

FEATURE

How American Cities Can Benefit from “Land Value Capture” Instruments in the Time of COVID-19 and Beyond

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Why Now?

The financial pressure cities are experiencing due to COVID-19 only amplifies the pre-existing historical underinvestment in municipal infrastructure and adds urgency to cities’ search for new sources of funding. Indeed, underinvestment in building new municipal infrastructure and replacing aging structures, along with chronic deferred maintenance, is an age-old story in many countries – even developed ones. For example, according to the American Society of Civil Engineers (ASCE), in 2009, even *before* the financial crisis impacted their condition, U.S. school infrastructure, drinking water systems, and wastewater systems were already graded poorly - “D,” “D-”, and “D-” respectively. Moreover, the expected five-year budgetary shortfall for school infrastructure was \$35 billion, and for drinking and wastewater, it was a combined \$108.6 billion.¹ Similarly, Canadians estimated the municipal infrastructure deficit at \$123 billion (Canadian) in 2007.² To illustrate at a city level: Portland (Oregon), which, since the early 2000s, has established a city-wide strategic approach to the management of its capital assets, with a focus on rebuilding and maintaining the city’s infrastructure, had an annual funding gap of at least \$92 million for the year 2007.³

Amid this environment, the 2008 – 2009 financial crisis delivered a new blow to municipal budgets - wiping out

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municipal investments in risky financial instruments, triggering financial liabilities, and, in many places, reducing revenues from local taxes. Transfers and grants from upper levels of government declined as well, a significant issue since in many countries upper-level government support constituted a substantial share of local budgets (roughly 40% or total local revenues in the U.S.).⁴ In such situations, municipal infrastructure and real estate are among the first items to be de-funded in local budget cuts. In Portland (Oregon), the funding gap just to maintain existing assets at then-current levels of service increased to \$475 million per year by 2019

How American Cities Can Benefit from “Land Value Capture” Instruments in the Time of COVID-19 and Beyond

- more than a five-fold increase from 2007 - to a large extent due to chronic deferred maintenance that led to accelerated asset deterioration.⁵ For the U.S. as a whole, ASCE scores indicate that by 2017 the infrastructure condition of schools, drinking water, and wastewater systems had recovered somewhat from the pre-crisis (i.e. 2007) level; nonetheless, all three systems still remain rated in the “poor” category, at “D+”, “D”, and “D+” respectively.⁶

Since 2010, “do more for less” has become a mantra among government asset managers at all levels of government, leading to practices such as rationalization of government real estate holdings, reduction or floor space consumption by government employees (though mainly at central government agencies), improving the energy efficiency of government buildings, etc. However, the fiscal squeeze has also led to many haphazard decisions and transactions, such as “fire sales” of public property.

The COVID-19 crisis has created additional strains on municipal infrastructure and service delivery budgets. First, it necessitated new expenses, such as for re-configuration of space in public facilities, including schools. Secondly, municipal revenues have declined across the board, from taxes to utility fees. For example, the drinking water sector in the U.S. has lost approximately 17% in annualized revenue; wastewater utilities lost about 20% of revenues.⁷

As a result, local governments around the world are examining opportunities for additional revenues and savings, along with new ways to deliver public services. In this regard, “land value capture” (LVC) instruments and government asset management (AM) have come into focus as tools for cities to enhance their municipal incomes and reduce expenses.

LVC instruments, their links to asset management, and use in the U.S.

Land value capture (LVC) instruments (a.k.a. “land-based financing”) is essentially a blanket terminology for a set of regulatory, ownership-based, and fiscal instruments that leverage the government’s ability to obtain public benefits through its powers over land and

property – both private and government-owned. Benefits produced by LVC instruments can include budgetary revenues and savings, private sector funding or in-kind provision of infrastructure or public amenities, and local economic development. These instruments are applicable and utilized to various degrees in both developed and developing countries.⁸

There are roughly 15 such instruments used internationally and discussed in the relevant literature, not including local variations and the more obscure tools. However, one instrument, which I refer to as *intensification of land uses on government-owned land*, has been overlooked despite having the key attributes of an LVC instrument and significant untapped potential. Therefore, I include it in the discussion of the instruments below.⁹

