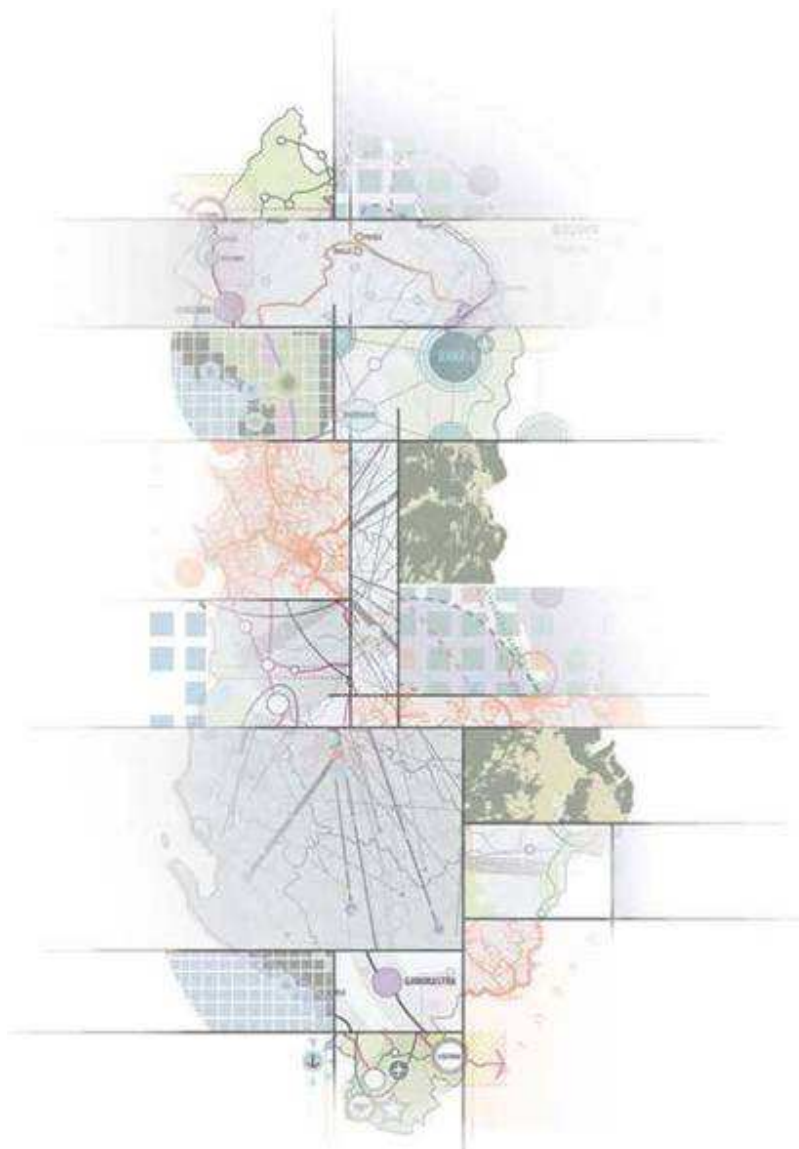




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FINANCIAL INSTRUMENTS FOR LAND DEVELOPMENT

POLICY PAPER



January 2016

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The authors' views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

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ACRONYMS AND ABBREVIATIONS

BID	Business Improvement District
CBI	Conditioned Building Intensity
DCM	Decision of Council of Ministers
FAR	Floor Area Ratio
GIM	Gross Income Multiplier
GLTP	General Local Territorial Plan
GOA	Government of Albania
LDP	Local Detailed Plan
MUD	Ministry of Urban Development
NTPA	National Territorial Planning Agency
PLGP	Planning and Local Governance Project
RDF	Regional Development Fund
SAD	Special Assessment District
SQM	Square Meters
TDR	Transfer of Development Rights
TIF	Tax Increment Financing
TPL	Territorial Planning Law
USAID	United States Agency for International Development

1. EXECUTIVE SUMMARY

The United States Agency for International Development (USAID)'s Planning and Local Governance Project (PLGP) is a five-and-a-half year initiative which provides technical assistance and training to the Government of Albania (GOA) and local governments to help them successfully implement decentralization legislation, policies, and reforms. To achieve its goal, PLGP pursues a comprehensive and coordinated strategy with four key components: (1) support the GOA's work to implement effective government decentralization policies and legislation; (2) improve the efficiency, transparency, and accountability of local government operations; (3) improve local government management and oversight of selected public utilities to provide services in accordance with European Union standards; (4) strengthen the capabilities of the GOA and local governments to plan and manage urban and regional growth.

ALBANIA NEEDS GREATER INVESTMENT IN ITS LOCAL INFRASTRUCTURE

Infrastructure is a pre-condition for most economic opportunities, a high quality of life, and sustainable patterns of urban development. According to the European Commission, the typical member nation of the European Union has seven times more kilometers of roads per 100,000 residents than Albania and more than three times more rail lines. Moreover, Albania invests only 25% of what is required to maintain current infrastructure.

Political and fiscal decentralization, territorial reform, shifting demographics, and growing community demands are increasing pressure on local government authorities in Albania to increase investment in infrastructure. However, increased pressure is not matched by increased income, and local governments are seriously under-resourced and hence unable to meet the demand for basic services and infrastructure.

PAYING FOR INFRASTRUCTURE

Ultimately, for decentralization to succeed, infrastructure has to be provided and maintained, and someone has to pay for it. Local governments can invest in infrastructure from their local taxes and intergovernmental transfers and/or use various revenue-raising instruments to capture some of the financial benefits from public investments that accrue to private developers or the community at large.

This paper outlines policy options for implementing six financial (i.e., revenue-raising) instruments for land development that may be appropriate for Albania. It was developed by USAID's Planning and Local Governance Project at the request of the Ministry of Urban Development. Financial instruments are authorized by Albania's 2014 Law on Territorial Planning and Development for local governments to manage urban and regional growth and fund physical infrastructure. This paper is aimed at national and local government policymakers and managers and others who are interested in formulating, influencing, and administering policy regarding:

- Transfer of Development Rights
- Conditioned Building Intensity

- Tax Increment Financing
- Business Improvement Districts
- Betterment Fees
- Special Assessment Districts

Transfer of Development Rights programs help direct development to areas where public infrastructure is in place or can be provided relatively efficiently. Conditioned Building Intensity programs require developers to pay a contribution for the public infrastructure or service in certain areas in return for the ability to build at a higher intensity. Tax Increment Financing allows local governments to use future gains in property tax revenues to finance current improvements. Business Improvement Districts provide privately-funded services that supplement public services. Betterment Fees capture part of the increase in property values due to public investment or changes in permitted land use. Special Assessment Districts spread the costs of infrastructure among those who directly benefit from it.

The paper also discusses Albania’s Infrastructure Impact Tax on New Construction, an existing financial instrument and a significant generator of own-source revenues for local governments.

RISK MANAGEMENT

All of the financial instruments are public-private partnerships, with local governments and private businesses sharing the costs and benefits of public and private investment. However, they also entail financial risk to municipalities, and this paper emphasizes that they are intended to complement, and not substitute for, an adequate capital budget, a sound capital investment strategy, strong internal financial controls, robust territorial growth regulations, and an active and involved civil society—all of which are necessary to create an enabling environment for sustainable development and to minimize risk.

USAID’S ROLE IN FACILITATING CHANGE

While the paper remains focused on financial instruments, it necessarily takes into account the significant changes that are underway or under discussion in Albania with potentially dramatic implications for local government finance and land use. PLGP is intimately involved in many of these efforts, including:

- Assisting the national government design, and commit to, a comprehensive fiscal framework which gives local governments more fiscal independence and sustainability, in terms of raising and spending own-source revenues, receiving more and more-predictable transfer funds, entering into public-private partnerships, and accessing debt financing. Through PLGP, USAID is helping develop and revise policies and laws governing local finances, including local taxing powers, tax sharing, local borrowing, capital improvement planning, multi-year budgeting, financial management and control, and other measures to increase local accountability.
- Building the capacities of staff of the national and local governments to modernize public administration and management systems (asset, financial, property/cadastre, human resources, etc.). USAID project assistance not only builds capacity but also creates momentum for change.

