

Affordable Housing Institute

South Africa

Using Tax-Relief Incentives (TRI's)
to Stimulate Affordable Housing

with commentary on the proposed
Urban Regeneration Tax Initiative

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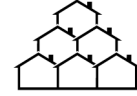
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Using Tax-Relief Incentives (TRI's) to Stimulate Affordable Housing and Urban Regeneration

David A. Smith, Executive Director, Affordable Housing Institute

Executive Summary

To stimulate urban regeneration and affordable housing, South Africa should make use of fiscal initiatives - specifically, custom-designed income tax incentives - to stimulate investment of private equity capital into targeted geographies, activities, and development programs.

Tax-relief incentives (TRI's) have the following principal benefits:

- *Property.* Stimulate new production or renovation. Lead or change markets. Provide affordability.
- *Delivery system.* Bring in new private capital, and new participants, that would otherwise invest elsewhere. Encourage entrepreneurial innovation.

At the same time, *how* TRI's are designed, enacted, and administered will have much to do with whether they work indifferently, excellently, or somewhere in between. Much care should go into programme design issues such as eligibility, targeting, calibration, use covenants, and compliance.

Government proposes Urban Regeneration Tax Initiative

In its 2003/2004 Budget Tax Proposal, the government has proposed to create an Urban Regeneration Tax Initiative (URTI; our terminology, our acronym, for convenience). The URTI should be taken up - preferably modified as recommended in §4 of this report - and enacted.

Recommendations for the Urban Regeneration Tax Initiative

(The programme is described in Exhibit 2; our recommendations are provided in Exhibit 3.)

AHI recommends that South Africa enact the URTI - preferably with some improvements. The following changes will improve its effectiveness and efficiency:

1. **Use credits, not losses**, as the TRI currency. More efficient and easier to understand and use.
2. Make **new construction the equal** of refurbishment. Equal value in urban regeneration zones.
3. Incentivize housing and **affordable housing as a target use**. It needs the boost to compete.
4. **Allow affordable housing** as a TRI-qualifying use **even outside URTI's**. Affordable housing is a national priority that knows no boundaries.

1. The role of soft debt and equity in affordable housing

Properties are financed with a combination of debt and equity¹. Further, equity is more expensive than debt, so as more equity is added - that is, as gearing decreases - a property becomes safer but at the same time the weighted average cost of capital (WACC) goes up².

In affordable housing, high cost capital means *unaffordable* housing. There is a diametric tension between capital cost and affordability - very decision to make the property safer means it will be less affordable. There are only two conceptual ways for government to resolve this tension. It may intervene on the debt equity or the equity side:

- *Debt*. Low-interest or low-cost loans or higher gearing (directly or indirectly through credit enhancement/ risk absorption).
- *Equity*. Lower the cost of equity by creating *soft equity*.

1A. The role of inexpensive debt. Whether or not it is *really* riskier than conventional housing, affordable housing - especially new programs or more challenging markets (such as townships or central city) is often *perceived* as riskier. As a result, unless government steps in, debt capital may be scarce (either expensive or parsimonious in its gearing, or both).

Government normally thus intervenes in one of two fashions:

- *Direct below-market lending*, normally via an allocated or capped program, at a rate that may be the government's cost of capital or even lower.
- *Credit enhancement* so as to lower perceived risk. This may be either through a pledge to take the top loss (perhaps on a formula), or a payment guarantee on loans of a certain type and underwriting standard. This risk absorption therefore translates normally into not only higher gearing but also a lower rate on the geared debt.

Inexpensive debt³ does play a useful role, especially as any inherent subsidy (whether direct or indirect) is applied to 60-70-80% of the total cost. But that leaves the conundrum of finding equity - and without government involvement, equity is either scarce (to the point of being non-existent?) or so expensive as to be self-defeating.

¹ Any financing that purports to be 100% is just a single capital source providing equity (say, the top 15-20% of the gearing) without realizing that it is such.

² A simple numerical example will illustrate. Assume equity costs 16% and debt costs 8%. At 80% gearing, the weighted average cost of capital (WACC) is 9.6% (80% x 8% + 20% x 16%). At 60% gearing the WACC is 11.2%.

³ One useful form of which is accruing, soft debt. See ¶2D.

1B. The potential role of soft debt. Government can extend the principle of inexpensive debt to create a further synthetic product, *soft debt*.

What is soft debt?

In this context, soft debt is capital that meets four tests:

Shaped like a loan	Carries loan indicia: has a maturity date, an interest rate, a source of security (e.g. mortgage or lien against the property), and a foreclosure right.
Deferral, accrual	Payment of some of the debt may be deferred until a future event (e.g. property cash flow), with the deferral accruing (and cumulating).
Affordability	Payment deferral will typically be directly linked to affordability (e.g. to cover rentup deficits or to abate rent increases).
Government pays	The inherent subsidy (below-market yield) is funded by government, usually because the loan is direct from a government agency.
An example	A loan that bears interest at the government's long-term borrowing rate, with current payments required equal to the lesser of (a) 50% of current-year interest, or (b) 25% of the property's cash flow. Unpaid interest accumulates (compounds?). The loan matures on sale, refinancing, breach of compliance provisions, or conversion to market use.

Soft debt can play a useful role in affordable housing⁴:

- The below-market *pay rate* is an inherent subsidy paid over time.
- It is customizable to property facts and circumstances.
- It can absorb rentup or early-year operating deficits.
- It may capture upside in appreciating markets (e.g. urban regeneration areas, reviving downtowns).
- It can hedge against inflation (high accrual rate, low pay rate).
- It may inhibit conversion (if legally permissible at some future date).
- It forms an effective compliance enforcer, since breach of use covenants can be an event of default entitling the holder to move against the security (the property).

1C. The role of soft equity. Unless government is willing to *grant* a sponsor the gap between cost and debt (not recommended; see ¶1D), the financing gap can be closed only by creating some form of soft equity.

