tax increment financing and loan programs to tax credits, small business lending and seed and venture capital funds, a community must be proactive in providing financing for the range of its economy's needs.

Whether the goal is brownfields redevelopment or assistance to manufacturing, technology or service industries, the financing options should be tailored and specific. What works for one industry sector (such as tax-exempt industrial development bonds for manufacturing) may not work for another (technology companies are more likely to require venture capital tax credits).

Ideally, agencies can provide targeted financing tools for special purposes and geographic areas while maintaining an overall financing toolbox that serves broader needs. Cities such as Minneapolis, Washington, D.C., and St. Louis, and states such as New Jersey, California and Ohio have been successful using this formula for their financing programs.

Yet many communities do not take advantage of all the financing tools available to them. This article outlines a menu of options available for communities looking to build the ideal financing toolbox – programs that can be replicated nearly everywhere. While this article is not an exhaustive review of every available financing tool, it provides an overview of the importance of a comprehensive approach to finance.

Broad-based financing tools

Bond finance is the cornerstone of development finance. The Tax Reform Act of 1986 distinguishes between two types of municipal bonds, general obligation (GO) bonds and private activity bonds (PABs), and outlines the requirements for each. Interest on GO bonds is exempt from federal taxation, while interest on PABs is exempt only for "qualified" bonds.

The federal interest exemption on GO and PABs is a significant asset in making bond finance attractive. Investors, either institutional or individual, gain a federal tax exemption by purchasing tax-exempt bonds, thus reducing the cost of lending on those bonds. This allows the bond financing to be more affordable to borrowers by providing a lower interest rate and more flexible payment terms. Compared to traditional lending techniques such as bank loans, tax-exempt bonds can save borrowers millions in interest and fees.

GO bonds work as the name implies, to finance the development of facilities that serve an "essential government function." Nearly all communities employ GO bonds to maintain their general infrastructure and provide necessary capital improvements. PABs, however, serve secondary purposes and are a key source of financing often overlooked by economic developers.

PABs are broken down into seven categories, of which four kinds – exempt facilities, redevelopment, 501(c)(3) and qualified small issue bonds – are the most useful in the development finance industry.

- **Exempt facilities bonds** are available to finance a number critical needs, including airports, docks, commuting facilities, sewage facilities and a host of energy, water, gas and power projects.
- **Qualified redevelopment bonds** are for infrastructure projects that do not meet GO bond requirements. These may qualify for a tax exemption if they meet several tests, such as the proceeds being used for redevelopment of a designated blighted area.
- **501(c)(3) bonds** have gained considerable popularity over the past decade for projects owned and used by

nonprofit organizations (such as religious, charitable, scientific, and educational entities). Many economic development departments have established 501(c)(3) Revenue Bonds and Bank Qualified Bank Direct loan programs to capitalize on the availability of this financing option.

The City of Minneapolis's Bank Qualified Bank Direct Loan Program provides tax-exempt financing for capital projects for smaller 501(c)(3) organizations. This program is almost unique in the country as a source for financing through the community's wide network of 501(c)(3) providers.

- **Qualified small issue bonds**, also referred to as industrial revenue bonds (IRBs), industrial development bonds (IDBs) and manufacturing bonds, have been the primary source of affordable lending for the manufacturing industry for the past 50 years.

Today, most IDBs support expansions of existing manufacturing facilities, although many states and localities market IDBs for business attraction purposes. IDBs can be used to finance a variety of manufacturing activities, and the portion dedicated to "core manufacturing" (i.e., the production line where the product is made or processed) may be financed with bond proceeds without limitation.

However, the rules governing the use of IDBs are extensive. Communities with quality IDB programs work tirelessly to understand the possible tax-exempt transactions, and often combine IDBs with other debt financing options to provide additional support.