- Helping the national and local levels of government redefine their roles and responsibilities in response to territorial consolidation and financial decentralization, as a basis for greater cooperation and coordination.
- Integrating a voice for citizens, and thereby accountability, into mainstream practice and policy. In fact, an active and involved civil society is a necessary basis of an enabling environment for sustainable development.
- Assisting governments at all levels develop a policy and legal framework and the technical resources for managing territorial growth and development in a sustainable manner, including providing decision makers, administrators, and other community stakeholders with an understanding of an array of land development financing and management tools drawn from international best practices.

SUMMARY OF RECOMMENDATIONS

The recommendations of this paper are framed within the broader context of momentous political, economic, and social change in Albania, as well within the specific context of U.S. assistance to make more human and financial resources available to local governments. The recommendations are complimentary and require cooperation across all levels of government, and between governments and the private sector. As is true with any suggested recommendations for intricate policy issues, they need to be adjusted according to local circumstances, and this paper provides guidance for choosing the best option to meet particular local situations.

The paper proposes four principal recommendations.

- Practical action steps are offered for the successful design, implementation, and monitoring of each financial instrument. The action steps accompany the Program Design discussion of each instrument and are based on international best standards. They are recommended to guide the work of elected officials, policymakers, municipal professional staff, citizens, and other decision makers.
- A review of the enabling environment for the six financial instruments is recommended. Relevant policy, legal, and regulatory frameworks should be assessed to identify and address any gaps that make it difficult for local governments to properly implement the basic requirements of any of the six financial instruments.
- Revenues from the use of the financial instruments discussed in this paper must remain with local governments and not be required to be shared with the national government. The ability of local governments to raise and control own-source revenues, and link them to local service delivery, is the essence of efficiency and accountability under decentralization.
- A model is suggested for optimizing local own-source revenue for local infrastructure development in targeted areas. This model funding framework considers the current Albanian legal and institutional context and suggests a method for utilizing three financial instruments—betterment fee, infrastructure impact tax, and special assessment—to raise revenues for infrastructure in designated areas of a municipality.

Supporting recommendations for successful implementation include:

- Standard and accountable methods should be used to value properties. Property valuation based on internationally-recognized standards can help eliminate the arbitrariness from buying, selling, and appraisal decisions that can increase risk, lead to financial shocks, and deter economic growth. Standard and accountable property valuation methods should be used consistently by the private and public sectors.
- Information should be provided to local governments on best valuation practices. Local governments need general advice and information-sharing on best property valuation and other issues related to valuation in order to make informed and accurate decisions regarding the application and use of financial instruments.
- Clear guidelines should be established for public auctions. Auctions are required by law for Conditioned Building Intensity programs and may be advisable for Transfer of Development Rights programs. Efficient and well-run auctions can dramatically increase the amount of revenues generated compared to an ad hoc auction or no auction.
- The infrastructure impact tax should be amended. Revising the methodology for imposing costs on developers and dedicating a portion of the tax revenues to infrastructure investment could increase the amount of revenues raised, make the tax more efficient, and fund public facilities.
- A clear and unequivocal definition of market value should be developed by the Government of Albania. Although regulations governing financial instruments specify that property valuations must be based on market value, there does not appear to be a clear definition of market value in Albanian law. This makes it difficult to know with certainty the range of property valuations that might be applied in Albania, and, therefore, the extent to which financial instruments might be customized to fit the context and needs of different municipalities.

2. LOCAL GOVERNMENT REVENUES AND TERRITORIAL PLANNING AND DEVELOPMENT

2.1 BACKGROUND

Local governments in Albania struggle to provide basic services and infrastructure to meet the demands of their populations. Two major challenges are the unplanned nature of growth and development and the limited fiscal resources available to finance local public facilities. Much of Albania's built landscape, especially on the periphery of cities, is characterized by incompatible or illegal construction with relatively poor public services. This is the result, in large measure, of the lack of a legal and institutional framework to ensure comprehensively planned land use and development in the aftermath of communism, corruption, and insufficient funds at both the local and national levels.

While these are long-standing problems, recent national territorial reform—which consolidated 373 local governments into 61 municipalities with larger populations and larger land areas—and related decentralization policies are transferring additional service-delivery responsibilities downward. Local governments are responsible for public education, health, transport, and community and economic development in the newly-consolidated and larger municipalities. In 2016, they are expected to be assigned responsibilities for agriculture, irrigation and drainage, environmental protection, and fire protection services.

The downloaded services are rarely accompanied by sufficient resources. Moreover, the territorial re-configurations are often striking. In many cases, primarily urban municipalities gained a rural hinterland, and inland areas gained coastal zones. All local governments must now plan for not only larger land areas but also a larger and more diverse spectrum of land uses.

The 2014 Law on Territorial Planning and Development (TPL) and related 2015 bylaws provide a powerful legal and regulatory framework for local governments to shape land use and direct development within their municipal boundaries. The Law requires each municipality to develop comprehensive General Local Territorial Plans, or GLTPs. The GLTPs must address growth and development through a future land use plan, prioritize infrastructure investment, and develop a realistic capital budget for funding public facilities. No GLTPs have yet been adopted by the newly-merged municipalities. USAID's Planning and Local Governance Project is providing intensive technical guidance to five local governments in drafting GLTPs and, with the assistance of the Ministry of Urban Development and the National Territorial Planning Agency, has prepared and distributed a *Territorial Planning Toolkit*, a detailed technical manual to help all 61 municipalities comply with planning laws and draft effective GLTPs.

If designed and implemented properly, the General Local Territorial Plans will begin to provide a clear nexus between furnishing and paying for public infrastructure and planning for the efficient

use of land at the local level. However, implementation of all of the GLTPs will be severely compromised if the national government fails to transfer additional funds and allow local governments to access additional debt financing, as well as give local governments the authority to raise sufficient own-source revenues.

Infrastructure investment is central to sustainable local growth and development. The interplay of land use policy and infrastructure provision, such as roads, water, sanitation, and electricity, drives economic activities, directs patterns of growth, and affects quality of life. According to a study by the European Commission, Albania has 13.8% of the roads and 32% of the rail (in kilometers per 100,000 inhabitants) of the average European Union nation. Similar ratios exist for other types of infrastructure, such as water and solid waste management facilities. Moreover, Albania invests an estimated 25% of what is required to maintain existing infrastructure.¹ Clearly, Albania must make considerable infrastructure investment if it hopes to boost economic growth and improve quality of life.

Construction, legal and illegal, is a driver of economic growth in Albania, accounting for 10.3% of GDP.² Although public infrastructure has not kept pace with private construction activity, land development and land values remain highly sensitive to infrastructure investment, and most development occurs where roads, water, and other services are in place or planned. In other words, many of the financial benefits of public infrastructure investment accrue to adjacent private development. These benefits accrue not only to real estate developers but also directly to individuals and families. Property ownership and increases in property values fuel personal wealth creation and a higher quality of life.

Municipalities capture some of these gains through the Infrastructure Impact Tax on New Construction, one of the few locally-leveled and locally-controlled revenue sources. The tax has accounted for as much as 25% of all local government revenues in recent years.³ There are wide swings in total revenues collected each year from the tax in most municipalities, due to the sensitivity of the construction industry to economic change and to public policies, such as a limited national moratorium on new construction. Unsurprisingly, the more urban a municipality, the more it raises through the infrastructure impact tax. Despite the unpredictability, the tax remains a major source of local revenues for many municipalities. Proceeds, however, are rarely dedicated specifically to infrastructure, but go to municipal general funds. Moreover, the tax often seems an incentive for municipalities to issue building permits without proper scrutiny of the permit application.

The larger picture is that without new construction growth, local governments have few ways of raising revenues to pay for important services. However, with such growth they incur more costs and thus need more revenues from new construction.

It seems clear that the ability to sustain growth and increases in property values in Albania is largely dependent on the wise planning and adequate provision of infrastructure. This potentially can be

¹ European Commission. *Instrument for Pre-Accession Assistance: Indicative Strategy Paper for Albania (2014-2020)*.

² 2013 data from INSTAT, *Structure of Gross Domestic Production, 2008-2013*.