While there is no commonly agreed-upon classification of LVC instruments, one practical, useful categorization involves grouping LVC instruments according to the three types of government power involved in enacting them, namely:¹⁰

1. *Control over government-owned land/property*: this would include instruments such as leases and concessions, sales, public-private partnerships (PPPs), air rights contracts, naming rights contracts, and intensification of land uses on government-owned land;
2. *Power to regulate land uses/land-use parameters on both public and private land*: including sales of development rights/density bonuses, land conversion charges, and land readjustments; and
3. *Power to mandate taxes, fees, and in-kind contributions on private land (“fiscal instruments”)*: including developer charges/exactions (or impact fees), special assessment districts, property taxes, tax incremental financing, betterment charges, real estate capital gains taxes, and real estate transfer taxes.

The instruments in the first two groups (and even some in the third group) are usually under municipal control, so city governments in particular stand to benefit from a

How American Cities Can Benefit from “Land Value Capture” Instruments in the Time of COVID-19 and Beyond

systematic review of how they could make better use of them.

Furthermore, all six instruments in the first group fall under the realm of municipal asset management (AM) – a link usually overlooked both in literature and in practice. This implies that increasing the value of many LVC instruments for cities simply boils down to *systematic* – and as I argue further – strategic improvements to municipal AM. Finally, all six of these instruments are site-specific, transactional, and voluntary for private participants, making them simpler to implement, both administratively and politically. In contrast, most fiscal instruments typically have a much broader payer base, are mandatory, and may be difficult politically.

It should be noted that the LVC instruments associated with municipally-owned property (i.e. first group) often are used together, in varying combinations, creating a spectrum of hybrids. For example, a municipal site may be the subject of a complex transaction, which includes elements of a partial sale, PPP, air-rights provisions, and deviations from standard zoning requirements.

Most of the above 16 instruments have been tried by at least some U.S. municipalities and counties, perhaps attributable to the entrepreneurial nature of U.S. local governments.¹¹ However, information on the full scope of LVC instruments’ deployment in the U.S. is incomplete; information from municipalities is often unavailable, and when it is, in most cases it is only anecdotal evidence.

How significant is the under-utilized potential of LVCs, and where do the opportunities lie?

It is impossible to make “average” estimates of potential fiscal and in-kind benefits that U.S. cities might obtain from better use of LVC instruments. Such benefits depend on a number of factors, including the size and composition of municipal real estate portfolios, local economic conditions, the state of the local real estate market, prevailing densities of land use, and, to no small degree, local politics and the influence of ‘NIMBY’ attitudes. To illustrate the latter: a proposal to replace an obsolete fire station - without public spending, by

allowing a private developer to build a modern facility in exchange for permission to incorporate the station into a new 8-floor residential building – was blocked by a neighboring affluent residential community, based on the reasoning that the new residential building would change the character of the neighborhood, despite the obvious fact the updated facility would be highly beneficial for the community at large.¹²

Nevertheless, the potential to leverage several types of LVCs exists in many, if not most, U.S. jurisdictions. Below is a brief overview of LVC instruments that are currently underutilized in the U.S., along with suggestions on how they could be better applied, with a focus on non-tax instruments.

Leases or concessions of municipal property

In most developed countries, local governments do not own investment properties, for two general reasons: (i) to avoid the risks of investing public funding in the inherently risky real estate business, and (ii) to avoid competing with the private sector, whose success is a pillar of the market economy and its political systems. However, exceptions are more common than one might think. For example, in Sydney (Australia), rental income makes up 13% of local budgetary revenues.

In the U.S., most municipalities rent some public property (for example, renting a few classrooms in a public school to a private Sunday school, or granting eatery concessions in a city hall), but without an explicit policy or systematic approach. However, most large jurisdictions could generate additional revenues if they were to implement an explicit jurisdiction-wide policy on non-governmental use of municipal property. Such a policy should include at least (i) an obligation for asset managers to monitor and minimize vacancies by actively renting space and (ii) rules for pricing municipal property for non-governmental users. Such policy principles may appear rudimentary, but as recently as 2017, as prominent an American city as San Francisco lacked a centralized picture of conditions and vacancies at its properties, did not monitor or estimate revenues forgone by renting space for free / below-market to non-profits, and failed to utilize its investment

How American Cities Can Benefit from “Land Value Capture” Instruments in the Time of COVID-19 and Beyond

properties for their highest and best use.¹³ In contrast with San Francisco and similar cities, The Hague (The Netherlands) has a municipal bylaw that requires the city to minimize vacancies on municipal premises. As a result, vacancy rates are benchmarked and actively managed. The bylaw also stipulates that municipal leases should be priced at market levels or at cost-recovery (the latter for government agencies and non-profits); furthermore, properties deemed to be surplus must be sold according to the city’s strategic AM plan.

