

LEVERAGING DEVELOPMENT INCENTIVES IN DETROIT

DETROIT ECONOMIC GROWTH CORPORATION

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LEVERAGING DEVELOPMENT INCENTIVES IN DETROIT

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■ CREDITS

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■ EXECUTIVE SUMMARY

This report, commissioned by the Detroit Economic Growth Corporation (DEGC), considers how commercial development subsidies could be leveraged to increase projects in the development pipeline, reinforce public policy and planning agenda, and increase revenue for future public investments. DEGC has identified the following goals for incentive use: 1) accelerating commercial development in targeted neighborhoods, 2) analyzing overall incentive allocations, and 3) ensuring incentive are limited to their “but for” purpose.

Moving past municipal bankruptcy and several decades of disinvestment, the Detroit commercial property market has seen a remarkable, if geographically concentrated, regeneration. Since 2013, almost all development projects in Detroit’s Greater Downtown have been supported by public subsidies ranging from state property tax abatements, to federal New Market Tax Credits, to state Community Revitalization Program loans. However, as Detroit is rapidly approaching a position in which downtown projects maybe be viable without large development incentives, DEGC faces a window of opportunity to revise its incentive programs, targeting strategies, and project underwriting procedures.

This report analyzes 21 projects provided by DEGC that have received incentives over the past three years. These projects received \$73 million in state, federal, and local support including New Market Tax Credits, Brownfield Tax Credits, CRP Grants, CRP Loans, and

Federal Housing Tax Credits. In comparison, the City provided \$52.6 million and \$67.5 million of property tax abatements in 2016 and 2015, respectively. The fact that the combined value of all other incentive sources is almost comparable to the value of property tax abatements in one year speaks to the importance of this subsidy source to development.

Used judiciously, property tax abatements may be especially useful to the City in shaping future development projects, especially as Detroit’s popularity as an investment market grows. Mixed-use projects received the most incentives by far, and nearly all incentivized projects were located in the Greater Downtown area, particularly Downtown, New Center, and Midtown. If neighborhood development outside of Greater Downtown becomes a priority, the City will need re-evaluate the current incentive structures.

A review of three other major metropolitan finance systems confirms that restricting incentive eligibility would not put Detroit at a competitive disadvantage vis-a-vis its peers. It also reveals several best practices that could offer the City greater fiscal flexibility and value recapture.

Our recommendations from this analysis, elaborated in the final section of this report, are as follows:

Centering Neighborhood Development

- Restructure abatement eligibility to advantage non-downtown development

- Conduct neighborhood market analyses
- Establish value recapture provisions on abatements

Tracking Incentives, Calculating Benefits, Enhancing Transparency

- Establish maximum IRR benchmarks by asset type or located neighborhood
- Establish citywide annual budgetary targets for discretionary incentives
- Update and standardize public information architecture

Aligning incentives with Public Policy Agenda

- Coordinate with Department of Housing and Revitalization on affordable housing
- Integrate Community Benefit Agreements (CBAs) and other forms of linkage

■ INTRODUCTION

After decades of sharp decline, the City of Detroit has seen an economic rebound through significant investments in community and real estate development in the past seven years, particularly in central areas of the city. The purpose of this report is to examine the real estate development incentive structure at the Detroit Economic Growth Corporation (DEGC) given these changing economic circumstances. The report is divided into five sections: 1) a summary of Detroit's changing market conditions; 2) an overview of current development incentives offered by the city; 3) an analysis of fiscal gaps across asset types and projects that have received subsidy through DEGC; 4) a review of development programs in comparable U.S. municipalities; and 5) a series of recommendations to enhance the agency's current and future use of incentive programs. This report was commissioned by DEGC and conducted by graduate students enrolled in the Fall 2016 "Financing Economic Development" course in the Department of Urban Studies and Planning (DUSP) at the Massachusetts Institute of Technology (MIT).

■ BACKGROUND

Detroit Economic Context

The City of Detroit was among the hardest-hit municipalities during the 2009 financial crisis. The automotive industry, a driving force of the metropolitan economy, underwent significant contraction and restructuring. The bankruptcy of General Motors and Chrysler, the loss of employment and public revenue that these companies provided, and the subsequent federal bailout of the auto industry amplified Detroit's profound economic woes and provided a wake-up call to the region.

After the crisis, the city's weakened economy and reduced property values created an especially challenging development financing environment. Financial risks—high vacancy rates and low rental values—reduced the availability of senior bank debt and increased

the level of project subsidy (tax credits, grants, and soft loans) needed to make projects financially feasible. This created pressure on the finance system to both supply more subsidies and increase non-bank debt to offset reduced bank lending. In addition, poorly structured municipal debt obligations tied up the fiscal resources available to relieve the bank credit crisis.¹

By 2010, Detroit did not have distinct finance systems for various types of development. Most community development finance entities were involved in small business, real estate, and housing finance and worked to promote investment in all three realms. This reflected the emphasis on bringing all types of investment into the city and creating increased housing density and repopulation as part of a broader development strategy. While development

¹ Bomey, Nathan. (2016). *Detroit Resurrected: To Bankruptcy and Back*. New York: W.W. Norton.

financiers could escape traditional silos and pursue creative financing options, they were less specialized and connected to national financing networks tied to each field. Community facilities relied on a different funding pool than the housing and economic development system, with specialized lenders (e.g. Nonprofit Finance Fund), foundations, and national sources of New Market Tax Credits (NMTC).

While some real estate and business loans were made available through the Detroit Economic Growth Corporation (DEGC), the city government did not have a comprehensive strategy to invest in community development projects. Indeed, a 2015 report by the Kresge Foundation found that Detroit had a poor track record of deploying federal Community Development Block Grants (CDBG) or HOME funds to provide project subsidies or soft, subordinate loans.² Given the great need for project subsidies (and their strategic use), the absence of an active federal government partner with well-developed funding programs created a key gap in the finance system.

Due to limited private bank financing and weak government fiscal capacity, foundations, several nonprofit and quasi-public entities, and state government have become critical community development capital sources in Detroit. The Ford Foundation, Kresge Foundation, and the Hudson Webber Foundation all provide grants and loans for specific projects and capital for loan funds and CDFIs. Several Detroit-based nonprofits—including Invest Detroit, Enterprise Detroit, LISC, and Midtown, Inc.—supply

predevelopment loans and short-term real estate loans. The first two entities also make small business loans, and Invest Detroit is an NMTC intermediary.

Since 2012, the community development finance system of Detroit has experienced several changes which have helped improve the city's market conditions. First, while the State of Michigan previously provided competitive tax credits for historic rehabilitation and brownfield development, the state has since cut back on development subsidies. Michigan replaced the Brownfield Tax Credit and Historic Tax Credit programs with direct grants and loans delivered by MEDC under the Community Revitalization Program (CRP). MEDC has utilized this program to support investments in Midtown, providing loans or grants of up to \$1 million for projects along commercial corridors.³

Several national CDFIs and banks have begun investing in Detroit since its bankruptcy. In particular, the entrance of Capital Impact Partners (CIP) into the Detroit area has boosted the city's commitment and capacity to finance a range of development projects. In addition to the capital provided by Living Cities' Integration Initiative, CIP was able to attract and deploy funds raised from other sources, including NMTCs, foundation program-related investments, and bank investments.

A stronger collaboration has also notably emerged between the three main CDFIs investing in the Downtown and Midtown areas: Capital Impact, Detroit Development Fund, and Invest Detroit. These three parties have co-invested in projects and provided

² Kresge Foundation (2015). *Capital Absorption in Detroit: Past, Present, Future*.

³ DEGC (2012). *Dedicated to Detroit's Growth*. Presented to the Council of Development Financing Agencies.

complementary financing to advance development projects in Detroit's complex financing environment.