³ Planning and Local Governance Project/USAID. *White Paper on Fiscal Decentralization*, p. 43 (2008-2011 data); and Ministry of Finance (2012-2014 data)

Total infrastructure impact tax revenues collected each year as a proportion of total local government revenues:
2014, 17%; 2013, 14%; 2012, 13%; 2011, 25%; 2010, 17%; 2009, 22%; 2008, 18%.

facilitated by strategically utilizing a portion of the land value benefits to finance infrastructure, as well as better managing growth.

The financial instruments for land development discussed in this paper, as well as more strategic use of the infrastructure impact tax, offer local governments tools to manage growth according to their General Local Territorial Plans while ensuring that a significant portion of new development pays its own way.

While financial instruments for land development offer an opportunity for municipalities to embark on a path towards sustainable growth and development, the magnitude of the money involved may invite nontransparent deals, political favoritism, and outright corruption. Financial instruments must be implemented according to sound principles of governance and financial management, and the USAID has provided considerable guidance to national and local governments in both areas.

2.2 USAID's PLGP POLICY GUIDANCE

The aforementioned problems of unplanned growth and inadequate local revenues are clearly articulated in several policy documents prepared under the auspices of the USAID's Planning and Local Governance Project, most notably the *White Paper on Fiscal Decentralization* (2012), *Policy Brief on Options for Implementing Immovable Property Tax* (2013), *Recommendations for Draft Law on Local Finance* (2013), and *Policy Paper on Creating an Equitable, Transparent, and Predictable Unconditional Grant Formula* (2015). These documents recommend the long-term rehabilitation of municipal finances by:

- **Strengthening local tax systems**, particularly allowing local establishment of property tax rates, local collection of property taxes, and local control of property tax revenues, as well as instituting tax assessments based on the current market value of property. The value-based property tax, for which the PLGP advocates, is essentially a benefit tax because public investment in local services and infrastructure can enhance property values, which, in turn, increases tax revenues in a virtuous cycle.
- **Linking local taxes and other revenues to service improvements**. If local governments have to raise revenues to fund the necessary public goods, local officials must explain to taxpayers how the revenue will be spent. Ultimately, as noted in several PLGP studies, a revenue-expenditure link is perhaps the only way to persuade local residents and businesses to provide more municipal revenues.
- **Making realistic public debt instruments available to local governments to finance long-term infrastructure investment**. It is impossible for local governments to finance basic operating services and to provide new services, much less adequately maintain existing infrastructure and build new infrastructure, with existing revenue streams. Through the project, USAID has recommended to the GOA that long-term infrastructure investment should be financed by public debt to match actual consumption and payment for services. The use of debt financing should be transparent, strictly tied to the prioritization of infrastructure investment through General Local Territorial Plans, and minimize risks for local governments.
- **Improving data collection and reporting**, especially regarding real estate transactions and property registrations. Accurate and readily-available information on parcels and buildings is essential to local governments' ability to capture some of the value of those properties. USAID assists local governments in increasing own-source revenues and operational

efficiency; however, the efforts are hampered by the national government's unwillingness to share data with local governments, including information from the Immovable Property Registration Office's database.

- **Increasing national-local government revenue sharing and collaboration.** Municipalities cannot and should not handle their financial problems alone because they are required by the national government to fulfill their public mandates. Whether local governments can enhance local revenues often depends on authorization by the national government. Local governments in Albania have fewer financial resources than their counterparts in Southeastern Europe.⁴As part of decentralization, it is reasonable for local governments to gain additional scope to deal with their fiscal problems and to negotiate spending and revenue responsibilities with the national government. Specifically:
 - It is recommended that the GOA increase the size of its annual unconditional grant and anchor it to a stable macroeconomic indicator such as national revenues, as well as improve criteria for grant allocations. This would increase the predictability of this important local government revenue source and thus allow local governments to plan more effectively. To aid policymakers, USAID's PLGP developed a modeling tool which allows the GOA to simulate distributions to individual municipalities under different scenarios.
 - It is recommended that the GOA revise its policies related to the size and use of the Regional Development Fund which disburses competitive grants; specifically, that the GOA favor the unconditional grant to increase local governments' fiscal autonomy and use the RDF more strategically. It is further recommended that the criteria for selecting projects and allocating RDF funds be revised and made more transparent.
- **Exercising additional options for raising local government revenues and ensuring local fiscal autonomy.**

The final item is closely linked to territorial planning, as all of the municipal revenue raising and spending options revolve around real estate development, and is the focus of this policy document. USAID's PLGP 2013 *White Paper on Fiscal Decentralization* recommends "the development of local government revenue sources linked to improving land use planning and development." The Government of Albania included the recommendation in the 2014 Law on Territorial Planning and Development. In essence, the TPL, the *White Paper*, and other PLGP studies provide a roadmap for the exercise of territorial land use planning not only as a physical design process but also as a financial planning process.

2.3 LAW NO. 107/2014 ON TERRITORIAL PLANNING AND DEVELOPMENT, LAND VALUES, AND FINANCIAL INSTRUMENTS

Law No. 107/2014, *On Territorial Planning and Development*, outlines an integrative policy and governance approach to land use management. The TPL enables planning instruments, including general local territorial plans, sectoral plans, and local detailed plans. It enables regulatory instruments, including development regulations and bylaws. And it enables financial instruments for land development. All of these instruments are different, but all must work together. The

⁴ Planning and Local Governance Project/USAID. *White Paper on Fiscal Decentralization*.

planning instruments specify what can be built and where; the regulatory instruments specify how things must be built; and the financial instruments make developers and property owners financial partners of the municipality in providing needed public facilities and managing growth. The TPL thus establishes territorial planning as a vehicle for advancing many of the nation's and municipalities' overarching goals, including: building infrastructure; conserving agricultural land, natural land, and cultural and historic resources; and supporting sustainable development and redevelopment. Moreover, the TPL states that territorial development “must be fair and the generated value must be acquired and assimilated by the society that creates it.” (Article 4b).

2.3.1 Land Values and the TPL

The TPL also enables local governments to implement financial instruments to leverage the economic value of private land. The value of privately-owned land often increases as a result of public investments in infrastructure, changes in local land use policies, and broader socioeconomic changes that lead to growth in population and income. In the fields of spatial planning, public finance, and international development, a consensus has evolved in recent years that local governments are entitled to collect a portion of this increase in land value—through taxes, fees, or in-kind payments. These funds can then be used to fund infrastructure and municipal programs to serve the community at large. In other words, if a private developer builds on private property along a public road or taps into a public sewer, the local government can use various financial instruments to “capture” some of the economic benefits of development.

It is important to note that, in accordance with Albanian law governing financial instruments, land value in this document refers to the “market value” of a parcel and all that is built on it. However, there doesn't appear to be a clear and unequivocal definition of market value in Albanian law. The European Parliament defines market value as “The estimated amount for which the property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without being under compulsion.”⁵ This is the definition used in this paper.

It is also important to understand that the value of private land comes from rights that can be bought or sold. Land ownership consists of a package of different rights, which are conferred by national laws and may differ from country to country. Generally, when someone purchases a parcel they purchase the entire bundle of rights that might be associated with it, such as the right to access, or the right to farm, or the right to develop. Owning a development right thus means that one owns the right to build a structure on the parcel. Development rights, like other rights, may be “possessed by the land owner, exchanged, or sold” (TPL, Article 3.10).

Typically, most land value is “captured” from sites that are very desirable and profitable to build on. The private sector will drive development on these premium sites. In addition to being captured, land value can also be “created” or “protected”. For example, a brownfield or junkyard site or a site with a less-than-ideal location may be too costly or too risky for a private developer to develop on its own. Or, to give another example, residents of an area may want the municipality to install a new sanitary sewer line to serve their homes and businesses. In such cases, the public sector may wish to utilize specific tools to make the development feasible, that is, to create value. On the other hand, there may be locations where development is not in the best interests of the community, such as a wetland or agricultural land, where construction could cause flooding or disrupt a critical environmental ecosystem or economic sector. In such instances, the land value should be protected.

⁵ Regulation (EU) No. 575/2013 of the European Parliament and of the Council, Article 4, Paragraph 76.