St. Louis County, Missouri, employs a diverse and comprehensive bond finance strategy. Through the St. Louis County Economic Council, the county provides several fixed-asset loans, including tax-exempt bonds and mini-bonds for both manufacturers and 501(c)(3) organizations, bank qualified bonds, and taxable bonds. St. Louis County has been recognized for these programs and has used its full issuing authority as a catalyst for industry investment. To learn more about the county's programs, go to http://www.slcec.com.

So if tax-exempt bond programs are so useful, why doesn't every community have one? The answer is that they are not easy to run. They require due diligence, open books and a great deal of oversight – the price of doing business in the tax-exempt world. But for entities that have figured out how to do it, fees can pay for the entire cost of the running the program.

Bond finance is not the only source of broad-based financing. Other programs such as loan guarantees, infrastructure pools, grants and direct loans also are important. These programs can be tailored to meet the needs of designated industry sectors such as small business, manufacturing or innovation ventures.

Targeted financing

Area-based: Tax increment finance and special assessment districts

Tax increment finance (TIF) and special assessment district financing have become the primary funding mechanisms for the development of defined geographic areas. TIF captures the future increases in property or sales taxes that new development generates in order to finance the present cost of improvements (such as infrastructure, land acquisition, demolition, utilities, planning costs and more) in economically sluggish or blighted areas.

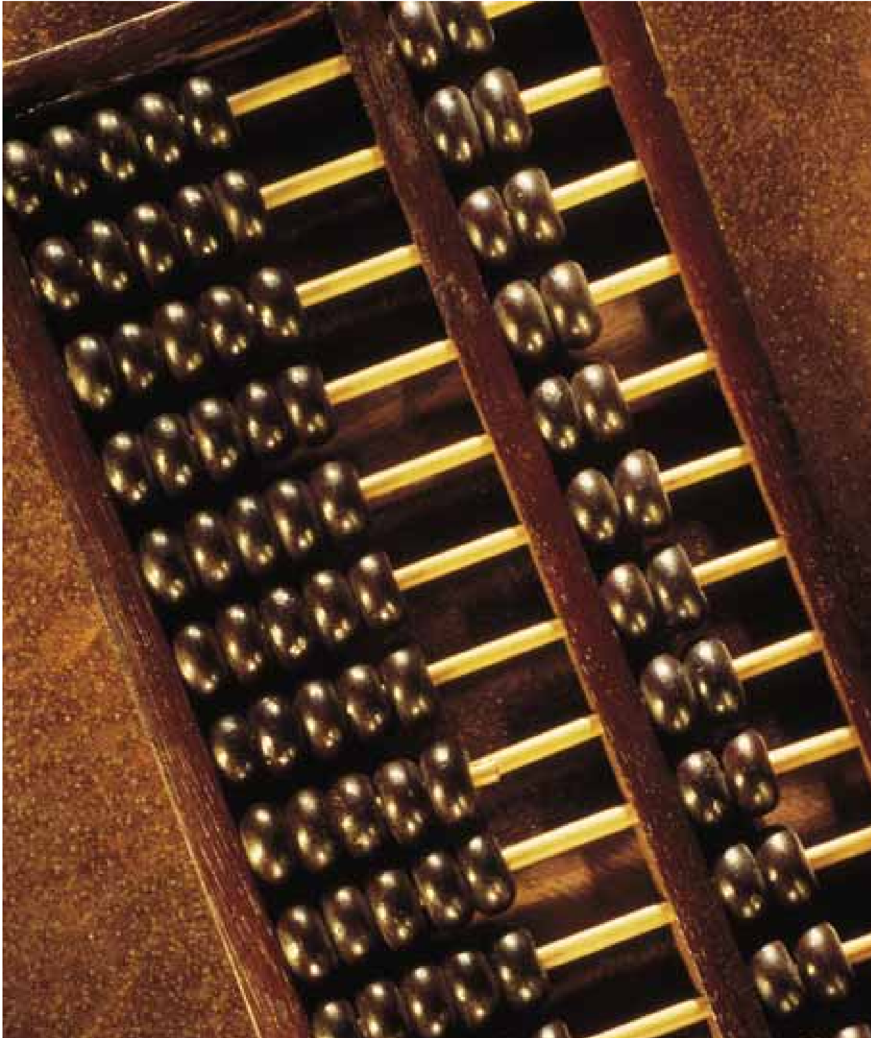
TIF provides local governments with a mechanism that does not rely on federal funds, escapes state limits on revenue and expenditures and does not apply new taxes on municipal taxpayers. States authorize local governments to designate TIF districts, and city, county or nonprofit redevelopment entities usually administer them.