In general, a lack of distinction between the investment use of properties (which should be at market prices) and targeted social uses (at subsidized prices) seems to be a common problem in the U.S. In this regard, the management of municipal property in many U.S. cities is not much better than in developing countries – despite (i) the fact that good methodology was tested and published in the U.S. thirty years ago, and (ii) all the depth of the private real estate expertise in our country.¹⁴

Property sales

Similar to rentals, most jurisdictions have historically engaged in occasional sales of their property. Under the current fiscal squeeze, American cities are at risk of repeating the global failures of 2008 – 2011, when many governments engaged in a “dual sin,” from the viewpoint of long-term public interests, specifically: (1) fire sales of assets at the bottom of the market and (2) spending the sale revenues to patch immediate operating budgets rather than spend on capital investment. In contrast, a good disposition approach should i) operate under a long-term time horizon, ii) be tied to the real estate market cycle, and iii) be based on city-wide strategic planning of property needs. Such planning should take into consideration intensification of land uses on government-owned land, as well as the resulting release of properties for sale or repurposing, as illustrated further below.

However, in the COVID-19 induced market environment, with its general economic downturn and expected lowering of demand for office space and

specialized properties, sales of municipal real estate under favorable terms can be problematic, in the short- and medium-term.

In addition, it is useful to recall past lessons from governments’ engagement in sale-leasebacks, which, by their nature, are complex public-private partnership (PPP) deals. There are examples of sale-leasebacks not serving the best interests of taxpayers when the deals are motivated by a search for a quick cash infusion (e.g., the “Golden State Portfolio” in California in 2010, later withdrawn) or political agendas, such as sweeping privatization (e.g., Australia from 1980- 1990). Both of these sale-leaseback deals, when independently assessed, turned out to have a lower net present value in the long term, compared to continued public ownership. In yet another example, the 2009 sale-leaseback of seven federal buildings in Canada led to multi-year disputes between the partners and arguments by experts that the deal provided poor value-for-money to taxpayers. Apparently, a common cause of such problems is that political agendas drive the terms of sale-leaseback deals and influence how their justification is conducted.¹⁵ Similar dangers can be expected for municipal governments in the U.S. if they embark on complex PPP deals without the involvement of sufficient - and independent - expertise.

Public-private partnerships (PPPs) (a.k.a. Joint Development Agreements (JDAs) in some countries)

Typically, in financially self-sustaining PPPs a government contributes a land site and a private partner funds construction of a public facility while recouping his costs and obtaining profit from a commercial part of a project. As PPPs, such deals do not appear as promising for the U.S. as in other countries: the U.S. is far behind other developed countries in terms of using PPPs. To illustrate: in the U.S. in 2016, PPP spending as a percent of total infrastructure spending was 0.9%; by comparison, it was 10.9% in Australia, 3.6% in Canada, and 15% in the U.K.¹⁶ Though specific annual numbers vary, the U.S. lag in PPPs has been fairly constant.

How American Cities Can Benefit from “Land Value Capture” Instruments in the Time of COVID-19 and Beyond

Whether in the U.S. or elsewhere, the private sector’s willingness to engage in a PPP / JDA and self-fund the public portion of the facility in exchange for some commercial rights (as opposed to financing the public facility and being repaid by the government over time) depends on the perception of market demand for the commercial portion of the project. Hence, the applicability of such PPPs is sensitive to a site location and other demand factors, and these PPPs often work best in Transit-Oriented Development (TOD) areas.

Such PPPs are usually contract-based, as opposed to establishing a joint legal entity between the public and private partners. Legally and financially, such deals can be structured in numerous different ways; for example, in terms of property rights, they may involve leases, sales, air rights, etc.