Land in a healthy free market economy constantly recycles through a process of growth and decline, in which properties become more or less desirable and thus change in value. By providing planning, regulatory, and financial instruments to capture, create, and protect land values in conformance with a general local territorial plan, the Law on Territorial Planning provides the framework for an effective and comprehensive land use management system to direct and support the types of development that help a local government attain its goals.

Indeed, the inclusion of financial instruments in Albania's Law on Territorial Planning is critical. A 2010 UN-Habitat report notes that "the effectiveness of [financial instruments for] land value capture is greatly improved if they are embedded in an effective land use management system."⁶ Financial instruments give local governments a greater capacity to stimulate, guide, share, and reward private uses of land in ways that benefit the community good, when accompanied by transparency and due diligence.

Transparency, due diligence, and effective land value capture are strictly related to a property valuation system that is accountable. Annex B describes internationally-recognized methods of property valuation. Their use is crucial to the efficiency of the municipal finance system and to growth of the local economy. When property values are arbitrarily decided between parties, and the monies paid for the property are not subject to any accepted standard valuation, the result very often is arbitrarily high capital and rental values, especially for residential properties and especially in urban areas.

2.3.2 Financial Instruments and the TPL

In addition to the aforementioned Infrastructure Impact Tax, the TPL specifies two specific financial "instruments for guiding development" in conformance with the General Local Territorial Plan:

- *Conditioned Building Intensity*, or the right of a developer to build at a greater intensity in certain areas in return for providing a public amenity or an in-lieu financial contribution that is earmarked for public capital investments (Article 30).
- *Transfer of Development Rights*, in which cultural or historic monuments and agricultural and natural lands are protected from being developed by legally transferring the parcel owner's "right to develop" to another site where development is desired (Article 31).

Furthermore, the TPL allows "benefits from the right to development and increased value of the land... to be used to build or fund public infrastructure, mainly in the area where the benefits were generated," thus permitting additional financial instruments to capture land value gains (Article 22).

2.4 PLGP INSTITUTIONAL CAPACITY BUILDING

Moving from policy creation to policy adoption, and then to the drafting and ratification of enabling legislation, and then to program implementation, is rarely smooth and easy. Government officials and their staffs at the national and local levels in Albania are trying to cope with the complex tasks of implementing territorial planning and development regulations and initiatives.

The mandate of USAID assistance through the PLGPis to build capacity through training and technical assistance.

⁶ Hendriks, M. and Tonkin, A. "Land Value Capture Taxation (LVC/T) Scoping Study-Final Report".

Support is especially critical in the fifth year of the project as municipalities and national institutions confront the challenges of 2015 territorial reform, which reduced the number of local governments from 373 to 61. Working at the national level, primarily in cooperation with the Ministry for Urban Development (MUD) and the National Territorial Planning Agency (NTPA), USAID will continue to assist in formulating and analyzing policy, strategy, and legislation. At the local level, USAID will continue to work to build the capacity of local governments, particularly its 13 partner municipalities and six model municipalities.

The purpose statement of Component 4 of the PLGP's recently-approved *Year Five Work Plan*, is to "strengthen the capabilities of the Government of Albania and local governments to plan and manage urban and regional growth." Since the project's beginnings, the consistent emphasis of PLGP's capacity building activities has been to facilitate conditions which stimulate systemic change.

The present discussion on financial instruments for land development is consistent with the PLGP's mandate for strengthening skills, abilities, knowledge, instincts, processes, and resources as defined in the *Year Five Work Plan*.

According to the *Work Plan*, USAID's PLGP will, in Year Five:

- Provide technical expertise in the implementation of financial instruments for land development at national and local levels, including drafting a policy paper on financial instruments and assisting the Ministry of Urban Development, as requested, in drafting or revising enabling legislation for various financial instruments.
- Continue to support the Ministry of Urban Development and the National Territorial Planning Agency, thus increasing the institutional impact of U.S. assistance with regard to territorial planning and development in Albania, including:
 - Lending support for legislation.
 - Providing tailored trainings and workshops.
 - Conducting an internal institutional analysis.
 - Drafting and disseminating a study on spatial land development typologies for use by MUD and NTPA to review territorial planning and development standards.
 - Supporting MUD in structuring a newly-created agency for issuing building permits.
- Continue to support MUD and NTPA in preparing the General National Territorial Plan. PLGP will provide demand-driven support to MUD and NTPA during the GNTP drafting and implementation processes.
- Provide intensive technical support and assistance to five model municipalities in preparing all aspects of their General Local Territorial Plans.
- Support the five model local governments in adapting quickly to their enlarged management, administrative, and services-provision roles in the aftermath of territorial reform, including delivering thematic trainings in territorial planning and public administration and facilitating public participation.

- Publish and disseminate, in coordination with MUD and NTPA, a *Territorial Planning and Development Technical Manual*, or “Planning Toolkit”, which provides guidance to local governments across Albania in drafting GLTPs and achieving compliance with the Law on Territorial Planning and Development. The Toolkit includes a brief chapter on financial instruments.
- Support the Ministry of Urban Development in drafting new national public space legislation. The new law regulates the creation and management of public spaces; defines options and procedures for the use of private space as public space; and provides a model public-space-use agreement. It has particular relevance for the design and implementation of many financial instruments since most public facilities and public properties are open and accessible to the public and/or serve the public.

3. FINANCIAL INSTRUMENTS

The financial instruments described below make the private-sector financial partners with the municipality in achieving a community's goals. All, in various ways, generate revenues upfront, that is, before infrastructure investment is undertaken. However, they should not be seen as practical or advisable ways to pay for an entire capital budget or to circumvent other municipal fiscal reforms identified in this policy paper. Rather, they should be viewed as individual tools to finance capital investments, each of which carries a different practical advantage. When implemented properly, these instruments add flexibility and choice to local public administration. In all cases, their value ultimately depends on the quality of the fiscal and land use management that underlies municipal investment decisions.

3.1 INTERNATIONAL PERSPECTIVE

It is fair to assume that most of the challenges Albania may face in designing and implementing programs for financial instruments will have been experienced before by other countries. However, different legislative procedures, constitutional laws, and taxation systems virtually guarantee that apparently similar situations will lead to different policies and outcomes. Learning from others' experiences can be helpful, but only when they build on the experience of Albania.

Political and cultural considerations are also paramount. While higher-income countries are more concerned with financing infrastructure maintenance or new infrastructure that supports additional growth, many countries like Albania struggle to provide basic infrastructure. And, while many countries embrace dense patterns of development, others accept it very conditionally. Other variables include property rights, the public interest, expropriation, and so on.

Clearly, there is a movement in cities around the world toward greater private-sector involvement in infrastructure development and growth management. This paper attempts to identify the considerations that are common to the successful implementation of financial instruments in most, if not all, countries. Specific international case studies are cited sparingly, but strategically. These are examples of high relevance for Albania, not to copy them directly but to understand the reasoning behind them.

3.2 INFRASTRUCTURE IMPACT TAX ON NEW CONSTRUCTION

Albania's Infrastructure Impact Tax on New Construction is a one-time levy assessed on developers during the permitting process. It amounts to 1-3% of a developer's total investment in a project (2-4% in Tirana), as reported by developers, subject to verification and acceptance by the municipality. The tax is intended to offset a development's impact on community infrastructure.

As previously noted, the tax represents a significant source of income for local governments, accounting for as much as 25% of total municipal revenues in recent years. There are wide variations among local governments, and municipalities with the fastest-growing populations generate the largest proportion of their revenues from the tax. There are also wide swings in the amount of revenues collected from year to year. Returns from the tax are not legally dedicated to investment in public infrastructure, and frequently fund municipal operating expenses.

A large and robust body of international studies finds that impact taxes are “economically efficient” ways of financing infrastructure because the costs are incurred by the new development, which benefits most directly from the infrastructure. For such efficiencies to be realized, however, revenues from impact taxes must be earmarked for capital expenditures related to public infrastructure installations or improvements that are needed to accommodate growth, such as streets, schools, public open spaces, libraries, sewer mains, and water lines. Spreading the costs over both the new development and the existing population, as occurs when general revenues are tapped to fund infrastructure, is found to be less efficient and less fair to taxpayers.