⁴ At present, South Africa has made little use of soft debt, although the Gauteng Partnership Fund (GPF) is now exploring creating soft debt vehicles.

What is soft equity?

In this context, soft equity is capital that meets six tests:

Private capital	Provided by <i>private investors</i> , not government.
Not debt	Is not a loan and does not have a maturity date, a foreclosure right, or a lien against the property. It has the indicia of equity.
Expected return	The investor expects to make money from the investment; that is, however socially motivated, the investor can justify the capital as a pure business case.
No rent impact	There is no overriding economic imperative for the investor to force a property out of affordability. The investor will care about property <i>viability</i> but breakeven or modest cash flow should suffice.
Not a loophole	Soft equity arises as an intended outcome of a conscious expression of deliberate government policy.
Tax savings	Thus the investor's economic return on soft equity must come from <i>outside</i> the property, using Tax <i>Relief Incentives (TRI's)</i> . How these work is covered in §2.

1D. Policy benefits of soft equity. In early-stage financing evolution, government tends to adopt the direct approach of using grant. However, from a policy outcomes perspective grant is generally inferior to soft equity because:

- Grant tends to be directly administered by government.
- It is normally paid up front and may be hard to recoup if mis-spent.
- It tends to have few if any collectible compliance or enforcement mechanisms.

Grant is a weak-tea form of equity with no performance strings; it takes all the risk of hard equity without the policy benefits of soft equity.

For more on the comparison of grant versus TRI's as a soft equity source, see <http://www.hartcredit.org.uk/Description/differences.html>.

1E. The relationship among debt and equity, hard and soft. Conceptually, the relationship among debt and equity in both the hard and soft forms can be illustrated in Table 1 as follows:

Table 1
Relationship among debt and equity, hard and soft

	Hard	Soft
Debt	<p>First loans</p> <ul style="list-style-type: none"> • Low interest rates • Credit enhancement 	<p>Accruing debt</p> <ul style="list-style-type: none"> • Capture upside value? • Accelerate on default? • Forgive if compliant?
Equity	<p>Market investors</p> <ul style="list-style-type: none"> • Seek cash flow, residuals • Tension with affordability mission 	<p>Tax Relief Incentives</p> <ul style="list-style-type: none"> • Tax deductions • Tax credits

Significantly, soft equity is compatible with *both* soft debt and hard debt. Hard equity is incompatible with affordability in hard debt situations, and if hard equity is used with soft debt, in effect the debt is making a disguised wealth transfer to the equity (because cash flow or other receipts that would otherwise flow to debt are passing over the debt to provide equity return).

It's little exaggeration to say that, *absent grant, soft equity is essential to broad affordability production.*

Points to remember: §1, Soft debt and soft equity

1. Affordable housing is best delivered via **public-private partnerships**. Public sector sets the rules and provides resources. Private sector takes risks, raises capital, develops and operates the property.
2. In affordable housing and urban regeneration, **hard debt** must be *cheap*, and normally government must intervene to make it cheap.
3. Deeper affordability or more ambitious schemes usually require **soft debt** - debt whose interest accrues, is deferred, or may be waived entirely for long-term affordability or other use.
4. **Soft equity is essential**. The alternative, grant, is more expensive and provides less market discipline and sponsor accountability.
5. **Use the tax code** to create soft equity, with suitably designed tax relief initiatives (TRI's).

2. How TRI's work and how they change resource delivery

2A. Preconditions of using TRI's as a fiscal tool. TRI's work as a fiscal tool only when a variety of basic preconditions are present. These include:

1. *Rule of law* as it relates to real property⁵: title, perfectability of mortgage deeds and security instruments, foreclosure and repossession, eviction.
2. *Viable tenure paradigms* such as homeownership, rental, shared ownership, or sectional title that will be explicitly financed with targeted TRI's. These need to be clearly understood in the community and to be areas where a reasonable observer would find strong demand, especially for affordable tenure.
3. *Efficient capital finance* in the conventional residential arena so that normal debt and equity instruments and investment are commonly understood and thus adapted affordable housing forms are an evolution rather than a revolution in thinking.
4. *A populated ecosystem of actors* such as developers, loan originators, lenders, and property managers, so that investors can gain confidence properties will not only complete but survive their affordability or compliance periods.
5. *Government endorsement* of the mandate (e.g. affordable housing), the model (e.g. homeownership, rental), and the TRI vehicle (e.g. explicit confirmation it is not a loophole, pledge to respect future benefits earned, good-citizen recognition for investors).
6. *High-net-worth investors* (either individuals or corporations) who have the sophistication to evaluate complex TRI's, the expected future tax liability to make them worthwhile, and the disposable cash to sustain the investment.

⁵ In view of its recent history and apartheid-era laws regarding property ownership, South Africa faces challenges establishing rule of law and chain of title in some areas, including urban regeneration target sites. To the extent that investors fears about debt or economic return collectibility, arising from rule-of-law doubts, inhibit capital flows into inner-city areas, TRI's can to some degree compensate, because a TRI equity investor knows that the *government*, at least, will deliver the TRI's as anticipated. We can thus imagine higher levels of TRI's being required in area where rule of property law is questionable or unproven, to compensate for that higher real and perceived risk.

Who the players are

Allocator	An entity (typically government, often regional) that can award forward commitments for TRI's.
Investor	A capital source that seeks to use TRI's to reduce taxes otherwise payable. May have no previous interest whatsoever in affordable housing. May, however, have external motivations (e.g. CRA, HMDA) for finding such investments.
Regulator	Entity (typically government, although it could be contracted) that reviews a property's operations and confirms its compliance with TRI use covenants. Can issue certifications of compliance or, conversely, revocations of TRI status.
Sponsor	A developer (usually private, often non-profit) seeking to build, renovate, or acquire an affordable housing property. Secures TRI's and must sell them for equity capital.
Syndicator	An intermediary (part of a bank, possibly an independent specialist) that works in between sponsors and investors to structure, package, and market TRI investments. Often takes an ongoing role as an investor watchdog.