Air rights contracts

Internationally, these have been used in Australia, Canada, Hong Kong, France, India, Japan, Philippines, Poland, and the U.K., and likely in some other countries. Air rights contracts are often employed by government entities managing railroads, highways, roads, and TODs. Air rights are also well-known in the U.S., and there are famous cases, both private-private and public-private. Recent examples include the High Line Park and Hudson Yards redevelopment in NYC. Granting municipal air rights works best in specific, high-value locations (not necessarily just in big cities) when economic and market conditions support them. Air rights can be used as part of deals that include PPPs and intensification of uses on government-owned land.

Naming rights contracts, i.e. temporary rights of a private sponsor to name a high-visibility government property

These are used in at least 38 countries, including Australia, Brazil, China, Finland, Mexico, and others. Naming rights are also granted in the U.S., on public libraries, public stadiums, schools, and office buildings, though the nation-wide scope is not clear. Revenues go directly to the public entities selling the naming rights to help renovate or maintain their facilities.

Intensification of land uses on government-owned land

This instrument might be the most promising among those discussed here; in fact, virtually any city or town in the U.S. could leverage opportunities related to this type of LVC. Its promise lies partly in the fact that some of its modalities do not need private participation and can be implemented by municipal governments unaided. This type of intensification would lead, at the very least, to budget savings; in most cases, benefits would also include some revenues and local economic development. The different modalities of the intensification instrument often overlap one with another. This instrument provides the most benefit when applied not as the occasional one-off, but as part of a city-wide strategic AM effort. We can expect that COVID-19 will accelerate emerging trends in innovative applications of this instrument.

- *Reduction of a government / public services footprint.* This has been introduced as explicit policy, with quantitative targets, by several central governments internationally (e.g. Australia, Belgium, Canada, etc.). For example, in the U.K., office space per person decreased from 13 m² per full-time employee (FTE) in 2011/2012 to 9.2 m²/FTE in 2018/2019 (achieved partly through telecommuting and desk sharing). Total public holdings in the U.K. were reduced by 30% from 2010 to 2018/2019, and the associated operating and maintenance costs have been monitored, benchmarked (against the private sector), and reduced as well.¹⁷

As an example of COVID-19 induced innovation at the local level: after the municipal government in the City of Hague realized that mandatory work-from-home during the pandemic turned out to be rather productive, the city began moving toward a more flexible work concept. It plans to vacate some office buildings (selling or repurposing them), while the city staff will combine working-from-home with working part-time in the remaining office space – with regular meetings at public places such as museums, libraries, or sports halls. The novelty of

How American Cities Can Benefit from “Land Value Capture” Instruments in the Time of COVID-19 and Beyond

this approach is that the government makes drastic changes in its own modus operandi before reducing public services.

- *Reduction of vacancies on government properties.* As a matter of explicit policy, this exists at some central governments internationally (Australia, New Zealand, the U.K.). As an example at the municipal level: 20 municipalities participating in voluntary benchmarking in The Netherlands reported that a total of 1,132 properties changed from vacant to occupied from 2017 to 2018.¹⁸ Each participating municipality also monitors vacancies on all their own-use properties.
- *Combining several public uses on a government land site (i.e. consolidating uses for efficiency).* At the municipal level, combinations already attempted in the U.S. include a city hall + library; library + affordable housing; fire station + affordable housing, and fire station + medical emergency, etc.

A new potential direction is to combine government agencies from *different levels of government* in one building. The U.K. central government aggressively promotes this concept through its “One Public Estate” initiative, which is voluntary for municipalities, though 95% of them have reportedly joined the initiative.

- *Sharing public land or facilities with the private sector.* This takes two main forms: on a permanent basis (exemplified by the case in Washington D.C., below), and on a temporary basis, including time-share leases.

Intensification of Land Uses on Municipal Land: West End 37/50, Washington D.C.