Research and practical experience also demonstrate that:

- ✓ Infrastructure impact taxes should be differentiated by residential, commercial, and industrial construction. For example, the costs of providing public services to residential developments are generally higher than for other types of development, and taxes should reflect such differences.
- ✓ A standardized method for reporting construction costs, as a basis for calculating infrastructure impact taxes, should also be instituted.
- ✓ Infrastructure impact taxes tied to a long-term infrastructure investment plan can help sustain growth. In Mumbai, India, for example, it has been estimated that a 10% tax on the cost of new construction could finance as much as 40% to 50% of all required infrastructure investment for the next 20 years.
- ✓ Infrastructure impact taxes do not inhibit a local government’s ability to offer other financial instruments. For example, a municipality wishing to steer growth to areas where it can be accommodated most efficiently can differentiate infrastructure impact taxes by location, thus contributing significantly to the efficiency of territorial development and complementing Transfer of Development Rights or Conditioned Building Intensity programs, as is the experience in Brazil, the United States, and elsewhere.

In summary, research and practical experience indicate that infrastructure impact levies that differentiate tax levels and have clear rules for application raise more revenues for municipalities and are fairer to taxpayers. They also establish a predictable process that applies equally to all developers.

By these standards, the current method for calculating Albania’s infrastructure impact tax is not fair to taxpayers or developers. It may also increase a municipality’s financial risks. Volatility in real estate development is part of market reality. Practical protection against this risk includes dedicating one-time and unpredictable tax revenues to one-time capital projects.

On the other hand, the infrastructure impact tax is easy to apply, and that simplicity is a powerful virtue that should not be understated or lost in any future revisions to the tax. It may also plausibly be argued that the infrastructure impact tax, as currently employed, does in fact capture some of the benefits conferred by the non-specific provision of general public infrastructure and incremental community development, which the other site-specific financial instruments discussed in this paper are not designed to capture. Annual property taxes also automatically capture some of these benefits, but, at the low rates employed in Albania, they capture such benefits to a minimal extent.

Local governments in Albania are in a difficult situation. Not diverting infrastructure impact tax revenues to general funds would add more pressure to local budgets that are already under stress. However, by using revenues for general operations, the tax shifts infrastructure costs to all

residents and/or results in little or no public investment being made in infrastructure. Moreover, the infrastructure impact tax is essentially expected to substitute for the inability of local governments to access general obligation debt funds for infrastructure, a role it is not designed to play.

It is reasonable to assume that the level of local service provision would be lower without the infrastructure impact tax. It may also be reasonable to assume that, if local revenues from other sources increased, municipal officials would be willing to dedicate more impact tax revenues to infrastructure.

In essence, the infrastructure impact tax looks better or worse, in terms of efficiency, fairness, or political willingness, depending on the alternatives one considers most probable. The reality is that Albanian municipalities currently have few reasonable fiscal alternatives.

Perhaps, as a compromise between no or full dedication of the tax, municipalities could, annually, earmark a portion of projected infrastructure impact tax revenues for investments in specific, critical public facilities to supplement other capital investments and thus stimulate or sustain growth. Reduced budgetary flexibility in the short-term likely would be compensated by long-term savings that could be reallocated to finance other services.

BOX 1

Infrastructure Impact Fee in South Carolina, USA

Over 1000 local governments in the United States use impact fees (also called taxes, levies, assessments, charges, and so on) to raise funds to finance infrastructure. In some fast-growing counties in Florida and California, impact fees account for a quarter or more of local government revenues.

Generally, in the US, developers install the internal infrastructure needed for a project at their own expense and then transfer ownership of all or most of it to the municipality. Impact fees are designed to cover the external costs of new development, that is, the costs of the increased demand which new development generates for roads, water supply, sanitary sewers, parks and recreation spaces, and other public facilities.

According to US law, states must authorize local governments to impose impact fees, and all revenues from impact fees must be used exclusively for the capital investment purpose used to justify the fee. They cannot be used to contribute to the municipal operating budget. While there is considerable variation in state legislation, all local governments that impose impact fees must:

- Have a comprehensive land use plan and capital budget in place as the basis for impact fees.
- Develop reasonable formulas to assess the fees.

Legislation in the State of South Carolina is fairly typical of laws authorizing impact fees in the US. Local governments in South Carolina may assess impact fees for the construction of new facilities, or the major repair or expansion of existing facilities, for: water supply production and treatment; wastewater collection and treatment; solid waste and recycling collection, treatment, and disposal; roads and bridges; storm water and flood control; public safety and fire protection; street lighting; parks, libraries, and recreation. Local governments may also assess impact fees for capital equipment and vehicles to provide the above public services. School and health facility construction cannot be financed by impact fees in South Carolina.

Municipalities in South Carolina must comply with the following implementation process:

1. **Create a Development Impact Fee Study Report**, which specifies a list of projects eligible for impact fee funding in the municipal capital budget. According to the South Carolina law, the report

(continued)

BOX 1

Infrastructure Impact Fee in South Carolina, USA (*continued*)

must also calculate the amount of the development impact fees, “based on actual improvement costs or reasonable estimates of the costs, supported by sound engineering studies,” in conformance with an approved comprehensive spatial plan. The plan and budget must detail current infrastructure capacity, note assumptions for future land use, provide projections of future infrastructure needs, and define acceptable levels of service delivery.

If the entire municipality does not benefit from the new or improved infrastructure, or if the cost of providing a facility varies in different parts of the city, then the municipality must designate one or more service areas for calculating, collecting, and spending development impact fees.

2. Adopt a municipal ordinance authorizing the fees.

3. Issue an annual report with details of all impact fees collected in the previous year.

Municipalities in South Carolina generally use basic formulas for calculating impact fees for residential and nonresidential uses. The formulas account for different types and sizes of development at different locations:

Residential Development Infrastructure Impact Fee = (NNDU) x (P/HH) x (COST)

NNDU = number of net new dwelling units generated by the proposed development.

P/HH = average person per household estimate published by the US Census Bureau for various dwelling unit categories.

COST = cost per capita of providing a particular municipal facility (i.e., parks, fire protection, roads, etc.) to residential users in a particular location within the municipality, based on calculations in the Development Impact Fee Study Report.

Nonresidential Development Infrastructure Impact Fee = (NNSF)/1000) x (ESR) x (COST)

NNSF = amount of net new floor area generated by the proposed development in square feet. In instances where a variable other than square feet is used in determining the ESR (such as hotel rooms, classroom desks, etc.), then that variable is used instead of square feet, and that variable is not be divided by 1,000 in the formula above.

ESR = Average employee space ratio as approved by the municipal Director of Planning.

COST = cost per capita of providing a particular municipal facility to nonresidential users in a particular location within the municipality, based on calculations in the Development Impact Fee Study Report.

Mixed-use developments pay fees based on the proportion of residential and nonresidential uses.

If a developer does not believe the fee is fair or justified, he or she may request an independent calculation performed by a qualified third-party professional and approved by the municipal Director of Planning.

Infrastructure impact fees must be paid at the time a construction permit is issued. No utility service can be provided or Certificate of Use issued until the fees are paid.

Experience in South Carolina and elsewhere in the US suggests that the largest impact fees are for, in order, roads, water, parks, and sanitary sewers. In South Carolina, a state with a population of 4.8 million, the average impact fee for residential construction is about \$6,000 per residential unit. In 2014, infrastructure impact fees for residential construction alone yielded \$148 million, all of which must be invested in growth-related infrastructure.

3.3 TRANSFER OF DEVELOPMENT RIGHTS

Transfer of Development Rights (TDR) is a land use management technique that transfers development from areas where a local government would like to see less development to areas where it would like to see more development, consistent with a General Local Territorial Plan.

Law No. 107/2014, *On Territorial Planning and Development*, requires all municipalities to adopt General Local Territorial Plans that meet seven goals and 18 principals, including: the protection of natural and historic resources; the provision of adequate infrastructure to encourage investment; the capture of land value increase by the society that creates it; and the promotion of balanced regional development. Article 31 of the TPL allows transfer of development rights to help municipalities achieve these goals.

In addition, Decision of the Council of Ministers 408/2015, *On Adoption of Territorial Development Regulations*, specifies procedures for establishing a transfer of development rights program.