2B. A short primer on converting TRI's into equity. TRI's convert into cash equity via the following conceptual sequence:

1. *Sponsor secures TRI's as a forward commitment.* A sponsor planning a particular property secures a "forward commitment" of TRI's, either (a) as-of-right (by virtue of a particular statutory provision that calls TRI's into being upon the occurrence of some controllable events such as construction completion), or (b) from a finite source (an allocator). Either way, the forward commitment is *documented* and *verifiable*.
2. *Syndicator develops an investment proposal.* The syndicator takes the sponsor's information, negotiates an appropriate set of economic sharing, control provisions, guarantees and other elements, and creates an offering book (sometimes called a prospectus) that describes the proposed TRI investment.
3. *Syndicator solicits investors and raises capital.* Syndicators must thus have access to and credibility with the target investor profile and population.
4. *Investor capital is contributed up front.* Sometimes the investors' capital commitments are staged over time (and tied to performance milestones), in which case there is a further step: someone (probably the syndicator) factors the pledges for cash.

This sequence imposes market discipline (because both the syndicator and later the investors review the transaction) and market competition (because in a healthy market there are many potential investors and at least several syndicators).

2C. Equity raised is a fraction of TRI's awarded. It does mean, however, that the equity capital raises is a fraction of the total TRI's awarded, because of:

- *Time value of money.* Equity comes up front, TRI's are received over a period of years.
- *Risk absorption.* The private sector is taking completion, operating, and compliance risks.
- *Cost of intermediaries.* Syndicators and other intermediaries are compensated.
- *Monitoring and asset management.* Investors want oversight and intervention rights.
- *Downstream tradability or lack thereof.* Tradability enhances liquidity, and liquidity lowers yield requirements. This is especially true when a TRI investor may face annual fluctuations in his or its reportable income; with liquidity, an investor can sell TRI's that become unneeded because the investor's financial situation reverses.

2D. Measuring investor return and diminishing yield spread. All these discounts can be condensed down into a single metric: the Internal Rate of Return (IRR) that represents, in essence, a single yield-to-maturity over the entire projected investment period. IRR's will always be higher than baseline inflation or the government's cost of capital (two commonly used metrics).

The magnitude of the spread (that is, IRR minus government baseline) depends principally on:

- *Perceived riskiness of the TRI investment.* A mixture of real risk, newness, and ignorance. Over time, it diminishes ... although poor early-entrant performance can rapidly erode nascent investor confidence.
- *Competition for the TRI's.* Both among sponsors and, more importantly, among investors. External stimuli such as CRA can pique investor interest.
- *Breadth of market knowledge.* In the early years, fewer participants understand TRI's. First movers want a premium and they tend not to want to share knowledge or access to investments.
- *Lack of confidence in government.* To stay the course on property viability and to honor the bargain regarding TRI benefits. Experience in the US shows it can take 5-8 years for government to build investor confidence.

2E. TRI's as a step change in resource delivery. The foregoing description makes clear that TRI's are a step-change in resource delivery. Among the elements of difference are these listed in Table 2:

Table 2
Direct government programmes versus TRI's

	<u>Direct government programs</u>	<u>TRI's</u>
Type of resource provided	Direct lending or grant	Forward commitment of TRI
How does it monetize?	Cash from inception	Converted by private sector
What is monetization rate?	100% (plus admin costs)	<100% (to give market IRR)
What it is used for	Hard debt	Soft equity
Compliance approach	Government reviews directly	Self-certify with penalties
What does compliance test?	Process	Outcomes
Who does compliance?	Government department	Third party (e.g. CPA's)
Clawback?	Not directly	Yes
Who does clawback hurt?	Sponsor or property	Investor (property is safe)

For a further discussion of the differences between grants (even performance-based grants) and TRI's, see <http://www.hartcredit.org.uk/Description/why.html>.

2F. Externalities: additional benefits from using TRI's as a delivery system. Beyond their direct impact -stimulating new production or renovation that would otherwise be deferred or never happen at all - tax-relief incentives (TRI's) have the following external benefits:

- Bring in new private capital that would otherwise invest elsewhere.
- Marry sponsors to capital sources, strengthening capital flow for activities beyond the TRI's' scope.
- Build capacity and awareness of government priorities.
- Expand the overall sector capacity by growing specialized developers, managers, and financiers.

These externalities are tangential benefits important in their own right.

2G. Resource allocation issues: open-ended versus capitated; as-of-right versus allocated. Once government decides it will create a TRI, it then faces two questions relating to *how much* of the TRI will be used, and *how do sponsors access it?* In each case, there are two choices:

- *Open-ended versus finite.* A TRI is *open-ended* if its total usage is bounded only by participating properties; if there is a limited amount available (so much per capital annually, say), then the TRI is *finite*.
- *As-of-right versus allocated.* Some TRI's are *as-of-right* - the taxpayer who undertakes a particular transaction is automatically entitled to claim whatever treatment gives rise to the TRI. Others (usually but not always finite⁶ TRI's) are *allocated* - before the taxpayer may claim the TRI, a government entity must approve the proposed transaction.

⁶ In the US, for example, the historic tax credit is as-of-right - it applies to all buildings meeting certain statutory criteria - but is allocated in the sense that the Historic Commission must confirm that the proposed renovation is historically appropriate.

South Africa's proposed URTI's are *open-ended and as-of-right* - that is, available for any qualifying property within the designated areas.

Open-ended TRI's have the great benefit that the sponsor planning a transaction not only can be certain of receiving the TRI, but also has no intervening step or check that may represent cost or delay. Conversely, finite TRI's assure government that there will be a limit on its tax expenditure.

As-of-right TRI's are easy to use, whereas allocated TRI's require not only a government step (the allocator) but also the development of capable and honest allocators. Developing allocator capacity takes time and inevitably there are some embarrassing properties or questionable award decisions along the way.