The city owned two nearby dilapidated facilities: a library and a fire station. Through a non-solicited offer, later converted into public procurement, the city selected a development consortium, to which it sold the sites, in exchange for obtaining

two in-kind contributions from the developer: (i) a new library as a part of a mixed-use building designed by Enrique Norten, which includes luxury apartments, street-level retail spaces, and underground parking; and (ii) a new fire station as a part of a mixed-use building that also contains a squash court, commercial retail, subsidized and market-rent apartments, and parking.¹⁹ The developer, in addition to land, received two tax credits and was exempt from a mandatory affordable housing quota on the library redevelopment site. The subsidized housing was financed by the city. While most stakeholders are satisfied with outcomes, as often in such cases, an open question remains whether the public obtained a fair value for the municipal sites that the city contributed.



*West End Square 37, Washington, D.C.
Photo: Olga Kaganova*

How American Cities Can Benefit from “Land Value Capture”
Instruments in the Time of COVID-19 and Beyond



West End Square 50, Washington, D.C.
Photo: Olga Kaganova

It seems that deals similar to West End 37/50 are rare in the U.S., and more common in Europe where they have been practiced since at least 1990s. For example, a building in The Hague may combine district administration, library, police station, and/or supermarket; in this case, the city government and a supermarket owner formed a condominium.

Opportunities on a small scale include leasing in public spaces, such as street kiosks or advertisements and ATMs on mass transit stations.

- *Relocation of government from prime to more modest locations and selling prime properties.* The U.K. government has been very active in dramatically reducing its portfolio in central London: from 126 to 63 properties between 2012 and 2016, with expected further reductions to about 20 buildings by 2025.²⁰ Reportedly, Chinese municipal governments earned significant revenues during an early market development and urbanization in

1990s by selling their centrally-located city halls and moving city administrations to the outskirts of town. This idea is not entirely foreign to the U.S. either: for example, The City of Norwich (NY) has been considering selling its city hall and moving to the third floor of a fire station.²¹

- *Repurposing public facilities for new uses, either public, private, or some combination thereof.* Many local governments become familiar with this issue when schools, libraries, or prisons become vacant. For example, the repurposing of juvenal detention centers in several U.S. states included a youth center, mixed urban-agriculture / affordable housing project, technology park, commercial redevelopment, etc.²² Repurposing is led, of course, by policy goals as well: does the government want to convert the property into another public-use facility or put it up for market-oriented redevelopment? From a financial viewpoint, repurposing, especially for social purposes, is often associated with large public liabilities and expenses, in which cases repurposing cannot serve as a source of immediate revenues. Nevertheless, even if repurposing does not produce transaction revenues, it can at least create jobs and may even have a broader spill-over effect. For example, when the City of Tilburg (The Netherlands) redeveloped an old locomotive depot into a multi-use public-private facility, LocHal, this property became a national tourist destination, feeding the retail and hospitality sectors in the city.

However, the potential for repurposing is fundamentally defined by the local context: large cities with strong housing markets may have more options for commercial repurposing, while declining neighborhoods with lower population density may face challenges attracting businesses and other economic developments to vacant properties.²³

It should be noted that COVID-19 has added a new variation to repurposing: temporary conversion of public facilities into alternate care facilities (ACFs). The U.S. Army Corps of Engineers alone built 38 such facilities between late March and the end of

How American Cities Can Benefit from “Land Value Capture” Instruments in the Time of COVID-19 and Beyond

June, using sites or buildings of facilities such as a convention center, an athletic complex on a college campus, schools, hospitals, etc.²⁴ The Corps also upgraded infrastructure related to properties housing ACFs – including roads, power supply capacity, and air conditioning. After completion, these improvements are transferred into state ownership, along with the costs of ownership. A question is whether states will dismantle these facilities when they are no longer needed – as some states have already done – or will close but maintain them in case of further need.

The entire issue of ACFs may become universal for all local jurisdictions in the U.S.: experts from the Johns Hopkins University recommended that all cities and towns plan for ACFs, even if only jointly with neighboring jurisdictions or states.²⁵

One universal challenge that cities face is that prudent management of surplus municipal property involves identifying the best strategies for these assets, be this a lease, sale, PPP, or some intensification of land use. The ability to identify such strategies, however, requires advanced asset management expertise and flexibility, which municipal government organizations often lack. Moreover, hiring qualified experts to sort out asset portfolios and identify long-term solutions for particular properties is typically not affordable for municipal governments, so funding such expertise may necessitate unorthodox financial solutions that involve a bold political will (i.e., experts’ compensation as some percentage of a newly generated revenues). Not surprisingly, corporatization of government asset management (i.e. creation of a specialized government-owned corporation) has also been tested in some countries (e.g., Ontario (Canada), Finland, Austria, etc.) and has its proponents.²⁶ However, how broadly the corporate model is applicable and viable remains to be seen. Perhaps its main issue is which municipal properties should fall under corporate ownership or management: all of them or surplus only? If the latter, how do municipalities address the fact that the line between the public-use and surplus properties is often quite fluid (as discussed above)?