At the same time, common financing gaps have seen more systematic responses. One outcome of this has been the formation of the Woodward Corridor Investment Fund to fill a common financing gap for projects: long-term mezzanine financing that can supplement senior debt and reduce the need for subsidies.

Meanwhile, the city has expanded and improved coordination of efforts to support small business development growth. This includes TechTown developing new programs aimed at supporting and nurturing retail entrepreneurs and the formation of a business development consortium by DEGC to provide better information on business development services and ensure assistance providers (and lenders) understand their respective services and can make appropriate referrals.⁴

The vast majority of these efforts have been focused in the Greater Downtown area, with an emphasis on creating a stable property market in the central business district. Today, Downtown Detroit enjoys a 98-percent residential occupancy rate, among the highest downtown rates in the country.⁵ But without a more comprehensive neighborhood investment strategy, incentives have had limited impact outside Greater Downtown. In recent years, development finance players in the city have sought to capitalize on this transformation of downtown urban cores into the residential neighborhoods, extending some

of the proven approaches to other anchor-based corridors throughout several city districts. In addition, the city has worked to capitalize on the transportation boom by exploring intermodal options including a metropolitan bus rapid transit system, the M-1 light rail line, and the planned Gordie Howe International Bridge.

As Detroit's economy reverses course, real estate investment and development has restarted as well. The City and its economic development professionals have worked to rekindle investment by providing guidance, technical assistance, and incentives to investors, developers, and entrepreneurs. To contextualize the challenges and opportunities that the City faces in its revitalization efforts, an overview of Detroit's current residential and commercial development incentives follows.

Detroit Real Estate Development Market Analysis

The first decade of the 2000s was a period of significant economic decline in Detroit. From 2000 to 2010, jobs in the metro area declined by an average of 46,700 jobs annually, or 2.4 percent year-over-year.⁶ Every nonfarm sector contracted except education and health services sector, which increased by an average of 4,700 jobs, or 1.8 percent annually. Much of this growth can be attributed to the strong healthcare anchors in the region, such as the Detroit Medical Center, Wayne State School of Medicine, and Karmanos Cancer Institute in Midtown Detroit. Meanwhile, Detroit's core

⁴ Federal Reserve Bank of Chicago. (2014) [An analysis of SBA loans in lower-income and black neighborhoods in Detroit and Michigan](#). ProfitWise.

⁵ Hudson-Webber Foundation. (2015) [7.2 SQ MI: A Report on Greater Downtown Detroit](#). 2nd ed.

⁶ Labovitz, Gabriel. (2014) "[Housing Market Profiles: Detroit-Warren-Dearborn, Michigan](#)." U.S. Department of Housing and Urban Development, Office of Policy Development & Research.

sector of employment, manufacturing, accounted for nearly half of job losses, shedding 20,500 jobs annually at a rate of 7.1 percent per annum.

Starting in 2010, the jobs economy of Detroit started making a rebound, with the greatest increases in the professional and business service and the manufacturing sectors. The three largest employers in the area are the “Big Three” domestic automakers: the Ford Motor Company, Chrysler Group, and General Motors. Through June 2014, automakers were on pace to post full-year sales of 16.2 million vehicles, the most since 2006. In December 2013, General Motors announced a \$493-million investment in the Romulus Powertrain Operations plant, which is expected to retain 650 jobs in that location. Chrysler and Ford have also been hiring significant new workers for their existing plants. Efforts to remake the city into a business entrepreneurship center

focusing on technology jobs has also had some moderate success so far.⁷

Despite the post-recession rebound, the city was set back again with municipal bankruptcy filed in July 2013. However, the bankruptcy also established an extraordinary alignment of interests between the city, its business community, the state legislature, and nonprofits.⁸ Since the bankruptcy, Downtown Detroit has seen a significant uptick in investment over the last ten years, led by Quicken Loans founder and Detroit native Dan Gilbert and fellow Detroit billionaire and sports team owner Mike Ilitch. Their efforts have led to the types of revitalization strategy that typified many cities in the 1980s and '90s: downtown stadiums, office, and entertainment district developments. Detroit’s Midtown, Corktown, Woodbridge, East Riverfront and other areas adjacent to downtowns have become development hotspots.

⁷ U.S. Department of Housing and Urban Development. (2014) Comprehensive Housing Market Analysis.

⁸ Bomey, Nathan. (2016) *Detroit Resurrected: To Bankruptcy and Back*. New York: W. W. Norton & Company.

■ REAL ESTATE DEVELOPMENT INCENTIVES

Development incentives, among the most important tools that cities use to attract capital investment and advance economic objectives, are highly debated in various cities. Incentive programs provide various forms of financial and nonfinancial support to help promote real estate projects, small business formation, and community revitalization. Incentivizing development projects also serves to expand the tax base, increase property values, and add amenities that improve the quality of life and provide long-term benefits to the community.

Well-designed incentives for real estate projects can bring dilapidated buildings back to life, revitalize neighborhoods, provide affordable housing, create jobs, and advance other important public policy goals. However, the most advantageous real estate developments are often the most challenging; complex and trailblazing projects can face significant financial challenges. Successfully completing the most difficult projects requires an understanding of how to identify, negotiate, and utilize all available financial tools.

Public incentives and nonfinancial guidance often improve the feasibility of complex real estate projects with the potential to advance community goals. Such financial incentives may come from the federal, state or local level of government and may include grants, loans and tax credits. Commonly used financial incentive tools include:

Tax Increment Financing (TIF): Used in districts designated as “blighted” or “under-

developed,” TIFs allow the municipality to earmark increases in assessed property value for reinvestment within the TIF district.⁹ Since the 1990s, TIF use has diversified in some cities to allow for project-based value recapture, or “project TIFs.”

Historic Rehabilitation Tax Credits: Designed to discourage unnecessary demolition of structurally-sound older buildings and to slow the loss of businesses from older urban areas by encouraging private investment in the cleanup and rehabilitation of historical properties.

Brownfield Incentives: Spur investment in blighted properties and assist in revitalizing communities through brownfield cleanup and redevelopment by allowing taxpayers to reduce their taxable income by the cost of eligible cleanup expenses in the year they are incurred.

Low Income Housing Tax Credits (LIHTCs): Enable the use of private equity in the development of affordable housing for low-income Americans by allowing developers to claim federal tax credits for the costs incurred from development of affordable units in rental housing projects.

New Markets Tax Credits (NMTCs): Designed to stimulate the economies of distressed urban and rural communities and create jobs in low-income communities by expanding the availability of credit, investment capital, and financial services.¹⁰

⁹ Dye, R. and Merriman, D. (2006). [Tax Increment Financing: A Tool for Local Development](#). Lincoln Institute of Land Policy.

¹⁰ EPA (2011). [Guide to Federal Tax Incentives for Brownfields Redevelopment](#). National Service Center for Environmental Publications (NSCEP).

DEVELOPMENT INCENTIVES IN DETROIT

DEGC manages a variety of financial incentive programs that aim to stimulate and real estate development across Detroit. The following list includes key financing tools for residential, commercial and industrial development projects.

Table 1. Detroit Incentives Managed by DEGC

| | |
|--|-------------------------------------|
| Renaissance Zones | Industrial, Residential, Commercial |
| Smart Buildings Grants/Green Fund Loans | Industrial, Residential, Commercial |
| Real Property Gap Fund | Industrial, Residential, Commercial |
| Brownfield Redevelopment | Residential, Commercial |
| DDA Housing/Office/Retail Loan Program | Residential, Commercial |
| Industrial Property Tax Abatements | Industrial, Commercial |
| New Personal Property Tax Abatement (PA 238) | Industrial |
| Business Development Loan Fund | Commercial |
| Creative Investment Fund (CCIF) | Commercial |
| Green Grocer Project | Commercial |
| Commercial Rehabilitation Exemption (PA 210) | Commercial |
| Obsolete Property Rehabilitation (OPRA/PA 146) | Commercial |

- Industrial
- Residential
- Commercial

A brief description of each program has been summarized from material published by DEGC.¹¹

Renaissance Zones: Provide an incentive for new jobs and investment in local districts experiencing acute economic distress. Qualified businesses located in these zones receive a waiver of most state or local taxes for up to 15 years. Areas designated as Renaissance Zones cannot exceed 1,200 acres across the city.