Over time, the US has migrated away from open-ended, as-of-right TRI's to capitated, allocated TRI's, largely because the former proved far too susceptible to both real scandals and journalistically induced perceived scandals. Low Income Housing Tax Credits (LIHTC's) in the US are awarded by the individual states' housing finance agencies (HFA's). When they first awarded under the programme, demand was low, experience was slim, and as a result some very poor properties went forward. Fortunately, with best-practice seminars among HFA's and annual award and feedback cycles, evolution was rapid. Today the HFA allocation system is regarded as a major programme strength, and the US Congress has repeatedly given the HFA's new resources to award (e.g. volume-cap bonds) that complement the soft equity derived from LIHTC's.

Allocators also performance downstream monitoring and compliance enforcement, since they can issue notices or penalties that can suspend TRI's yet to be received, or rescind TRI's previously awarded. There is thus powerful accountability at the investor level.

2H. A UK experiment possibly applicable to South Africa: HART. Though a highly developed nation, the United Kingdom (UK) faces issues not entirely dissimilar to South Africa's, in particular:

- *Unaffordability* of housing, especially in high-demand areas of job growth.
- *Need for urban regeneration*, especially inner-city brownfields.
- *A history of direct public ownership* of affordable housing.
- *Interest in fiscal initiatives and privatization* as a step change in delivery.

To that end, for the last fifteen months stakeholders, with AHI as their financial advisor and with the tacit encouragement of HM Government, have been conceptualizing, developing, and refining a fiscal tool whose principles may be applicable to South Africa: the Housing And Regeneration Tax (HART) Credit. HART:

- Uses a *tax credit* (rather than tax deductions) as the principal fiscal incentive.
- Targets two goals: (1) urban regeneration, and (2) affordable housing.
- Applies either to new-build or substantial rehab (including historic rehab).

- Is compatible with mixed-use (residential, live-work, and retail) and mixed-tenure (rental, shared ownership, and homeownership).
- Is fast-delivery and high-value, so it will strongly stimulate production.

HART is receiving a very favorable response from stakeholders and HM government.

Significant information concerning HART, including a detailed programme description, can be found at its Web site, www.hartcredit.org.uk, with subspecialties as follows:

Executive summary	http://www.hartcredit.org.uk/Introduction/exec_summary.html
How it works	http://www.hartcredit.org.uk/Description/how.html
Compliance and enforcement	http://www.hartcredit.org.uk/Description/why.html

2I. Issues in using TRI's in South Africa. In the context of South Africa, we note that:

- Some tribal lands and some townships may fail the rule of law test (at least as measured by the investment marketplace).
- Not all paradigms are equally viable. In particular, affordable rental carries a poor legacy from dysfunctional apartheid-era examples, homeownership must respond to the Servcon experience, shared ownership is largely unknown, and sectional title has not been applied to affordable housing.
- The ecosystem of actors is thin especially as it relates to affordable loan originators. Further, market-makers in the conventional arena have so far not crossed into affordable housing.
- It will be important to have allocators that are not only capable but also perceived as reputable and disinterested.

These and other factors unique to South Africa mean that, however much a fiscal incentive may draw upon principles and paradigms used elsewhere, any fiscal incentive used in South Africa should be custom-designed for the South African marketplace and government priorities.

Points to remember: §2, How TRI's work

1. **TRI's privatize risk-taking** and accountability. For this reason, TRI-based programmes have much better performance track records than grant-based programmes.
2. **Equity raised will be less than TRI value** because investors need to be compensated for risk, and there are costs of raising capital. This discount essentially represents the price government pays to outsource the decision-making, risk, and accountability.
3. In well-designed TRI's, the **TRI equity** will be **only a fraction of TDC**. This assures that the transaction maintains economic purpose and assures participating investors will exercise underwriting discipline.
4. TRI's work better if **finite and allocated** rather than open-ended and as-of-right. There will be some application and compliance
5. **Credits work better** than tax deductions because they are easier to understand and monetize.

3. Incentives now under discussion in South Africa

In its 2003/2004 Budget Tax Proposal, the government has proposed to create an Urban Regeneration Tax Initiative (URTI; our terminology, our acronym, included for convenience). Exhibit 2 excerpts key passages from government's somewhat sketchy description⁷, which is available at http://www.sars.gov.za/it/brochures/2003/2003_Budget_Tax_Proposals.pdf. In this section, we provide an overview and commentary.

3A. The problem to be addressed. From the 2003/2004 budget report:

In line with many countries, South Africa has a number of urban areas that are impoverished and are suffering from extensive urban decay. In order to address these concerns and maintain the existing infrastructure that was developed at great cost, governments internationally have increasingly utilized tax measures to support efforts aimed at regenerating these urban areas. Such narrowly targeted capital allowances seek to attract private sector businesses to areas where interest would otherwise be lacking.

3B. What is proposed. Government proposes to create an Urban Regeneration Tax Incentive (UTRI; our term, our acronym) using accelerated depreciation to create tax savings according to either of two approaches:

- *New construction: 17 years.* 20% writeoff in Year 1, then 5% annually for 16 more years.
- *Refurbishment: 5 years.* 20% writeoff annually for 5 years.

The URTI will be available only for property in "designated qualifying zones," generally impacted areas within large metropolitan areas (throughout the nation).

Government proposes to allocate R1,3 billion of tax revenue foregone⁸ within four years, after which the programme is scheduled to terminate.

3C. What it is worth. Straightforward net-present-value (NPV) analysis (presented in Exhibit 4) using a presumed safe rate of 13.5%⁹, shows that the Rehab URTI will be worth about 21% of total development cost (TDC); the New Construction URTI will be worth about 12% of TDC.

3D. Volume projections and potential housing impact. Assuming 100% utilization, reasonable projections of development costs¹⁰ suggest that, over four

⁷ The budget tax proposal refers to legislation "to be introduced." One infers the program's shape is quite fluid.