The use of TIF by local governments varies widely around the country. Some communities have become experts, some are just starting to understand its use and others possess the authority but haven't used it. A total of 49 states and the District of Columbia have TIF legislation, with North Carolina, New Jersey, Delaware, and Massachusetts recently adopting laws. Arizona is the only state without TIF enabling legislation.

There are some key tenets to using TIF successfully. A community that plans to use TIF needs to have a thorough understanding of the enabling legislation – the capacity and guidelines under which they are allowed to use it. That's important not just for economic developers, but also for the local elected officials who will be approving the districts and projects. TIFs require outside expertise, so communities should hire highly competent bond counsel and financial advisors – professionals who understand the law and the community's objectives for the project or district.

Community buy-in also is critical to using TIF successfully. Local governments should be as open and inclusive as possible in the process of putting a district in place, holding meetings and charrettes with property and business owners, affected school systems and the community at large. Communities also should have policies in place for processing the project and the bond sales, thus ensuring consistency, disclosure and transparency in how initial and future districts are implemented.

Special assessment districts such as community development districts (CDDs), community facilities districts (CFDs), business improvement districts (BIDs) and special improvement districts (SIDs) also are important programs. These



districts allow for either a special tax assessment or dedicated revenue stream for improvements and development of targeted areas. In many cases, assessments provide sufficient funding for issuance of bonds or acceptance of debt services payments on loans for projects.

Cities such as New York, Baltimore and Philadelphia have maximized the capabilities of SIDs and BIDs. Over time and with practice, economic developers in these communities have developed a full understanding of the enabling legislation and the process for implementing the districts; used them to leverage other resources; and taken a comprehensive approach to the capabilities of these tools. They have used them to coalesce business and property owners for everything from public safety and cleanliness to public art, issuing debt for infrastructure projects, providing assistance to the homeless, and marketing.

Business-based: Revolving loan funds and mezzanine, seed, venture and angel capital

Smaller, sometimes overlooked industry niches can have a great impact. According to a new study from the Center for Women's Business Research, the number of women-owned firms jumped 18 percent between 1997 and 2004, twice the overall national growth rate of 9 percent. The success of women-owned businesses demonstrates the importance of targeting niche industries, unique business sectors and potential high-growth ventures.

Revolving loan funds (RLF) are used primarily for developing and expanding small businesses. RLFs are a self-replenishing pool of money, using interest and principal payments on old loans to issue new ones. Some RLFs are targeted to specific uses such as healthcare, environmental cleanup, minority business development or microenterprise development (business with five or fewer employees that require $35,000 or less in startup capital).

Often, the RLF is a bridge between the amount the borrower can obtain on the private market and the amount needed to start or sustain a business. With low interest rates and flexible terms, an RLF reduces total expenses for the borrower while lowering overall risk for participating institutional lenders. The Cascadia Loan Fund, for example, provides loans to small businesses and nonprofit organizations in Washington and Oregon. This fund has been extremely successful in providing assistance to borrowers who are unable to access traditional sources.[1]

Mezzanine funds are a gap financing measure for growth-oriented small businesses that may not qualify for traditional lending. Just as the mezzanine is the mid-level of a theater or auditorium, mezzanine funds occupy the middle of the business finance scale – less risky than equity or venture capital, yet riskier than senior bank debt. The Texas Mezzanine Fund is one of the most widely acclaimed funds in the country and a good example of this type of lending tool.[2]

Traditionally concentrated on the coasts, seed, venture and angel investment financing has become very popular throughout the country. State finance agencies have built programs serving innovation, technology and early-stage ventures. Most programs are geared towards tax credits and incentives for individual or institutional seed, venture and angel investment. Communities must raise awareness of these programs in their entrepreneurial sectors. One option is designating state agencies as conduits for seed and venture capital investments.