Brownfield TIF: Promotes the revitalization of contaminated, blighted, and obsolete properties. Developers of approved brownfield plans are eligible for TIF reimbursement for activities such as remediation, demolition, site preparation, and public infrastructure improvements.

Industrial Property Tax Abatement: Provides incentives for eligible businesses to make new local investments by encouraging manufacturers and high-technology firms to build, expand, or renovate facilities, or add new machinery and equipment. Abatements must be approved at both the local and state levels.

Obsolete Property Rehabilitation Act (OPRA): In designated districts, projects that rehabilitate blighted commercial and residential property can be exempted from ad valorem taxes. Under state law, the City may establish Obsolete Property Rehabilitation Districts and approve exemptions for a term of 1–12 years.¹²

¹¹ Detroit Economic Growth Corporation (2016). "[Incentives and Financing](#)." Accessed 7 December 2016.

¹² Michigan Department of Treasury (2016). "[Obsolete Property Rehabilitation Act](#)." Accessed 7 December 2016

Box 1. Direct Development Subsidies Allocated by DEGC

New Personal Property Tax Abatement: Allows the City of Detroit to abate all taxes on new personal property, i.e. property not already subject to Michigan taxes, for businesses established in targeted areas. This can be set for a period of any duration.

Commercial Rehabilitation Exemption: Encourages the rehabilitation of commercial property by abating the taxes on new investment for up to 10 years. The rehabilitation must result in improvements not less than 10 percent of the property's true cash value before improvement.

Real Property Gap Fund: Established by DEGC to foster greater investment in real property rehabilitation projects to be owned, operated, and financed by City of Detroit residents. Properties must be located along the East Riverfront, the Woodward Corridor, or within the Central Business District.

DDA Housing Office Retail Loan Program: Designed to stimulate additional residential and commercial activities in Downtown Detroit by supplementing private investment with loans, generally at a minimum ratio of \$2 of private funds for every \$10 of public funds. Loans support the construction, redevelopment or improvement of real property located in the Downtown Development Authority's (DDA) Area No. 1.

Smart Buildings Grants/Green Fund Loans: Designed to improve energy conservation in commercial, institutional and industrial buildings in greater Downtown Detroit. Eligible projects can receive grants up to 25 percent of total project costs, plus loans of up to 40 percent of total project costs, and financial assistance for buildings that install energy efficiency and renewable energy technologies.

Creative Corridor Investment Fund: New program designed to create 125,000 square feet of office space specifically for companies in the creative industries and 400 jobs in Detroit over the next five years. The fund expects to create new centers of dense commercial activity that attract creative talent and companies.

In addition to the direct development subsidies listed above, the following tools offer indirect but complementary subsidies that support real estate and local economic development projects.

Box 2. Indirect Subsidies Allocated by DEGC

DDA Small Business Loan Transaction (SBLT) Program: Designed to create new employment opportunities, halt the deterioration of real property values, and promote economic growth within the Detroit Downtown Area. Loans supplement private investment to assist building owners, tenants and business owners located or to be located within Downtown.

Workforce development programs: The Detroit Employment Solutions Corporation offers workforce training assistance to new and existing businesses located in the city.

Green Grocer Project: Established by DEGC to stimulate renewed investment in Detroit neighborhoods while providing improved fresh food access to city residents.

In reviewing the financing programs used by DEGC, it is evident that an overwhelming majority of the real estate incentives available in Detroit over the past three years have been granted to development projects in the Downtown and Midtown areas. As these areas begin to stabilize, financial incentive tools must be reviewed and updated to accommodate a shift towards revitalizing the city's neighborhoods.

Revised and comprehensive details regarding the requirements and utilization of financing programs ought to be made clearer and publicly available for neighborhood development actors. Meanwhile, establishing steadfast benchmarks to effectively analyze and approve incentives for neighborhood development projects will be valuable to DEGC and the city's broader financing system.

The existing financial tools also serve to highlight key challenges facing the broader economic development of the city, namely abandoned housing, rehabilitation of vital infrastructure, and efficient and sustainable buildings. The indirect development subsidies listed further indicate the city's disposition to address other community concerns beyond land value, including job creation, promoting local wealth, and increasing access to fresh food options.

Roundtable of Detroit Developers

A series of challenges and recommendations regarding the use of incentives were raised during a developer roundtable hosted by DEGC and the MIT student team on November 11th, 2016. This roundtable included three Detroit-based developers ranging in company size, number of completed and planned projects, and project asset types in their

portfolios. While all three developers primarily worked on mixed use residential developments, the project types discussed also included industrial, hotel and historic restoration. The developers discussed obstacles to development and efficacy of incentive programs within the current market. Recommendations resulting from the discussion include:

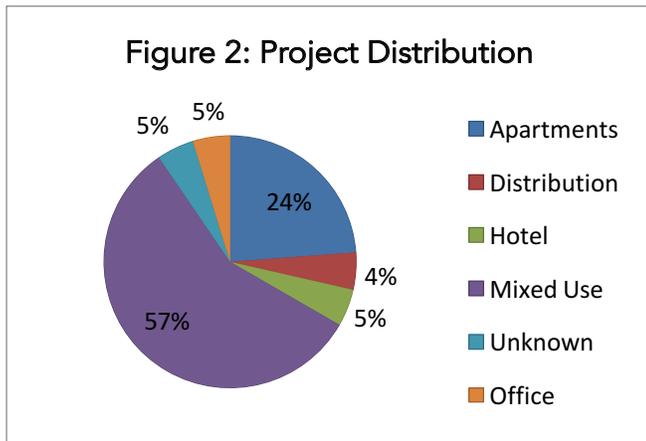
- **Target pre-development support.** A program could be designed to help smaller developers have the capital to invest in pre-development costs.
- **Provide bridge financing.** Create streamlined financial tool to bridge the gap between expenditures and the funding from tax credits or subsidies are issued. Certain entities such as LISC already provide gap financing, but the process can be complicated and can take up to six months.

There were other overall recommendations to the system of development finance in Detroit:

- Support anchor institutions in non-downtown neighborhoods, which have been critical for the success of development in the downtown area.
- Provide market studies of neighborhoods that can help support developers' interest in neighborhood development.
- Parking needs are among the greatest cost for Downtown development. space-tracking technologies or garage-sharing agreements may help defray costs in the short term, while having an assessment report on this issue may be helpful to developers.
- A need for local lenders to help increase the availability of capital. National banks do not fully understand the Detroit market and are thus less inclined to take risks.

■ DETROIT MARKET AND DEGC BASELINE PROJECTS

The following analysis is based on a dataset of 21 projects provided by DEGC. The dataset includes 5 apartment developments, 12 mixed-use projects, one hotel, one office development, one distribution center, and one unidentified project. This data shows us what types of projects have been funded, the location of the projects, and rough indicators of cost, profitability, and risk.



Apartments

The City of Detroit’s multifamily residential market is growing, with supply still below the growing demand for units. Zimmerman/Volk Associates estimate that over the next five years, there will be approximately 14,045 new households that will need housing in Greater Downtown Detroit.¹³ Inventory of downtown apartments has steadily increased at a rate of 1–2 percent annually while the vacancy rate has decreased annually, from 10 percent in 2010 to less than 5 percent in the first quarter of 2016.