⁸ Assuming this was projected used a 30% bracket (maximum for corporations), government is planning to allow R4,0 billion of depreciation under the programme.

⁹ The average of the interest rates SARS applies when refunding a taxpayer's (1) refund award and (2) voluntary over-estimated payment.

¹⁰ Assume a national average Total Development Cost of R1 500 per square meter. See Exhibit 5.

years, a total of 4,0 million square meters' of property will be rehabbed or developed using URTI's. This would be a very significant impact on South Africa's urban areas.

Of this, we (conservatively?) estimate that only 10% would be directed to housing. At 40 m_ per house, this represents 11,000 new houses nationwide over the four years, or about 300 homes per state per year - but all, presumably, in urban regeneration zones.

3E. Will it work? Will it help? The preceding little exercise demonstrates two things:

- A URTI would be a significant stimulus to urban areas.
- A URTI *would not be* a significant boost to available housing in metropolitan areas.

The URTI has presented here is an *urban regeneration* tool, not particularly a housing one.

Points to remember: §3, South Africa's proposed URTI

1. **South Africa is proposing a TRI** aimed particularly at urban regeneration.
2. The URTI as proposed could stimulate up to **4,0 million m_** of property development.
3. **Little** of this will be **affordable housing**. Boosting affordable housing incentives is desirable.

4. Recommendations for South African TRI's

For the reasons outlined at length above, we believe that South Africa needs new fiscal incentives in *both* urban regeneration and affordable housing development to create soft equity that fuels activity. Our recommendations are designed to advance these strategic goals.

4A. TRI's in the context of urban regeneration and affordable housing. The proposed urban regeneration tax initiative (URTI) clearly will boost inner-city development within its targeted geographies. For that reason, it should be adopted after due debate and technical improvement.

The URTI, however, will represent only a 20% contribution to capital cost; the remaining 80% will have to stand on its own merits. As a result, the ventures using URTI will be those with a predominantly *economic* orientation - retail, commercial, office, hotel - that are fundamentally for-profit endeavors. These initiatives achieve their public-policy benefit simply by improving vacant or derelict space; the completed building is a sufficient public-policy outcome.

That is not true of affordable housing. While new *market* housing can provide an urban regeneration benefit on its own - night footfall, mixed-uses, developing an after-work community - it faces two challenges:

- Affluent South Africans will generally not flock back to downtowns until *after* the cities have revived.
- Market housing does nothing to provide housing for the service workers who support large urban businesses.

Affordable housing is thus a social goal distinct from urban regeneration, one that is not satisfied by delivering market housing in inner-city areas. As such, it deserves its own programme.

4B. Elements of an affordable housing production program. An affordable housing production programme should include the following elements:

- *Property.* Viable with both new-build and rehab.
- *Income mixing.* Broad range of incomes served. The very lowest income levels may require additional capital-cost subsidies or possibly operating support.
- *Tenure mixing.* Should be compatible with homeownership, sectional title, shared ownership, and rental.
- *Not confined to urban development zones* but applicable throughout the country.
- *Compatible with the URTI* so that URTI equity can be an affordability booster.
- *A debt vehicle* because even the URTI will cover only 20% of the cost.

- *Significant interest-rate advantage* because otherwise it will not be possible to sustain deep affordability.
- *Long-term use covenants and enforcement* to be designed.

4C. Specific recommendations for the URTI. For the reasons noted above, the URTI is an urban regeneration tool almost exclusively, with a highly targeted geography and an implicitly targeted property type. Expanding the URTI to cover affordable housing would in our view dilute its focus and purpose, so it should be retained as exclusively an urban regeneration vehicle rather than seeking to be all things to all people. Within that framework, we recommend the following changes:

1. *Use credits, not losses, as the TRI currency.* Among their advantages, they are more readily comprehensible, do not suffer from bracket arbitrage (worth different amounts to different taxpayers), lend themselves to better downstream compliance (via credit recapture on disqualifying events), and can be more easily stepped down. Further, credits can be calibrated just as easily as losses - indeed, more precisely.¹¹

2. *Give new construction URTI's equal to those of refurbishment.* Given that URTI's are defined by geography, *any* improvement in the neighbourhood should be measured by its end state impact, not its beginning state. Developing a vacant urban wasteland (or demolishing a derelict hulk) is as valuable as renovating an existing eyesore.

3. *Incentivize or boost housing and affordable housing as a target use.* Otherwise the URTI's will gravitate to commercial/ retail uses exclusively, defeating the goal of diversifying urban uses. One approach easy to adopt would be shortening the depreciation period from 5 to 3 years for affordable housing.

Points to remember: §4, Recommendations for SA's URTI

1. **The URTI will produce little affordable housing.** Since urban regeneration often goes hand in hand with affordable housing, **affordable housing needs to be further incentivized.**
2. **A tax-credit-based URTI** offers greater flexibility and higher efficiency with no increase in complexity. **It should be adopted.**

¹¹ Instead of a 20% annual writeoff, one could adopt a 6% annual credit over the same interval (5 years). The resulting credit calculation is more intellectually graspable for both customers and policymakers.

5. Conclusion

By proposing a URTI, the government has taken an important first steps in two senses:

1. *Improving this proposal.* The proposal is being circulated in the expectation that stakeholder comments will enable government to improve it. Our recommendations are provided in Section 5 and Exhibit 3.
2. *Developing other fiscal initiatives.* There is no reason to have just one fiscal initiative; indeed, there are many reasons to have multiple types targeted.

The URTI should be reviewed, debated, and enacted. At the same time, a separate, debt-oriented affordable housing production program needs to be created - the sooner the better.

Policy and programmatic issues in using tax incentives

Designing a TRI raises a series of issues. Tax-motivated soft equity is a creature of government, not just its legislative will but its regulatory implementation. How the incentive is distributed and administered has significant impact on takeup, marketplace acceptance, pricing ... and hence, effectiveness.