A transfer of development rights program, as specified in the legislation, contains several basic elements:

- ✓ A municipality identifies areas it wants to conserve, known as “sending areas”. These can be properties in which development is prohibited or largely restricted by the GLTP, and are limited to:
 - Agricultural land
 - Natural land
 - Land with above- and below-ground cultural and historic monuments
- ✓ Property owners in sending areas sell the land’s development potential, or development “right”, to developers who wish to increase the development potential of projects in “receiving areas”. Receiving areas are identified by the municipality as being better suited for additional growth. By purchasing the development rights from a sending area, developers can increase the intensity (floor area) of projects in receiving areas.
- ✓ Transfer of development rights can be used in receiving areas only for residential development.
- ✓ In return for compensation from the sale of development rights, a sending area property owner places an easement on his or her property that permanently prohibits further development of the land. The property owner retains ownership of the land.
- ✓ TDR programs are voluntary. Transactions take place between willing buyers and sellers.

3.3.1 Realizing the Benefits of TDR

TDR programs respond to concerns about population growth and the impacts of development. They concentrate development in areas best suited for growth and, at the same time, help reduce the loss of agricultural land, forest land, open space, and cultural and historic sites. By managing growth and development, TDRs can help mitigate many of the public costs of infrastructure, while protecting the environment and enhancing quality of life.

To fully realize these benefits, local governments must carefully define how development rights are assigned, the value of them to sending area parcels, the formulas for their transfer, and the level of administration the municipality will provide. Within the parameters of the law, local governments can customize the elements of a TDR program to reflect their preservation and development objectives, and this ability to adapt and change is crucial to a successful TDR program.

3.3.2 Program Design

The enabling legislation requires a TDR program to be designed in conformance with the General Local Territorial Plan. There must be consistency between the location and regulation of sending and receiving areas and the policies of the GLTP, and the details of the TDR program must be included in the GLTP.

A large body of international research suggests that designing a successful TDR program involves certain actions, all of which are foreseen in Albania's enabling legislation. These actions are presented below as questions for policy makers to consider. Answers to these questions are inter-related, and will help a municipality determine the feasibility of a local TDR program. The actions are not necessarily sequential; many can, and should, occur concurrently, with one reinforcing the other.

1. Define the program's purpose.
2. Conduct public outreach.
3. Evaluate the interaction/compatibility of TDR with other programs and regulations.
4. Perform a market analysis.
5. Establish sending areas.
6. Establish receiving areas.
7. Establish transfer formulas.
8. Budget for administration and monitoring.

Step 1. Define the program's purpose

Right from the beginning, it is very important to carefully consider the purpose or goals a municipality wants a TDR program to achieve. This will shape the overall policy of the TDR program and inform specific decisions about its design.

- What types of land or areas does the municipality want to protect?
- Where does the municipality want to encourage growth?
- What is the desired mix of land uses in the receiving area?
- How will the receiving area change over time as the TDR program is used?
- What infrastructure needs will the receiving area face?
- What quality of life issues are important to the citizens who will be affected by changes in the receiving area? Do receiving area residents understand and support the potential benefits of a TDR program?

Step 2. Conduct public outreach

As a voluntary program, a key to success is a supply of development rights that property owners are willing to sell and that developers are willing to buy. A municipality must speak to those who would be affected by a TDR program and understand what motivates them economically. This includes property owners, developers, real estate professionals, urban planners, residents, and other

stakeholders. Learning the answers to the following general questions not only helps ensure public transparency but also helps municipalities design a program that satisfies the interests of the people it will serve:

- What are property owners' views of development pressures?
- Are property owners concerned about preservation or incompatible land uses?
- Do property owners view their property as an investment they plan to sell?
- What options do property owners have for the current and future use of their land?
- Do property owners support permanent restrictions on the use of their property, such as property easements?
- What are the needs of developers?
- Where do developers see the demand for growth and development in the community?

Focus group meetings with developers, planners, and real estate professionals could further refine the responses to these questions. They could help determine, for example, specific areas of the municipality that provide the most opportunity for the successful implementation of TDRs. Potential sending areas should be analyzed according to such market conditions as land characteristics, land values, and the potential sales market for sending parcels. Potential receiving areas should be analyzed according to, for example, residential development characteristics and residential development values. Based on these discussions, it should be possible to identify the lowest value that a property owner would accept and the highest value a developer would pay for a development right in a particular area. This knowledge would inform the establishment of formulas for transferring development rights.

Step 3. Evaluate the interaction/compatibility of TDR with other programs and regulations

It is very important for municipalities to review other adopted local regulations and programs to ensure consistency with a proposed TDR program.

- How would a TDR program influence existing or proposed programs? For example, if a municipality has another financial instrument for land development that offers a similar incentive to developers, will one program diminish the effectiveness of the other?
- How would existing programs influence the functioning of a future TDR program? For example, will existing building setback/buffer or lot coverage regulations prevent the use of TDR intensity bonuses in a receiving zone?
- Does local political leadership support and promote the TDR program? If developers perceive a faster or less expensive way to obtain additional building intensity for a specific project, it may take strong local political leadership to ensure that TDR is recognized and accepted as a viable business option.

Step 4. Perform a market analysis

Understanding the factors that drive demand in the receiving area and supply in the sending area is one of the most important and complex steps in establishing a successful TDR program. Such an analysis of the factors that drive market value in the local real estate market helps ensure the municipality establishes a program that is fair and encourages all stakeholders to participate. Since no one can be forced to buy or sell development rights, the financial value of the incentives and the cost of participation must balance in order for a TDR program to work. Most developers will

participate only if a project's profit is projected to be the same or better than what it would be without a TDR program. Most property owners will participate only if it is more profitable for them to sell their development rights than develop the land. The municipality must establish a method of allocating development rights that approximates a balance between buyers and sellers. This should be a major objective of a market analysis.

According to Albanian law, the monetary value of transferred development rights is determined by the seller and buyer. Individual property owners, developers, or other parties may freely negotiate prices for the purchase and sale of these rights. However, the municipality specifies how much land should be preserved in the sending area in return for a fixed increase in intensity in the receiving area, and this largely determines the rate and volume of transactions.

According to the law, a municipality must allocate development rights based on a formula. While there is no set value for development rights—nor any single methodology for establishing these values—formulas for transferring those rights must provide enough incentive so that both the buyer and seller are willing to participate in the program. The buyers of rights need to at least recover, but preferably profit, from the purchase of the rights; the sellers of the rights need to believe they have received a fair price for the development rights; and the formula must satisfy the needs of both of these participants.

Albania's enabling legislation allows sending areas to be agricultural lands, natural lands, or historic or cultural lands. Residential developments in receiving areas may receive an increase in Floor Area Ratio, or FAR. For example, if the surface area of a parcel is 1000 square meters and the FAR is 1:1, this means that the building can be no greater than 1000 square meters.

Basic questions regarding market analysis include:

- Does the municipality have accurate information on local real estate markets, such as population change, building permit activity, sales prices, construction costs, property values, annual change in property values? If not, can the municipality obtain this information from local real estate professionals, or should a consultant be retained?
- Has the municipality reached out to developers and real estate investors, as their participation will largely determine the success of the TDR program?
- Can the municipality establish a process for balancing the supply and demand for development rights?

Step 5. Establish sending areas

The process of establishing sending areas is influenced by the information gained from earlier design activities. Having already identified the purpose of the program and learned generally what people support, a municipality can now focus on more specific questions.

- What kind of land does the municipality want to protect? Agricultural land? Forest land? Suburban land? Land from which the municipality's water supply is drawn? Open space? Wild life habitat? Historic lands? Land of other special importance to the municipality? It is important to note that the marketplace will likely reward municipalities whose programs accomplish preservation of these lands. In other words, the value of these lands and adjacent lands are likely to increase once they are preserved.