The strong demand has led to a profusion of new residential developments in Detroit. The Michigan Strategic Fund approved incentives for developments in Corktown and in New Center, and the City of Detroit sought proposals from developers to build two more

significant projects in Midtown. Those four projects come on top of the 1,000 or so units already under construction around central Detroit in projects such as Orleans Landing and DuCharme Place, and perhaps at least 1,000 more units in various stages of the planning pipeline.¹⁴ This is significant new supply to absorb, especially compared to the existing supply of 12,800 units in Greater Downtown Detroit.¹⁵

The relative strength of the residential market in Detroit may be why we see significant proportion of projects as solely apartments or mixed use with a significant residential component. The apartment projects being underwritten by the City vary widely: from 30 units in a low-rise historic building to over 150 new luxury units in towers. All of these were rental units and a majority are one and two bedrooms. The projects were also scattered across different neighborhoods within the Greater Downtown. Despite most of the projects being market rate and luxury housing, we did see one project that had 15 units designated as affordable for families earning approximately \$35,000.

Through conversations, we have also seen an interest in encouraging condominium projects. This year, condominium prices have hit an

¹³ Zimmerman/Volk Associates. (2015) *An Analysis of Residential Market Potential*.

¹⁴ Aguilar, Louis (2016) "[Detroit area housing market hits new heights](#)." *The Detroit News*. 2 October.

¹⁵ Zimmerman/Volk Associates. (2015) *An Analysis of Residential Market Potential*.

eight-year high with median sales prices of \$165,000, demonstrating the new normal in the Metro Detroit housing market: prices steadily climbing as inventory remains far below pre-recession levels. As a result, homebuyers often find themselves in bidding wars over properties. Patrick Carolan, a realtor for Coldwell Banker Weir Manuel in Birmingham. "It is competitive, lots of overbids, lots of multiple offer situations," Carolan said.¹⁶ This month's sale of a loft condo in Corktown for a reported \$531,000 was just the latest anecdotal evidence that for-sale prices have begun to catch up with the demand. In the city's Brush Park district just north of Downtown, for-sale prices have approached \$300 per square foot, or about \$300,000 for a 1,000-foot unit. With such rapidly rising demand and a corresponding rise in prices, it is unclear if any subsidies are necessary to stabilize this market. The obstacles, if any, to developing a greater supply of condominium units to satisfy demand requires further investigation.

Mixed Use

The City has also helped finance a large number of mixed-use projects: primarily residential buildings with ground-floor retail. Similar to solely residential projects, a majority of these projects are market rate apartments with one or two bedrooms. Mixed-use projects have rates of return that are consistent with other asset types, approximately 13 percent (as shown in Figure 7). Furthermore, the 7.6 percent

projected cap rates for mixed-use projects was on-par with apartments.¹⁷

A thriving retail and commercial corridor is important to generating more lively pedestrian experiences and improving residents' quality of life. While there are a large number of mixed-use projects with retail, the incentives studies did not include many standalone retail developments. This is reflective of the larger retail market in Detroit that has not been particularly "flashy" but is showing signs of growth and steady improvement. Existing landlords have been able to slowly lease up vacancies. Thus, new retail space development is very slow, even though those that have come on line recently are doing well.¹⁸

Over the past five years, Detroit's restaurant scene has improved dramatically and some restaurants have drawn favorable attention in national media. The new crop of restaurants often renovates and adapts historic buildings, offering a trendy and urbane experience to patrons. For the most part, national chains have been slow to move into Detroit, but Shake Shack is opening their first and only Michigan location in Downtown Detroit, perhaps inviting greater interest among fast-casual chains. Current and historical vacancy rates remain low, therefore proposed and under construction retail developments are predominantly pre-leased.

This high demand combined with increased construction costs means that new developments are commanding high rents. Under these conditions, it is crucial to recruit retail

¹⁶ Aguilar, Louis (2016). "[Detroit area housing market hits new heights](#)." *The Detroit News*. 2 October.

¹⁷ Cap rates are a tool used to project expected sales price. The Net Operating Income (in the sales year)

divided by the cap rate is a rough indicator of the market value of the asset.

¹⁸ McGrath, Peter (2016). *Retail Moving in the Right Direction*. Colliers International Research & Forecast Report.

developments that would provide affordable retail spaces to smaller, local entrepreneurs, and not just established restaurateurs.

Other Asset Types

Aside from apartments and mixed-use projects, the City also underwrote one hotel, one office and one distribution center. Since there is such a small sample size for these asset classes, it is difficult to observe any overall trends or make informed comparisons. Thus, any further comparisons across asset class in this report may not reflect the broader market.

While there is limited new construction of offices, the office market in Detroit is performing well, particularly in Downtown Detroit. The rebound of the service firms and the automotive industry have also led to a growing demand for office space. Since 2012, downtown vacancies have dropped six percent to less than 15 percent vacancy, while rental rates have climbed 15.5 percent to over \$23 per square foot.¹⁹ Vacancy rates in Class A buildings are particularly low and many tenants that signed leases 5–10 years ago will be experiencing sticker shock in their renewal cycle.

Competition amongst tenants will likely continue to drive vacancy rates in Class A office buildings down. As large office spaces are being purchased, retrofitted, and occupied, large floor plates with contiguous spaces have also become sparse.

¹⁹ Jones Lang LaSalle Research (2016). "Detroit's office market appeals beyond the usual."

²⁰ McGrath, Peter (2016) Colliers International Research & Forecast Report. "Detroit Office Warms Up for the Summer"



Rendering of Little Caesars headquarters located adjacent to Detroit's Fox Theater

Despite such positive outlook on the office market and low vacancy rate in 2016 there is still limited new construction in the central business district.²⁰ The Little Caesars Pizza headquarters broke ground this year and represents the first office building to be built in the CBD since 2006.²¹

Downtown gross lease rates have yet to reach a point that justifies unsubsidized, ground-up construction.²² Correspondingly, there are a dearth of office projects in DEGC's development pipeline, and new projects have required outsized incentives. The Monroe Block project, a major office development slated for construction in 2018, is currently expected to receive \$35 million in TIF loans.²³

Given the new orientation towards neighborhood development, in the future, decisions to allocate such a high level of resources to one office development in

²¹ Jones Lang LaSalle Research (2016). "Detroit's office market appeals beyond the usual."

²² CBRE (2016). "Lease rates rise and vacancy declines as demand increases."

²³ Thibodeau, Ian and Louis Aguilar (2016). "[Bedrock touts two 'transformational' towers downtown.](#)"

Downtown should include a robust and transparent weighing of the costs and benefits. The adoption of an “incentive budget,” discussed in the recommendations section, would allow the City to have clearer sense of the trade-offs rather than scrambling to maximize incentives for each individual project. Maximum annual targets for public subsidies have been recommended to counteract the unlimited nature of these subsidies.²⁴

Comparison of Capital Stack by Asset Class

The provided projects received a total of \$73 million in state, federal, and local subsidies including New Market Tax Credits, Brownfield Tax Credits, CRP Grants, CRP Loans, and Federal Housing Tax Credits.²⁵ As shown in Figure 3, mixed-use projects received the most subsidies overall, but had some of the lowest average subsidies per project.

As mentioned earlier, Monroe Block is the only office development included in the data. This \$111-million project is a 16-story tower with 320,000 square feet of office space, ground floor retail and 1,000 parking spaces. It is slated to potentially receive \$35 million in a TIF brownfield loan, far more subsidy than any single project in our project dataset.

The project with the greatest amount of subsidy per square foot was the Wurlitzer Building, a \$22-million, 106-room boutique rehabbed hotel in Downtown Detroit with a restaurant, café, first-floor retail and a rooftop bar. Based on the data provided by DEGC, TIF brownfield



Wurlitzer Building in Downtown Detroit



Rendering of Monroe Block Development

²⁴ Bartik, Timothy J. 2005. “[Solving the Problems of Economic Development Incentives](#).” *Growth and Change*.