1. **Losses or credits?** Some TRI's use tax deductions (that are subtractions from income); others use tax credits. Credits are easier for the marketplace to understand because they are rand-for-rand and independent of the investor's marginal tax bracket. Credits are also easier to identify as a separate fiscal incentive since they flow directly, whereas losses are created as a byproduct of other factors (e.g. depreciation) so the amount of losses available in any investment is a function of its financing, operations, and other factors that require a complicated financial projection compiled by chartered accountants or investment bankers.
2. **Eligible property?** Exclusively residential, live-work space, or mixed use?
3. **Geographic targeting?** All property meeting the eligibility criteria or only those in certain specified geographies (e.g. townships, areas designated as low income, areas needing urban regeneration)? If targeting is to be imposed, how are the boundaries drawn? Is there a right of appeal/ exception property?
4. **Eligible tenure?** Some TRI's are targeted very specifically to a tenure option (rental and homeownership are the two most popular), others offer a multiplicity of tenures (e.g. the US historic tax credits applies to *any* use of a certified historic structure). Broader tenure makes a tool more flexible but risks its use in properties that may not be politically sustainable (especially if taken out of context as in a newspaper story).
5. **Allocated or as-of-right?** Allocated resources are given out by a (government) allocator (and may be subject to a cap). As-of-right resources arrive as a byproduct of a permissible tenure, use, or property. The latter are easier to finance but have a greater risk of misuse.
6. **Linking housing to community?** Most housing-related TRI's focus on housing to the tacit exclusion of other uses. They thus tend occasionally to develop new properties¹² in areas that lack jobs, transportation, retail, schools, or the other elements of a healthy community. They thus tend to provide short-term ribbon-cutting but sow the seeds of longer-term failure.
http://www.affordablehousinginstitute.org/why/ah_healthy_comm.html. If this is so, how does the programme assure housing is linked in with other resources? In this respect, allocated programs have a significant advantage

¹² At the risk of being seen as ignorant, one can view South Africa's 1950's townships as an experiment in housing planning gone awry. The basic apartments were reasonable but, sited wholly isolated from the rest of society and far from jobs, schools, retail, or public transportation, they were doomed.

over as-of-right because the allocator can review each case for community ties.

7. **Revitalizing South Africa's downtowns.** In the 1980's and early 1990's, many upper-income South Africans (and their jobs) migrated away from the center cities into new auto-dependent suburban enclaves. Left behind, the cities have atrophied. Yet the city's infrastructure - buildings, roads, transportation hubs, landmarks, waterfront - remain. In the US, affordable housing has been one of the anchors of revitalizing such previously decrepit downtowns as Baltimore, Pittsburgh, and Indianapolis (with varying degrees of success). Should TRI's pursue a secondary mission?
8. **Focusing the TRI's mission in affordable housing.** Governments seek or subsidize affordable housing for many reasons: http://www.affordablehousinginstitute.org/why/ah_reasons.html. Some of these are more challenging than others. TRI's should reflect the range of incentivized reasons and should recognize that core reasons may differ from market to market and will likely change over time¹³.
9. **Use covenants: what and for how long?** Government resources are tools to buy desired policy outcomes. These may include (a) production, (b) immediate affordability, (c) continuing affordability, (d) housing accessibility (some markets have enough because low income households cannot access it over barriers of ignorance, prejudice, or discrimination). What bargain should government strike? For how long? Too little benefit undermines a program's political viability; too much may render it stillborn because deals are uneconomic and no one wants to participate.
10. **Mechanic of investment: who raises the capital from whom?** Existence of a TRI does not automatically call forth the equity. Some TRI's are appealing only to some investor types (e.g. corporations with large capital or external motivations) who are not necessarily as limber as they ought to be to capture the opportunity. Hence the role of syndicators, who may also not come into being as quickly as government would choose. Thought should be given to jump-starting the processes of awakening investor demand and creating a syndication/ investment banking capacity.
11. **Tolerance of price discounts and investor IRR.** TRI systems explicitly accept there will be a discount between the government's cost to deliver the TRI and the equity it raises. This is politically sustainable only if government believes it has gained a good bargain (see ¶13C) both *before the property is built and then several years later, when it is a success*. Indeed, some programs have come a-cropper because they were too successful - at least in political terms - or they were seen as creatures of a previous administration or party and are repudiated after a change-of-control election.
12. **The rate of takeup: startup discounts.** A tax incentive must be *sold for cash* if it is to produce incremental soft equity. To that end, it must (a) migrate toward a suitable buyer, and (b) meet the buyer's risk-reward yield criteria. Typically this migration takes place over time and is influenced (speeded up or slowed down) by the larger environment of (to name just a few) familiarity

¹³ The best TRI's cure the problem they were designed for an in effect self-obliterate their original reason

with tax incentives, alternate uses of capital, non-financial motivation of the investors, and perceived reliability of the property's operations and sponsor. A learning-curve and investment take-up curve can be anticipated.

13. **What is it worth to government to shift risk?** And is this widely accepted and acknowledged before the programme begins?
14. **Participation barriers: are the small squeezed out?** Most TRI's are designed with a vision of larger sponsors and investors participating. Government thus tends to write the allocation/ compliance/ enforcement provisions with an unstated image of sophisticated participants. Inadvertently, therefore, TRI programs can drift into high processing costs that squeeze out small participants (especially local occupant-owned first-time homebuyers).

South Africa: Tax Reliefs Incentives (TRI's) as proposed

(All citations are from SARS's 2003/2004 Budget Tax Proposals as published in http://www.sars.gov.za/it/brochures/2003/2003_Budget_Tax_Proposals.pdf.)

Elements in ***bold italics*** are those with particular policy/ programmatic implications commented upon in the accompanying exhibit.