Tax credits

Tax credits are playing a greater role in the financing landscape as the availability of debt resources becomes scarcer. Tax credits can help in a variety of ways, from capitalizing new business ventures to solidifying financing for major real estate developments.

There are four main federal tax credit programs:

- Historic Preservation Tax Incentive for rehabbing and renovating old structures
- Federal Brownfield Expensing Tax Incentive for environmental cleanup[3]
- New Markets Tax Credits to provide capital for business and economic development ventures in low-income communities
- Low-Income Housing Tax Credits to promote construction and rehabilitation of housing for low-income persons

In addition, every state and the District of Columbia has

its own tax credit programs to address areas such as venture capital investment, low-income housing, job creation, machinery and equipment, targeted area redevelopment, wage adjustment credits and industry-specific credits. Philadelphia, San Antonio and Baltimore implement some of the most effective tax credit programs in the country.

Unlike other financing tools, tax credits don't disappear during economic downturns. On the contrary, tax credit programs are very dependable and politically popular. They also encourage private-sector resource leveraging and act as a catalyst for public-private partnerships.

Many tax credit programs are underutilized. There is a general lack of understanding of how tax credits can be used, and a central body of knowledge or resource base for using these programs simply does not exist. For local communities, getting the word out about available federal and state tax credit programs is critical to increased utilization. The most successful communities have researched the available federal and state programs, secured the applications and paperwork, trained staffers to understand the programs, and marketed them. For example, Baltimore has done a good job of marketing specific run-down properties as eligible for historic rehabilitation tax credits. New Markets tax credits are more complicated, but the most proactive communities are identifying eligible projects, approaching community development entities (CDEs) that have received the credits and partnering with them to finance projects.

Special-focus tools

Traditional methods may fail to address non-traditional needs such as technology development, import/export assistance and riskier endeavors such as brownfield development. Identifying these gaps and opportunities is key to developing a truly comprehensive toolkit. For example, in areas where technology growth is an opportunity, local agencies can align financing for technology development with private seed and venture funds, state tax credit programs and local technology assistance funds.

Additionally, financing resources for brownfields are at an all-time high. Agencies such as the Cuyahoga County (Ohio) Department of Development and cities such as Salt Lake City and Lowell, Massachusetts, have established effective programs that can be replicated.

The importance of federal funding

Federal funding continues to play an important role in many financing packages. A quality finance agency should have a sound understanding of the available federal resources. Traditional sources of federal funding include the Department of Housing and Urban Development, the Small Business Administration, the Department of Agriculture and the Economic Development Administration.

For example, SBA's 504 Loan Guarantee program, which provides loans to new or expanding small businesses, is highly effective and should be implemented in every community interested in supporting small business development. EDA's public works, planning and other grants programs are another solid financing option. Local economic development organizations should be well versed in the options available from these sources and also should work on innovative strategies that combine federal funding with local resources.

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The future of financing

The changing economy has placed an even greater burden on local finance agencies in providing assistance to job-creating entities. Resources available 10 years ago at the state and federal level do not exist today, requiring economic developers to become more innovative and forward-thinking in developing the ideal financial toolbox. The key to this innovation is to provide a comprehensive set of options that addresses broad-based and targeted financing needs and is closely aligned with local economic development strategies. ★★★

The Council of Development Finance Agencies is a national association of economic development finance agencies dedicated to the advocacy, education, research and advancement of the development finance industry. To learn more about these and other programs, visit CDFA's Online Resource Database at www.cdfa.net.

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[1] *For more information, see www.cascadiafund.org.*

[2] *For more information, see http://www.tmfund.com/.*

[3] *Currently inactive; awaiting reauthorization.*