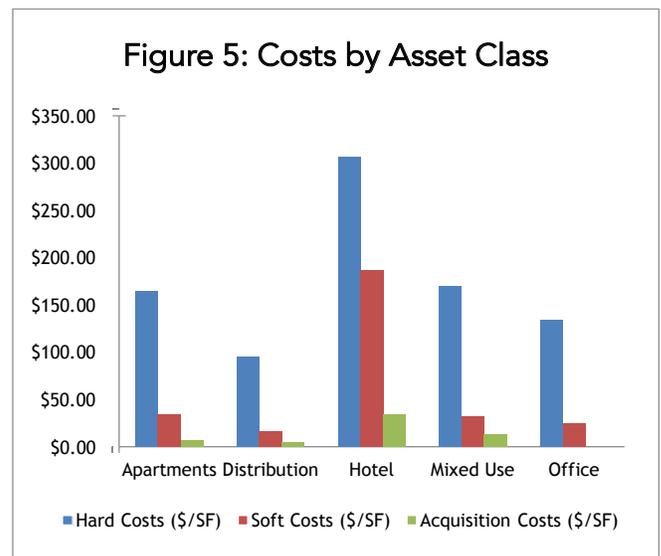
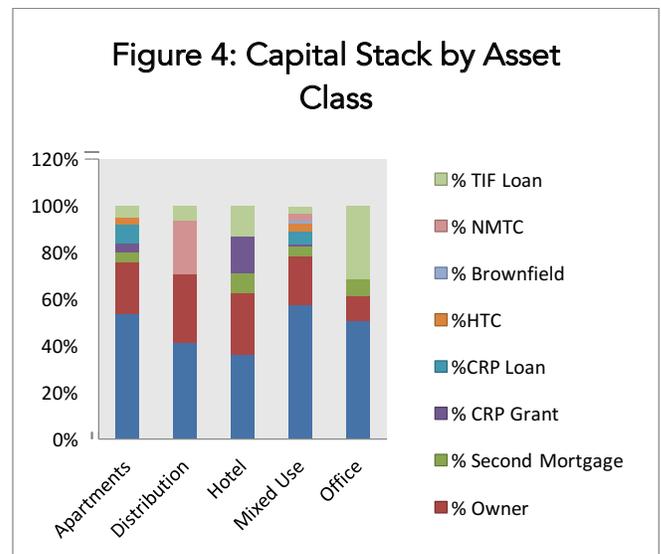
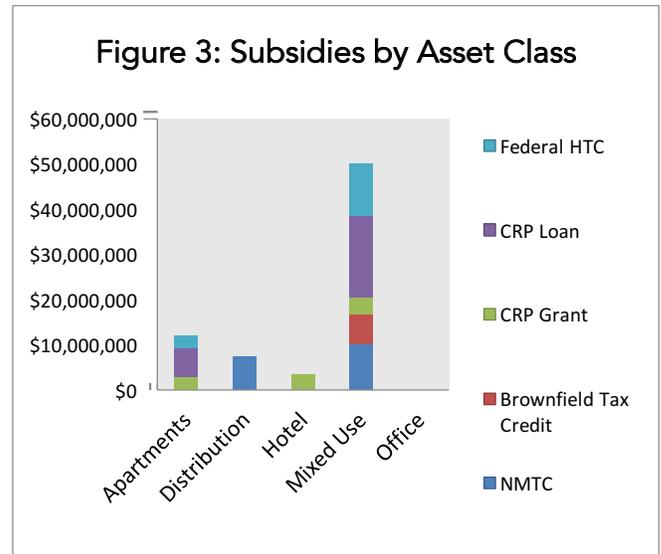
²⁵ DEGC provided \$52.6 million and \$67.45 million in property tax abatements 2016 and 2015, respectively. However, we were unable to match the specific projects to the database of abatements provided by DEGC.

loans constitute the largest public subsidy, followed by CRP loans, New Market Housing Tax Credits, and CRP Grants. As previously mentioned the largest TIF loan was awarded to the Monroe Block office project. Though serving a small portion of the capital stack only Mixed Use projects were able to take advantage of the Brownfield Tax Credits. A summary of each incentive was described in Sections IV and V.

Figure 3 shows the amount and type of subsidy funding obtained by each asset class. This analysis clearly shows that mixed-use developments receive the most diverse set of fiscal incentives, reflecting the current priorities of local incentives. Because of their hybrid nature, mixed use-projects need to layer a variety of sources to finance their projects.

Apartments and mixed-use projects are the only asset types that have been able to generate 75 percent of the required development costs through a first mortgage and owner equity (a combination of deferred developer fees, land contributions, traditional equity). The ability of apartment and mixed-use projects to acquire a significant mortgage covering over half of the development costs demonstrates that there is higher confidence from lenders in the success of these asset types.

Furthermore, this means that the corresponding tax abatements have decreased to less than 5 percent of total development costs on average. In most projects, the owner puts in 20 to 30 percent of development costs. We also saw that this office project required over 30 percent of its development costs in abatements and only had 10 percent of development costs coming from the owner.



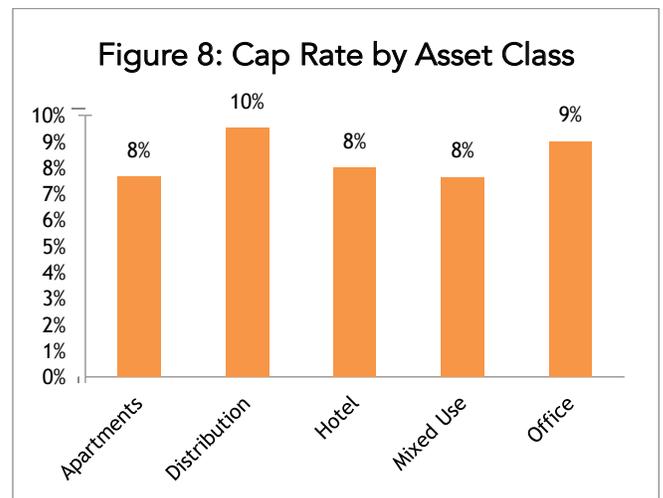
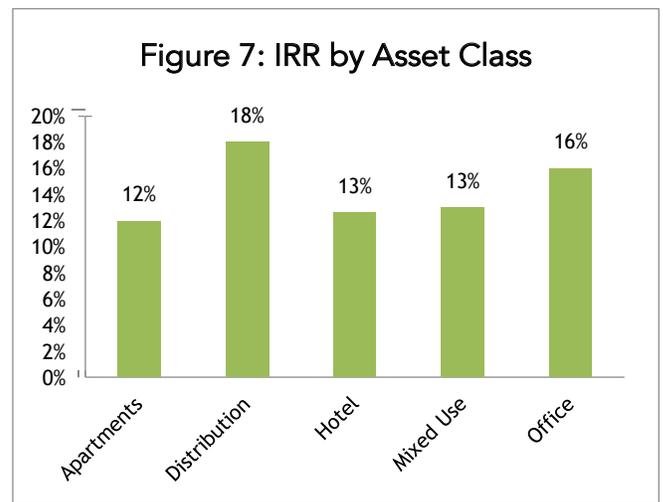
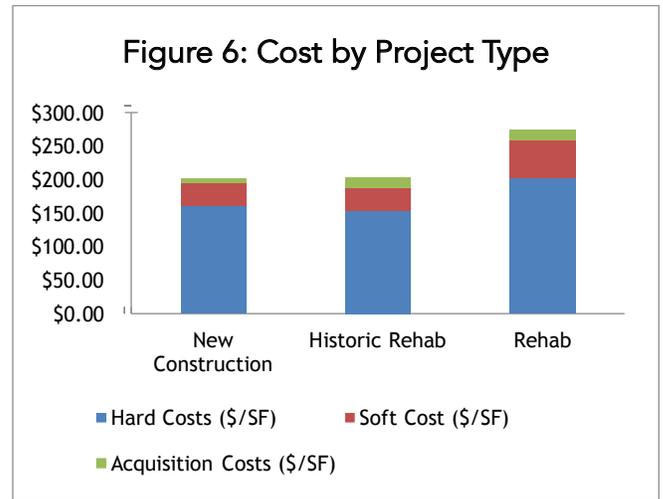
While the high owner equity contribution ensures that owners are invested in their projects, markets that depend on high owner equity typically disadvantage smaller, local developers who cannot contribute as much up front capital. Thus, smaller developers may need additional financial assistance such as grants for pre-development cost in order to compete.