A. Tax Relief Incentives (TRIs) proposed, principal provisions

<u>Topic</u>	<u>Page</u>	<u>Proposal</u>
1. Depreciation , refurbishment / rehab	10	"Taxpayers refurbishing a building with an [urban development] zone will receive a 20% straight-line depreciation allowance over a 5-year period." [That is, 100% depreciated straight-line over 5 years, or 20% per year.]
2. Depreciation, new construction	10	If taxpayers construct a new commercial or residential building within such a zone, they will receive a 17-year write-off period with a 20% writeoff in the first year and 5% write-off thereafter. " [That is, 20% + 16x5% = 100%.]
3. Use of depreciation	10	"This benefit will be available to owners as users of the building or as lessors/ financiers of these investments."
4. Geographic targeting	10	"Several criteria (to be included in legislation) will be taken into account in designating qualifying zones within the selected metropolitan and urban areas. The incentive is intended to encourage investment in: <ul style="list-style-type: none"> • Areas with high population carrying capacity. • Central business districts or inner-city environments. • Areas with developed urban transport infrastructure for trains, buses, or taxis."
5. Cost	11	"The programme will be allocated R1,3 billion of tax revenue foregone within four years, after which the programme will terminate. "
6. Governance	11	"Measures will be provided to ensure sound governance of the programme as well as transparent reporting and annual accountability before Parliament."
7. Affordable housing as public benefit	14	"Public benefit organizations [eligible to receive tax-deductible grants] will be expanded to exempt organizations devoted to low income housing and that contribute toward the regeneration of urban areas. "

B. Existing law relevant to housing and urban revitalization investment

<u>Topic</u>	<u>Page</u>	<u>Proposal</u>
8. Brackets, individual	6	Maximum individual tax bracket is 40% on income above R255 000 annually.
9. Brackets, corporate	N/A	Maximum corporate bracket is 30% on income above R150 000 annually.
10. Passthrough entities	N/A	Deductions from one trade can be offset against income from another (subject to some ring-fencing). It is expected that deductions from affordable housing and inner-city regeneration activities <i>will</i> be allowable against other income for corporations.
11. Transfer duty	8	8% of the value above R320 000.
12. Capital gains	N/A	Maximum bracket is 10% for individuals, 15% for corporations, 20% for trusts.
13. SARS interest rates	N/A	Refunds of overpayment of provisional tax, 11.5% annually. Refunds on tax of successful appeal, 15.5% annually.

South Africa: TRI's as proposed, comments and recommendations

David A. Smith

A. Overall

The urban regeneration tax incentive (URTI; our term and acronym) is significant initiative that will use fiscal incentives to direct private investment into urban regeneration policy. As structured, however, it will be almost an urban regeneration stimulus and will generate little or no affordable housing.

Affordable housing is a key element of healthy communities. The programme should add a separate incentive or incremental boost for affordable housing as a permissible use.

B. Concept: fiscal incentives with targeted geographic/ programmatic impact

The URTI as presented builds on sound principles of fiscal management as established in other developed and developing nations. Among them are:

- Using private investment to accomplish public purpose.
- Targeting investment by geography, use, or difficulty (in this case, rehab versus new construction).
- Deploying fiscal incentives to reduce capital cost (and hence to induce development that otherwise would not).
- Permitting fiscal incentives to be sold so as to encourage flow of capital from institutions to sponsors.

The URTI thus represents a sound initiative that should boost capital investment in South Africa's inner cities and regeneration areas. At the same time, however, the URTI could be improved from the initial SARS proposal in ways that will be more efficient and more broadly effective.

C. General comments and recommendations

1. **The tax incentives are not by themselves enough to justify development.** Rehab incentives have a present value of roughly 21% of total development cost (TDC); new construction incentives are worth roughly 12% of TDC. The rehab incentive is significant (the new construction much less so) but as it will represent no more than a 21% reduction in the required debt, by itself it will not stimulate otherwise uneconomic development.

Query: Is a 21% cost advantage sufficient to redirect capital from suburban greenfield development into inner-city regeneration?

2. Rehab is advantaged over new construction. Rehab incentives will be worth roughly twice as much as new construction. Even recognizing the large population of underused or derelict buildings within inner-city areas, it does not follow that rehabbing them is more costly than building new; hence the case for so advantaging rehab is weak. In practice, the vast differential means the URTI's will likely flow almost exclusively into rehab.

3. Housing is *not* advantaged compared with other uses. Normally, housing has a lower risk-adjusted economic return than other uses such as retail or commercial - thus, in tax-motivated systems, housing generally is advantaged relative to other uses. That is not done here.

4. Affordable housing will seldom work with URTI's. Affordable housing is by definition capped as to rents, cash flow, or future value or use. Thus systems that incentivise housing tend to provide incremental advantages for *affordable* housing.

Without analyzing deeply, it seems *very* unlikely that much if any *affordable* housing will use the URTI's - unless the URTI's are boosted with faster depreciation, a bonus basis multiplier, or other adjustments.

5. The tax incentives are delivered to "owners as users." The context leaves unclear whether this is intended to encompass synthetic owners (e.g. limited partnerships or joint ventures) that represent deal-specific business combinations of a sponsor, debt source, and equity investor. It should do so because generally developers will have little use for URTI's and will wish instead to sell them for cash via an equity-type investment.

6. Geographically-bounded incentives as-of-right are efficient and targeted. As now structured, the proposal will apply to *any* property within a to-be-defined geographic area within an urban metropolitan zone. From the perspective of *urban regeneration* - as distinct from the goals of affordable housing - this is efficient and can be well targeted. Indeed, if the geography is thoughtfully and dynamically bounded (that is, small at first, then moving as the city revives), the urban regeneration zone definitions can serve to catalyze neighbourhoods in turn.

7. Geographically-bounded incentives create edge phenomena. Understandably, the URTI's will be bounded by some geographically-precise definition (census tracts, distressed postal codes). Whatever boundaries are set will create odd edge-pricing and use phenomena where property on one side of a street receives a boost that the other side is denied. Edge phenomena would be mitigated through a step-down applied (e.g. anything within 1_ kilometers receives a 50% allowance) that would work slightly better with a credit rather than losses approach.