Sale of development rights/density bonuses

This instrument grants a developer or property owner the right to exceed the base land-use density or deviate from other zoning parameters in exchange for a payment or an in-kind contribution of a public-use facility (e.g. a public parking garage) or public amenity (e.g. a public space) on his property. This is a zoning instrument and requires a special “incentive zoning.” It is used in various large cities in many OECD countries, Singapore, and some cities in Brazil and India. In the U.S., the concept is familiar and utilized to a fair extent. There are famous cases, notably about 600 privately-owned public spaces (POPS) created in NYC since 1961 when incentive zoning was introduced. There are at least 11 U.S. states where these zoning instruments exist: California, Colorado, Florida, Illinois, Massachusetts, Minnesota, Maryland, New York, Vermont, Virginia, and Wisconsin. However, their scope is quite small: only about two percent of all municipalities and counties in the U.S. have incentive zoning.

Typically, density bonuses are site-specific. However, since 2004, the City of Sao Paulo (Brazil) created and auctioned “certificates of additional construction potential bonds,” which give a bearer additional construction density within a specific city zone. The bonds are sold on electronic auctions at the city Stock Market Exchange, and revenues are used to improve infrastructure in the zone where the bonds are applicable.

Density bonuses as a regulatory instrument have been criticized internationally for the arbitrariness of underlying density and challenged in courts in the U.S. on several grounds, including unconstitutional “takings.”²⁷ However, this instrument is likely to continue to be in use for the foreseeable future, at least in some jurisdictions, despite its controversial nature.

Other LVC instruments. Among the other nine LVC instruments listed in the beginning but not yet discussed, two - land readjustments and betterment charges - are seemingly not used in the U.S. and do not seem to hold any potential: the first one because contextually it is not relevant, and the second due to its

How American Cities Can Benefit from “Land Value Capture” Instruments in the Time of COVID-19 and Beyond

spotty success internationally, including massive lawsuits by property owners. The remaining instruments are of a fiscal nature and mandatory for payers. Discussion of the prospects of increasing local revenues from these sources during the current economic downturn is beyond the scope of this paper.

Instead of a Conclusion: Prerequisites of Success

Yes, even in the times of COVID-19, American cities can benefit from using LVC instruments, particularly those related to municipal property and land zoning powers. However, there are critical preconditions for these instruments to work at their full potential. In particular, policy and administrative actions are needed as follows:

1. Curb fragmentation of AM among multiple line departments and municipal entities, by either centralizing AM or subordinating departmental AM to city-wide policies, strategies, and incentives.
2. Implement specific policies aimed at strategic, portfolio-level AM.
3. Introduce tangible incentives for staff and departments in order to facilitate desirable changes. The explanation that public administration systems are not tailored for incentives seems to be more an excuse for doing business as usual than a real obstacle. For example, during the previous fiscal crisis, in 2010 - 2011, Montgomery County (Maryland) and Virginia both introduced effective incentives for municipal staff to create AM saving initiatives.²⁸

Another important pre-condition for LVC success is flexibility and responsiveness/speed of governmental actions, especially when private sector participation is expected.

Finally, one key overarching question is how budgetary savings and additional revenues, if mobilized through better AM, will be spent: will they be dedicated to reinvestment in maintenance, repair and replacement of public infrastructure – as experts recommend – or

dissolved into government operating budgets to cover up operating shortfalls, as has happened in the past? •

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How American Cities Can Benefit from “Land Value Capture” Instruments in the Time of COVID-19 and Beyond

9. Conceptually, it can be debated whether this is an “instrument” or something broader, such as an “approach.” Given the clear LVC nature of the “intensification,” on the one hand, and a certain buzz about LVC in general, on the other hand, it is useful to place this instrument on the list of “LVC canons.”
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