Geographic Distribution

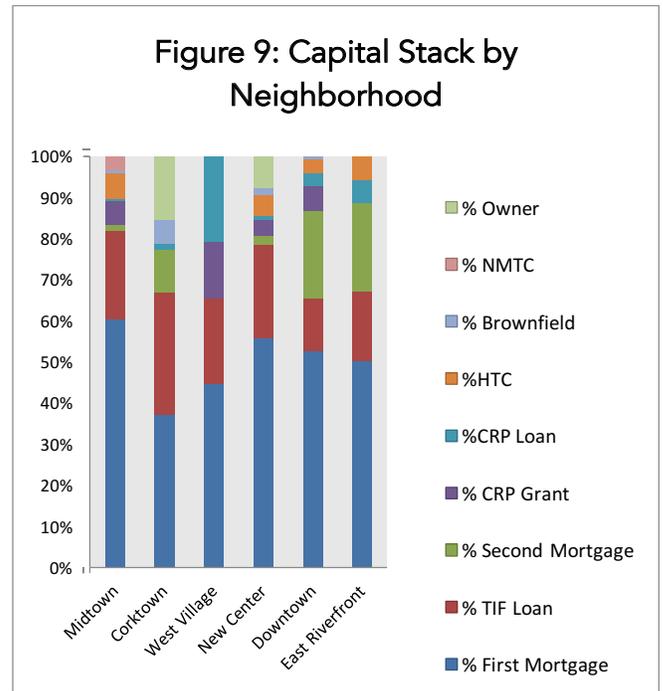
All 21 sampled projects are located in the Greater Downtown area, with a particular concentration in Downtown, New Center, and Midtown. Downtown had the greatest diversity of projects, whereas neighborhoods like Corktown, Midtown, and New Center were exclusively apartments and mixed-use projects, with the exception of the Cardinal Health distribution facility near Midtown.

The ability of projects to obtain a large first mortgage varied a lot across neighborhoods. On average, New Center projects covered 60 percent of their development costs through the first mortgage whereas most other neighborhoods had an average first mortgage that was closer to 50 percent of their development costs.

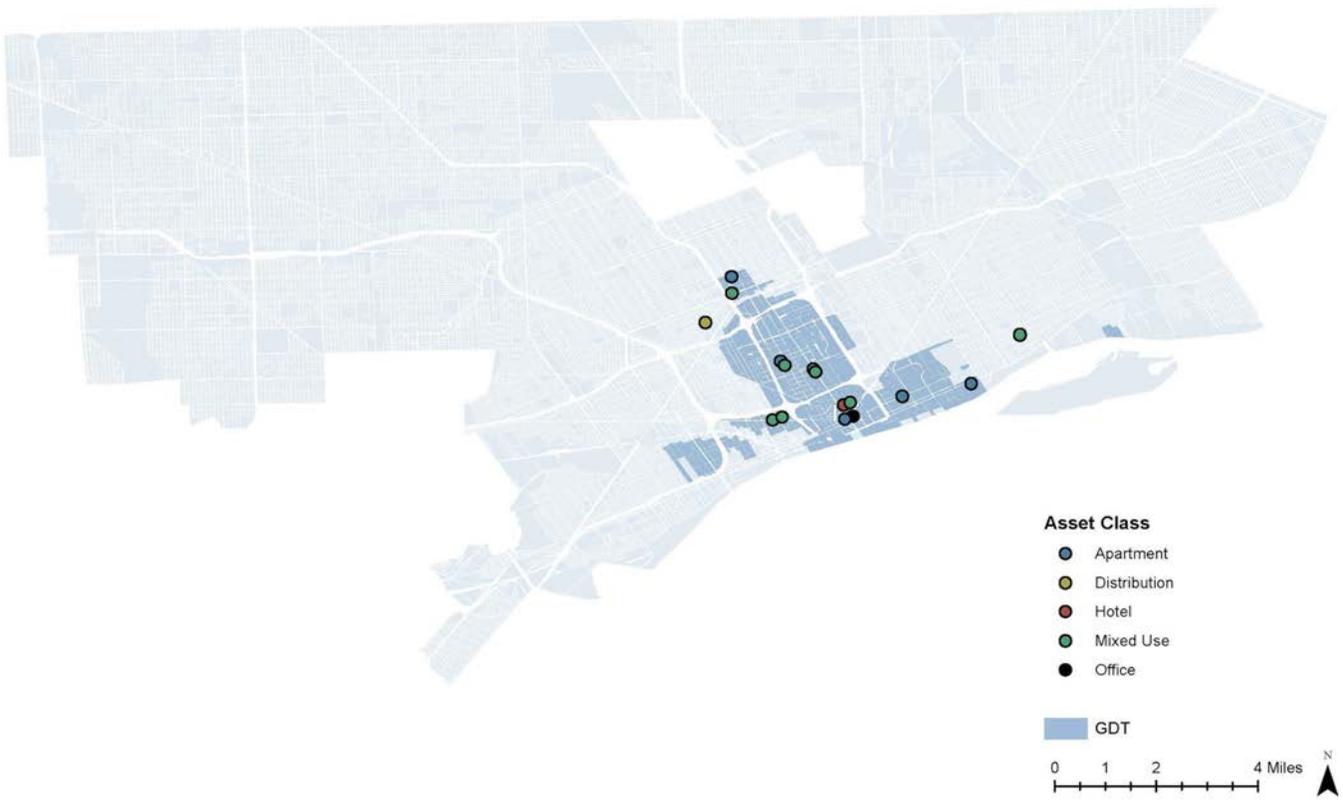
Corktown had the lowest average first mortgage as percentage of development cost; projects there had a greater share of owner equity. Corktown is a less demonstrated market and has been able to make up some of the risk through the NMTCs.