D. Recommendations: policy and programmatic level

Aside from providing specificity (see Section E below), we recommend these changes to make URTI's more effective and efficient:

1. **Use credits, not losses, as the TRI currency.** Among their advantages, they are more readily comprehensible, do not suffer from bracket arbitrage (worth different amounts to different taxpayers), lend themselves to better downstream compliance (via credit recapture on disqualifying events), and can be more easily stepped down. Further, credits can be calibrated just as easily as losses - indeed, more precisely.¹⁴

2. **Give new construction URTI's equal to those of refurbishment.** Given that URTI's are defined by geography, *any* improvement in the neighbourhood should be measured by its end state impact, not its beginning state. Developing a vacant urban wasteland (or demolishing a derelict hulk) is as valuable as renovating an existing eyesore.

3. **Incentivize housing and affordable housing as a target use.** Otherwise the URTI's will gravitate to commercial/ retail uses exclusively, defeating the goal of diversifying urban uses. One approach easy to adopt would be shortening the depreciation period to three years for affordable housing. (Converting the URTI's from depreciation deductions to tax credits would make boosting affordable housing much easier and more calibratable.)

4. **Consider allowing affordable housing as a TRI-qualifying use even outside URTI's.** South Africa needs affordable housing *everywhere* in the country. While the URTI's proposed may be a sufficient initiative for 2003, in 2004 and beyond there should be a production-oriented capital incentive targeted specifically to affordable housing (according to definitions to be developed with government).

E. More detailed comments, questions, and suggestions

1. **Termination in four years.** Presumably necessary as a first-order experiment, but will inhibit takeup and discourage dissemination of programme knowledge and support. An in-progress review after two years should encompass technical corrections, policy refinements, and the possibility of converting to permanency before the four-year interval is up. At all costs, the programme should avoid sunset uncertainty.

2. **Public-purpose use covenants.** Is development in an urban regeneration zone a use sufficient unto itself? Or should there be further use covenants? Do the covenants change depending on the property's use? (For example, regeneration of new for-sale homes, if successful, might lead those homes to rise rapidly in price as the neighbourhood improves. If the homes are sold just a few years later at much higher prices, how will that be viewed - as regeneration success or undeserved windfall to well-connected participants?) These questions are not administrative; they go to the heart of the policy motivation. They deserve a separate working group effort in conjunction with government.

3. **What is sound governance?** The URTI contemplates there will be standards for sound governance. Do these refer to property use? Development quality? Sponsor compensation? Tracing of public funds?

¹⁴ Instead of a 20% annual writeoff, one could adopt a 6% annual credit over the same interval (5 years). The resulting credit calculation is more intellectually graspable for both customers and policymakers.

4. **Public Benefit Organizations** that provide low-income housing are proposed to be included as eligible recipients of tax-deductible contributions. This is useful but by itself will make only modest difference in affordable housing production. Allowing property developed by low-income PBO's to qualify automatically for URTI-AH incentives *would*, however, greatly stimulate new production/ rehab without losing public benefit accountability (through SARS's control over who is a permissible PBO).

Exhibit 4
South Africa: Tax Reliefs Incentives (TRI's)
Value measured as percent of Total Development Cost

Property development and financing assumptions

100,000 Total property cost (per apartment)
 80% Gearing
 80,000 Debt

Benefits to capital

20,000 Equity (net of costs of raising capital)
 15% Costs of raising capital
 23,529 Equity (gross raised from investors)

A. Refurbishing

5 Years of depreciation
 20.0% First-year depreciation (if different)
 20.0% Average depreciation in remaining years

B. New construction

17 Years of depreciation
 20.0% First-year depreciation (if different)
 5.0% Average depreciation in remaining years

Year	100,000	15%	Discounted at 13.5%
	Annual depreciation	Tax savings at 30%	
1	20,000	6,000	6,000
2	20,000	6,000	5,286
3	20,000	6,000	4,658
4	20,000	6,000	4,104
5	20,000	6,000	3,615
6	0	0	0
7	0	0	0
8	0	0	0
9	0	0	0
10	0	0	0
11	0	0	0
12	0	0	0
Subtotal	100,000	30,000	23,663
Exit	76,471	(11,471)	(2,849)
Total			20,814

21%

Year	100,000	15%	Discounted at 13.5%
	Annual depreciation	Tax savings at 30%	
1	20,000	6,000	6,000
2	5,000	1,500	1,322
3	5,000	1,500	1,164
4	5,000	1,500	1,026
5	5,000	1,500	904
6	5,000	1,500	796
7	5,000	1,500	702
8	5,000	1,500	618
9	5,000	1,500	545
10	5,000	1,500	480
11	5,000	1,500	423
12	5,000	1,500	373
Subtotal	75,000	22,500	14,352
Exit	75,000	(11,250)	(2,794)
Total			11,558

New construction is

56% of refurbishment

Exhibit 5
AHI SA: Urban Regeneration Tax Incentive (URTI)
Volume projections used rough estimates

<u>Estimate</u>	<u>Commodity</u>	<u>Source or discussion</u>
1,300,000,000	Rands of tax foregone	SARS 2003/2004 budget proposal
20%	Percent of TDC funded with TRI's	AHI net present value analysis (see Exhibit 1)
6,500,000,000	Total value of property developed	
1,500	Rand per square meter	AHI estimate (see report ¶3D)
4,333,333	Square meters of property	
10%	of the inventory done as housing	AHI estimate (see report ¶3D)
433,333	Square meters of new housing	
40	Size in m2 of typical house	AHI estimate (see report ¶3D)
10,833	Total houses developed	
50	Houses in typical property	AHI estimate (see report ¶3D)
217	Properties developed	
4	Years over which program used	SARS 2003/2004 budget proposal
54	Properties per year	
9	States in South Africa	
6	Properties developed per state per year	
301 Apartments per state per year		