- How much land should the municipality aim to preserve? In many cases, the amount of land a municipality can protect is connected to the type of land it wants to protect. In all cases, the amount of land a municipality can protect is tied to the capacity of the receiving areas to accommodate additional development.
- How will the municipality designate the sending area? Map? Criteria? Land use typology? The municipality could draw a line around the area it wishes to preserve on map, or establish a set of criteria to determine sending site eligibility, or choose sending areas by land use typologies, or adopt a combination of the three methods. Whatever method is used, the sending areas must be identified on a map in the GLTP with information on each eligible property from the Immovable Property Registry, in accordance with the DCM 408/2015, *On Adoption of Territorial Development Regulations*.

The municipality should determine the total number of development rights in each sending area that is available for transfer to receiving areas.

BOX 2

Allocating Development Rights in Sending Areas

How development rights are assigned in a sending area depends largely on the land's uses, typologies or characteristics, ownership, and current or potential value. Let's look at some of the ways development rights might be allocated in a hypothetical 50-hectare parcel. These are not the only possibilities, but are offered to explain the general concept of assigning rights.

1. Development rights are assigned so that there is one right for every 10 hectares. The 50-hectare sending area thus yields 5 development rights. This format is frequently adopted for agricultural lands and natural lands.
2. Assume the 50-hectare sending area contains 10 parcels of similar but different sizes. One development right is assigned to each parcel. The 50-hectare sending area thus yields 10 development rights. This format is frequently used for land on the edge of a city that is likely to be developed or approved for development soon.
3. Assume the 50-hectare sending area contains several parcels with a total market value of ALL 2 million. For every ALL 100 000 of value, a property owner is assigned one development right. The 50-hectare sending area thus yields 20 development rights. This format is frequently adopted for sending areas with a mix of land uses; for example, some parcels may be vacant, others may contain one building, others multiple buildings, another a small lake.
4. Assume all of the parcels in the 50-hectare sending area have a building on them. Assume that a floor area ratio of 2.0 is allowed on these parcels, but they are only built to a FAR of 1.0. The unused FAR could be transferred to a receiving area. This format is frequently applied to suburban areas or older urban areas where redevelopment at a higher density is likely occur. It is also used to preserve historic properties.

Step 6. Establish receiving areas

The process of establishing receiving areas is also influenced by the information gained in previous program design activities, particularly gauging the support and quality-of-life needs of residents of receiving areas, as well as the input of developers. The receiving areas fund the preservation of sending areas and also reflect the growth goals of the municipality. Receiving areas, like sending areas, must be identified on a map in the GLTP with information on each eligible property, in accordance with DCM 408/2015. Therefore, in addition to having public support, receiving areas must align with the strategic goals, capital facilities plan, and development regulations of the General Local Territorial Plan; specifically:

- What areas are planned for residential growth?
- What areas are not experiencing growth that might benefit from a TDR program?
- What areas might become suitable for growth because of planned infrastructure improvements?
- What areas are most suitable for increases in intensity?
- How will intensity increases impact these areas?
- What are the base and maximum intensities for these areas?

The municipality should determine the total number of development rights required to build to the maximum intensity in each receiving area.

Step 7. Establish transfer formulas

Many TDR programs use a simple one-to-one ratio when outlining how many development rights are available on a parcel of sending area land and how many rights are required for a specified amount of additional receiving area intensity, or floor area ratio. Many others use a differential (one-to-many or many-to-one) ratio. In either case, the formula must establish the criteria for calculating these ratios in individual sending and receiving areas.

In its simplest form, the formula might be: “for every X square meters or hectares a property owner in a sending area receives Y development rights.” The development rights can then be sold and converted to increased building intensity in the receiving area. For example, a property owner might receive one development right for every 1000 square meters of suburban land put under protection or for every 50 hectares of agricultural land preserved. The formula also identifies how much a developer receives for each right in the receiving area. For example, in one area, one development right might allow a developer to increase the floor area ratio of a residential building by 0.1, or by 100 square meters, up to the maximum intensity allowed in the area. In another area, two development rights might be required to receive the same intensity increase. The municipality may issue a TDR Certificate to property owners for each development right they own.

Examples of development rights’ transfer formulas include, but are not limited to:

- For every X ALL a property owner in a sending area receives from the sale of his or her property (for example, ALL 1.000.000), a property owner in a receiving area can increase the amount of building floor area by Y square meters (for example, 250 sqm), but only within the overall maximum floor area restrictions.
- Unused floor area may be transferred at a ratio of X:X. For example, let’s assume the area of a parcel is 500 square meters, and the parcel has a FAR of 0.75. A building on the site could

therefore have a maximum floor area of 375 sqm (500 x 0.75). If there is no building on the parcel, all 375 sqm of unused FAR could be transferred. If a building of 200 sqm occupied the site, the unused FAR of 125 sqm (375-200) could be sold.

- Since the expenses of restoring an historic property often exceed the revenues they could reasonably be expected to produce, the owner of an historic building and the municipality could negotiate the number and value of development rights required to make restoration of the building financially feasible.

Different formulas will likely be necessary for different sending and receiving areas, as land values may vary considerably across a municipality. In all cases, the formula for calculating intensity increases is relative to a base intensity. Developers can exceed the base intensity of an area, but only within the maximum floor area and height restrictions. The GLTP regulations must set fair, firm, and clear base and maximum intensities for all receiving areas.

Development rights from one sending property may be allocated to more than one receiving property, and one receiving property may accept development rights from more than one sending property, up to the maximum intensity specified in the allocation formula. Intensity owners may sell all or part of their available rights at any one time.

The simplest form of TDR program is when an eligible property owner sells development rights directly to a buyer. The two parties negotiate a price and the terms of the sale, which can vary depending on market conditions. The property owner registers an easement on the property from which the development rights have been separated. The buyer can apply the rights toward a development project in a receiving area. While this is the simplest TDR process, it still requires the local government to issue, monitor, and redeem the development rights.

Over time, the value of development rights will be determined by analyzing the market, that is, by comparing the sale prices of development rights. Initially, however, there may be few sales in a new program, and the municipality may have to make sure the transfer formula reflects a balance in values between sending and receiving area properties.

Annex B explains basic but powerful methods of property valuation. Since real estate market conditions change, municipalities must reassess the local market periodically and making appropriate adjustments to the allocation formulas, based on sound property valuations.

Often, local real estate professionals will act as brokers between potential buyers and sellers of development rights, just as they broker other property transactions. This can help insert the program more solidly into the free market, as the knowledge and experience that real estate professionals bring to transactions can establish a process that is fair for buyers, sellers, and the municipality and thus reduces risk for all parties involved. In a free market, real estate brokers or other third parties, such as international donors, may become also become buyers and sellers of development rights. Some third parties may wish to profit on the trade of development rights; others may wish to preserve agricultural lands or protect heritage sites.

Municipalities in other countries have set up “banks”, or clearinghouses, to buy, sell, and hold development rights. Such a bank can be managed by a local or national government or a private entity. Basically, a TDR bank assumes much of the risk arising from a weak market for the rights. In TDR programs, there is rarely a guarantee that property owners in the sending area will be able to sell their development rights. A TDR bank could purchase all of the development rights at their

market value and hold them in the bank until buyers can be found, or the bank could divide the proceeds from any individual sale among all of the property owners who separated their development rights. These are only two examples of how a TDR bank might function. A bank also makes it easier for nonprofit conservation organizations or other donors to buy rights to retire or resell. The municipality or national government would need to dedicate funding for a TDR bank, at least initially; in time, proceeds from the sales of development rights would be reinvested in the bank to finance further purchases, creating a revolving fund.

The Immovable Property Rights Office has confirmed its ability to register TDR transactions.

BOX 3

TDR and the GLTP

In designating sending and receiving areas and assigning development rights, the General Local Territorial Plan is where a municipality should start. A local government should start from a desired outcome and then determine how to make it work.

For example, let's assume, a goal of a GLTP is to preserve family farms. According to the United Nations Food and Agricultural Organization, the typical family farm in Albania is about 2 hectares in size. To help achieve this goal, a municipality could allocate one development right to every two hectares of land in an agricultural sending area and specifically connect the rights to family farms. The municipality could also establish a very low base intensity in a receiving area, thus forcing developers to purchase development rights in order to be able to build a profitable project. By matching the sending area with family farms to the receiving area with a low base density, the municipality would create a market for the development rights, and family farmers would receive additional one-time income.