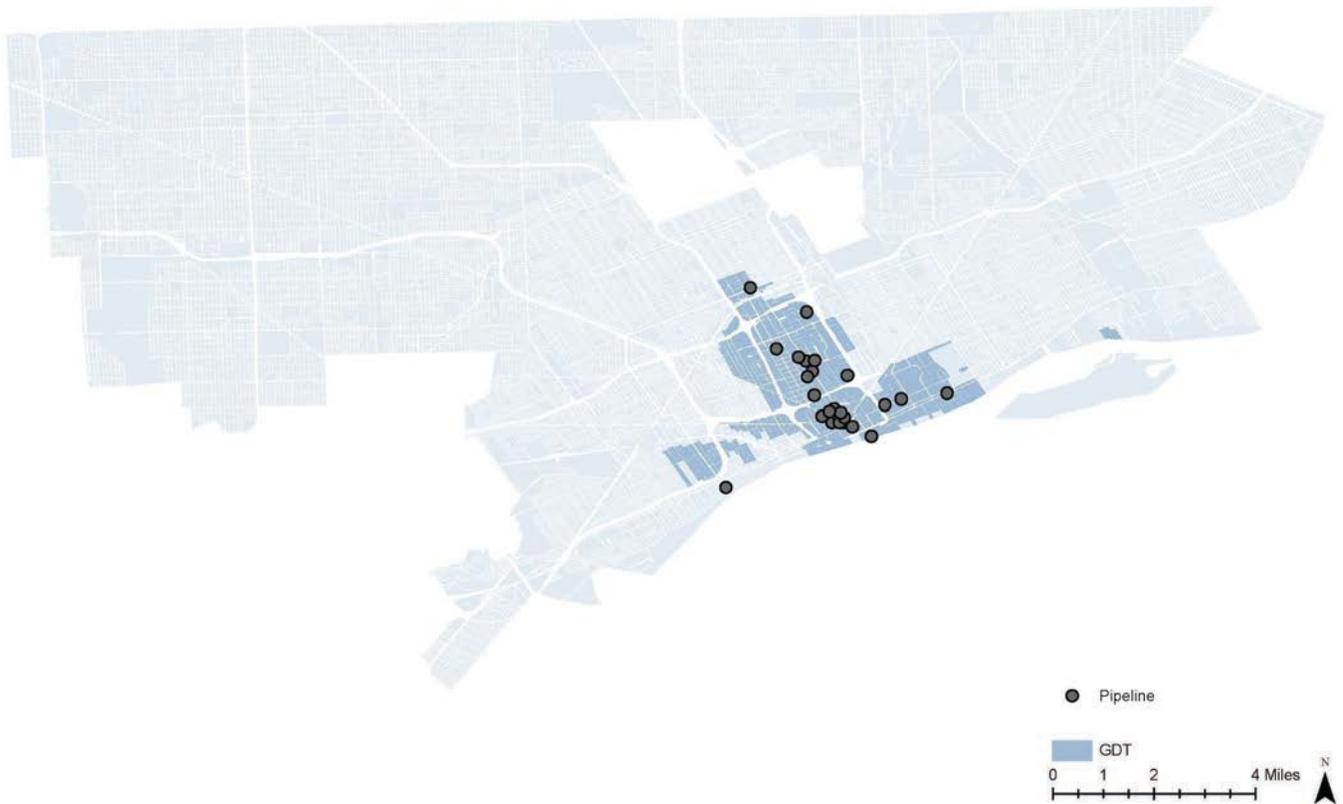
Brownfield TIF loans that Corktown projects cover only 10 percent of total development costs. This is low in comparison to the level of Brownfield TIF loans provided to projects in Downtown and the project in East Riverfront, where over 20 percent of development costs was financed through Brownfield TIF loans. Even in absolute dollars, we see that over 70 percent of Brownfield TIF loans are provided specifically to Downtown Detroit. This is consistent with the strategy that Detroit has employed in recent years to concentrate development resources in the Downtown area, but with increased lending capacity there, the City may wish to direct public loans to priority neighborhoods.



DEGC Projects by Asset Class



DEGC Projects in the Pipeline



■ PEER CITY ANALYSIS

To determine whether Detroit's gap financing system is competitive with other markets, we profile three of its peer cities: Chicago, Cincinnati, and Cleveland. All four were identified by DEGC as places which national financiers and real estate interests consider to be comparable metropolitan markets, though not necessarily direct competitors. The first—Chicago—is considered a “primary market” for real estate investment, whereas the latter two—Cleveland and Cincinnati—share a regional history and have experienced comparable dynamics of population loss and economic disinvestment since the 1980s.

As development finance became more footloose and nationalized in the late 20th century, North American cities began competing to recruit and retain investment capital.²⁶ For real estate developments, this has been achieved primarily through gap financing for projects that would be inviable “but for” public subsidy. These subsidies are now used in all major American metropolitan areas, and have proliferated in their size and application over the past three decades.

In major cities like Los Angeles and Chicago, prolific use of incentives has caused concern that they have breached their original “but for” purpose, functioning more as discretionary entitlements for the city's preferred projects. In Chicago, for example, more than a quarter of municipal land is currently designated for TIF financing, with nearly half of all investment

funneled into the stable, high-value business core.²⁷

Detroit and its three peer cities have developed their gap financing systems in tandem, but with divergent development strategies and incentive portfolios. They are most similar in their common constraints on gap finance instruments. Because U.S. cities are restricted in their power to raise revenue, municipal governments are generally unable to offer major grants or credit programs to preferred projects. Instead, development is primarily subsidized via local tax relief to developers. The most common forms of subsidy are tax abatements and value recapture mechanisms, such as TIFs. An exception to the rule is Cleveland, where development officials have focused on providing up-front grants to increase supportable debt.

While it is useful to compare incentive strategy, program details, and preferred financing instruments, there is scant basis to compare the actual value of awarded subsidies. Local governments rarely track the total value of these incentives because they consider foregone revenue to be “budget neutral.” Thus, instead of direct numerical comparison, our profiles rely largely on secondary literature and, where available, strategic assessments of the respective finance systems.

²⁶ Bartik, T. J. (2005). Solving the problems of economic development incentives. *Growth and Change*, 36, 139-166.

²⁷ Joravsky, Ben. 26 March 2015. “Who wins and loses in Rahm's TIF game?” *The Chicago Reader*.

Key Observations

1. In general, our analysis shows identifies that Detroit has the most generous and unrestricted public subsidies of any selected peer city. Although this flexibility has been spurred by unique economic distress and high property tax burdens, **a more selective underwriting strategy would not put Detroit at a competitive disadvantage with peer cities** (see Table 2). In particular, all four cities place greater restrictions upon commercial tax abatements.
2. An emerging **best practice is to track supported projects to calculate fiscal benefits ratios and evaluate promised job growth**. In Cleveland, ongoing monitoring assesses whether expected tax growth and jobs targets are met by the developers over 5 to 10 year horizons.
3. In other jurisdictions, **subsidies are structured to safeguard taxpayers and contemplated infrastructure programs**. Considerations include school district indemnification, infrastructure recapture options, and clawback provisos. A model program in this respect is Cincinnati's VTICA program, which allows the city to exercise a limited (7.5 to 15 percent) tax recapture to fund infrastructure which directly enhances land values.

Table 2. Restrictions on Commercial Property Tax Abatements by City

| City | Max. Abatement | Max. Period (Years) | Notes |
|------------|-----------------------------------|---------------------|--|
| Detroit | 100 percent of all assessed taxes | 10–15 | Maximum abatements restricted to Renaissance Zones |
| Chicago | \$4 million per project | 10-15 | Sparsely used. TIFs preferred because of looser regulations. |
| Cincinnati | 100 percent of tax increment | 8-15 | Frequently used. Most comparable to Detroit. |
| Cleveland | 75 percent of assessed value | 10 | Sparsely used. Abatement restricted to non-Downtown areas. |

Cleveland

Despite convergent demographic and economic trends, the Cities of Cleveland and Detroit have very distinct development finance strategies. In terms of secular population trend, Cleveland is the American city most similar to Detroit, experiencing a 17 percent population decline between 2000 and 2010 while Detroit lost 25 percent. Cleveland has experienced comparable losses in factory jobs with the retreat of automotive manufacturing.

Although Cleveland has avoided bankruptcy, it experienced multiple periods of several fiscal stress in the twentieth century, requiring consolidation of services and programs. Since 1990, much of the city's revitalization strategy has concentrated on large-scale projects in downtown Cleveland. Since 2009, over \$6 billion in new development has found footing in the downtown area, including new stadiums and office space.²⁸

Presented with similar challenges and a similar profile of business-district revival, Cleveland has been extremely judicious in granting abatements or TIFs. Abatements are only used where neighborhoods face vulnerabilities requiring special intervention, such as a lack of a grocery operator, significant residential vacancy, or environmental remediation. The City expressly avoids using these instruments in the downtown area, because projects have been self-supporting for the past decade. In the past five years, a handful of commercial abatements have gone to neighborhood-based

multifamily developments and LEED-certified buildings.

Instead, Cleveland's Department of Economic Development concentrates its efforts on grant-making and forgivable loans, which encourage proposers to blend city support with its equity pool to secure more debt. It shares with Cincinnati a statewide Job Creation Tax Credit, which maintains a 1.25 fiscal benefit ratio, meaning income-tax generation must exceed the credit award by 25 percent.²⁹ Cleveland, better than any other reviewed city, internally tracks incentive-receiving projects to evaluate the city's long-term fiscal returns and job-creation statistics.

Cincinnati

Like Detroit, the City of Cincinnati makes extensive use of commercial abatements as a subsidy. Its other major source of development support comes in the form of Project TIFs, which are reserved for large and complex projects with significant risks.³⁰

Because its total property tax revenue is capped by city ordinance, the City considers abatements to be a "revenue neutral" concession.³¹ As is also the case in Cleveland, abatement awards are also structured to protect school district revenue with Payments In Lieu of Taxes (PILOTs), a system which recognizes the independent obligations of the school district and holds public education revenues harmless from the city's development support.

²⁸ Downtown Cleveland Alliance. 2015. [The State of Downtown Cleveland](#). Accessed 8 December 2016.

²⁹ Ohio Attorney General's Office. 2015. [Report to the General Assembly: Compliance with State Awards for Economic Development](#). Accessed 8 December 2016.

³⁰ HR&A (2016). Cincinnati Incentives Policy Review.

³¹ In the event that property tax revenue would exceed the budget cap, the city reduces its millage rate.

Although multi-family residential developments are capped at an 8-year abatement, Cincinnati offers extended abatement periods to non-residential and new construction projects, and up to a 15-year abatement period for LEED-certified buildings. There are no restrictions on project eligibility, but the City has offered a plurality of abatements in distressed neighborhoods.

Box 3. VTICA Program

Traditional abatements are inflexibly structured to write off potential public revenue for the full abatement period. A major disadvantage of this structure is that when cities invest in new infrastructure, they cannot capture the land value increases that accrue to private parcels under abatement. If a city invests in a new rail system, parcels along the corridor increase in value without any private effort. Under Cincinnati's tax abatement structure, the City can exercise an option to reduce abatements by 7.5–15 percent for certain local infrastructure projects, particularly fixed-path transportation systems. This gives the City the flexibility to capture infrastructure-driven land value increases without pre-emptively shifting the cost of unrealized projects to property owners.

Chicago

For over a century, the City of Chicago has remained one of the most-demanded and resilient commercial property markets in the country, with its high-value properties often receiving national and international

attention. Chicago is known as the country's most prolific user of tax-increment finance districts (or District TIFs), first introduced in 1984. District TIFs allow the City to redirect expected future property tax receipts in designated "blighted areas" from its general operating funds to local improvements. Because they offer the greatest fiscal flexibility, executive discretion, and subsidy value under Illinois law, they constitute the vast majority of development finance.

In a sample of forty subsidized development projects, all subsidies above \$5 million were granted via TIF district designation. By 2013, fully a quarter of all municipal land was designated as TIF district, raising concerns that the incentives, conceived to help distressed neighborhoods, had lost their targeting value.

³²

In comparison to other major metropolitan areas, property tax abatements for real estate projects are rare, in part because their use is restricted by use and their value cannot exceed 10 years or \$4 million in total value.

The Chicago Metropolitan Agency for Planning (CMAP) has raised concern that subsidy allocation is largely project-based and not integrated with any kind of geographic or sectoral targeting.³³ The unlimited nature of this subsidy has been damaging to developing a broader economic development strategy, and there has been increasingly negative civic reaction to the City's discretionary and untargeted use of these incentives in a strong property market.

³² Chicago Metropolitan Agency for Planning. August 2013. [Examination of Local Economic Development Incentives in Northeastern Illinois](#).

³³ Chicago Metropolitan Agency for Planning. June 2009. [Economic Development Incentives](#).

■ RECOMMENDATIONS

Centering Neighborhood Development

Restructure abatement eligibility to privilege out-of-downtown development. Direct subsidies are an effective tool for geographic and asset targeting, but do not support planning strategies when equally available to all proposed projects. Under the current system, most gap financing tools are geographically untargeted, permitting developers to seek equivalent levels of subsidy in all city neighborhoods. As its peer cities do, Detroit can cap the maximum allowable abatement value for downtown or extend the maximum allowable abatement periods in targeted neighborhoods.

Conduct neighborhood market analyses. Lenders often require developers to submit a market analysis for projects contemplated in low-transaction markets. This shows the lender that demand, occupancy and rental rates are accurate for their projects. It would support and incentivize development in targeted neighborhoods to conduct a market analysis available to developers. By creating a shared resource for targeted markets, the city saves all developers time and pre-construction soft costs.

Establish value recapture provisions on abatements. A basic problem of abatements is that they force the city to forgo land value increments that accrue from future public investment. If, for example, the city builds a new transit line, abated properties along the line will capture property value increases without contributing any private effort. Cincinnati's VTICA program provides a model

by which the City of Detroit can reduce private capture of these public investments. By including provisos that allow the city to reduce abatements by a fixed percentage under certain circumstances, the city gains additional flexibility to fund new public projects while still embracing the local-recapture principles of TIF.

Incentive Tracking, Calculating Benefits, Transparency

Establish maximum IRR benchmarks by asset type or located neighborhood. To limit the eligibility of projects for incentives, the city needs to maintain an *de facto* level of return for projects. These may vary by asset type or investment size as developers incur different risks for differing project types. The city would also be able to permit developers to seek higher expected returns in targeted neighborhoods outside the Downtown core.

Establish citywide annual budget targets for discretionary incentives. Public-choice economics teaches us that we are only compelled to be strategic when resources are scarce. Since abatements and TIF represent unlimited pools of subsidy, there is very little incentive to allocate these to the most deserving projects, or to monitor projects for their "but for" compliance. As Detroit's economy improves, the City should aim to reduce the overall level of abatements and TIFs awarded per year on a normalized (per square foot) basis.

Update and standardize public information architecture. While the incentives managed by DEGC are published online, it would be helpful

to standardize their presentation. Furthermore, providing this information in other languages such as Spanish and Arabic would help to incentivize smaller, potentially more community-oriented projects trying to include communities that make up some of the target neighborhoods that DEGC is looking to revitalize. In the long term, DEGC can work with outer community development institutions in Detroit to consolidate all the information on financing real estate development and create a one-stop website for project proponents.

Aligning Incentives with Public Policy Agenda

Coordinate with City on affordable housing.

Housing affordability needs to become a more intentional and better coordinated priority as the city pursues neighborhood investment outside of the stabilizing Downtown and Midtown cores. DEGC can work with the Housing & Revitalization Department to synchronize their efforts for incentivizing the

development of affordable housing options in the Neighborhood Revitalization Strategy Areas, and to improve coordination of housing programs and policies including Community Development Block Grants, Low Income Housing Tax Credits, and the recently passed inclusionary housing ordinance.

Integrate Community Benefit Agreements (CBAs).

Truly investing in Detroit's neighborhoods means engaging residents as stakeholders in the development process and ensuring that public investments can be leveraged to address actual community needs. In light of the city's recent approval of a community benefits ordinance, DEGC should aim to incorporate CBAs into the financing and real estate development structure in order to prioritize housing affordability, workforce development, improved streets and other pressing local needs. DEGC's position in the development pipeline allows it to direct CBAs towards citywide policy priorities and leverage state finance to do so.

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