Step 8. Budget for administration and monitoring

Transfer of Development Rights programs are complex to implement and may be costly administer and monitor. (However, they may be less costly than managing unplanned growth.) A small program with low government involvement may require a fraction of one staff person's time to review and process applications and to maintain a record of the purchase and sale of development rights. Most successful programs require many more municipal resources.

- What level of involvement is the local government willing and able to provide? Administration and monitoring of a TDR program may require municipal staff to:
 - Create and maintain a database of TDR transactions and property easements.
 - Create and maintain a database of interested, potential users.
 - Create and maintain maps and criteria for sending and receiving areas.
 - Create applications and other forms.
 - Issue TDR Certificates to document development rights.
 - Process applications.
 - Make sure building permits are not issued for properties that have sold development rights.
 - Manage development right transfers either by running the TDR bank or by negotiating the transactions with property owners and developers.
 - Establish an enforcement mechanism.

- Monitor the local real estate market for development rights and recommend adjustments to allocation formulas as needed.
 - Establish and collect fees to help recover the costs of administration and monitoring.
 - Ensure that the municipality's capital facilities improvement plan and development regulations continue to support the program as development rights transfers occur.
 - Ensure the program continues to meet the goals of the GLTP.
 - Respond to a wide range of opinions from developers and property owners.
 - Establish guidelines to guide staff in their interactions between property owners and developers.
 - Educate local officials, property owners, developers, and residents about the program.
 - Create and maintain a user-friendly website.
- How will the municipality track and report on TDR program progress, as required by the enabling legislation? During normal administration of the program, certain data will be acquired which the municipality could use to measure the program's progress against its purpose, to modify the program's design to better meet its purpose, and to report to the public. These data include, but are not limited to:
 - Number of transactions completed.
 - Areas, amounts, and values of different land types preserved.
 - Areas, amounts, and values of additional residential space added.
 - Changes in transactions and area preserved compared to previous periods.
 - Development right price changes.
 - Feedback on user experience in transactions.
 - Feedback from residents of receiving areas.
 - Costs of program administration.

BOX 4

Tradable Development Rights in Brazil

Sao Paulo, Brazil helps finance new infrastructure and other municipal improvements through the sale and trade of development rights. The city establishes the base and maximum densities (floor area ratios) for certain areas. Developers must purchase development rights to build in excess of the base density.

In areas authorized for higher density, the city estimates the maximum total new floor space, in square meters, that could be constructed in a year. In another zone, the city calculates the total annual investment needed for new or improved infrastructure. The total amount needed for infrastructure in the targeted zone is then divided by the total authorized new floor area to arrive at a cost per square meter. This is the minimum selling price of the development rights.

A developer wanting to build an additional 1000 square meters of floor area would thus be required to purchase 1000 development rights. The proceeds from the sale go to a special fund that can be used only to finance new or improved public facilities in targeted areas according to a comprehensive municipal spatial plan. In this way, specific projects, such as new metro stops, have been financed, as well as broader initiatives to bring sewers, public water, and new streets to underserved neighborhoods.

(continued)

BOX 4

Tradable Development Rights in Brazil(*continued*)

Sao Paulo maintains a base floor area ratio of 1.0 in areas authorized for higher density. The low FAR ensures a strong market for development rights. The city also auctions development rights, and they often sell for considerably more than the minimum rate.

Sao Paulo is one of the largest cities in the world and has a robust real estate market. Sao Paulo's system of selling and trading development rights has been replicated in other cities in Brazil and Latin America with mixed results. The system generally works best where the base density is kept low, property values are relatively high, and there is strong market pressure for development.

The laws regulating Transfer of Development Rights and other financial instruments in Albania mandate that transactions must be based on market value, that is, on prices determined by willing buyers and willing sellers. In Sao Paulo, the city determines the price of the development rights based on its infrastructure investment needs. This appears to be regulated value, rather than market value. However, the auction of development rights injects market discipline into the process.

3.4 CONDITIONED BUILDING INTENSITY

Conditioned Building Intensity (CBI) allows a developer to build at a greater intensity in certain areas of a municipality under the condition of providing public improvements. For example, the municipality creates a base floor area ratio limit in a given area, such as a street or a zone, and then offers developers additional FAR—a “bonus”—but only in exchange for providing public benefits.

Article 30 of Law No. 107/2014, *On Territorial Planning and Development*, stipulates that building permit applicants, in return for being allowed to build at greater intensity, may provide contributions, which:

- Fund capital investments in public infrastructure and services, including social housing,
- in areas foreseen in the General Local Territorial Plan,
- in agreement with local authorities.

DCM 408/2015, *On Adoption of Territorial Development Regulations*, further stipulates:

- A CBI program is limited to buildings with a residential component.
- Building intensity, including bonus intensity, can never exceed the maximum intensity allowed in an area by the GLTP.
- The value of additional intensity is determined by market value, in conformance with applicable laws and regulations.
- Payment for additional intensity is in the form of public improvements or cash.

All areas of the municipality may be designated in a new or amended General Local Territorial Plan as eligible for a Conditioned Building Intensity program or just certain areas. Different programs—with different mixes of intensity bonuses and public benefits—could be tailored to different zones of the municipality.

Public improvements sought by the municipality in exchange for an increase in building intensity must be defined through the General Local Territorial Plan. They may include, but are not limited to:

- Social housing
- Public squares or open space and related improvements
- Public parks or playgrounds
- Child-care or elder-care facilities
- Utilities
- Street improvements
- Health care and human-service facilities
- New cultural facilities and public art
- Land for public improvements
- Other facilities or benefits to the residents of the municipality
- Any combination of improvements and/or cash in lieu of any improvement(s)

Improvements may be provided on-site or off-site.

In return for the improvement, the local government will grant an increase in floor area to the property owner on a specific site, up to the maximum intensity allowed in the area by the GLTP.

3.4.1 Realizing the Benefits of CBI

Essentially, a Conditioned Building Intensity program is a public/private partnership, in which local governments and developers share investment in desirable public improvements. Little or no public subsidy is required for the improvement. A CBI program could provide an economic stimulus to areas where redevelopment is needed.

Conditioned Building Intensity programs are often perceived by the public as the municipality giving too much to developers and/or not receiving enough in return. Open communications with the public and transparent program regulations are required to realize the benefits of CBI.

3.4.2 Program Design

The enabling legislation requires local planning authorities wishing to establish a Conditioned Building Intensity program to prepare a detailed implementation plan, a study of carrying capacity, and a public transparency program, in accordance with the General Local Territorial Plan.

The following steps can help guide local planning authorities in establishing a CBI program, in accordance with the enabling legislation:

1. Conduct public outreach.
2. Determine the details of the target areas.
3. Determine public benefits.
4. Evaluate the interaction/compatibility of CBI with other programs and regulations.
5. Determine market value and developers' payments.
6. Budget for administration and monitoring.

Step 1. Conduct public outreach

It is critically important—for public transparency and to establish an effective program—for local governments to get ideas from the people who will be directly affected by a CBI program, particularly developers and residents of areas where the intensity bonuses would be applied.

- What types of public improvements do residents view as desirable in a target area?
- What types of improvements do developers view as feasible in a target area?
- Where should the target areas be located?

Step 2. Determine the details of the target areas

Using information gathered during public outreach, begin to establish the details for:

- Where in the municipality higher intensity residential development should be encouraged.
- The base intensity, the intensity increases, and the maximum intensity that will be allowed in each targeted area.
- The public benefits to be provided by the developer in each area in exchange for the intensity increases.

Answers to the following questions will help a municipality refine these details:

- Is there enough demand for increased intensity in areas programmed for intensity increases? If a municipality is not certain, then perhaps it would be a good idea to conduct a market analysis to find out if there is enough demand.
- What is the highest intensity a municipality could have in a targeted area and still be able to service the area with current infrastructure? How much impact will this intensity have on the surrounding area? Before implementing a Conditioned Building Intensity program, a study of the carrying capacity of each target area is required by law. The study should analyze the maximum possible intensity in the targeted area, that is, the intensity the targeted area would have if all developable properties received intensity bonuses, and the impact of the additional intensity on public services.

Based on carrying capacity and other information, the municipality must establish a base intensity, as well as a maximum intensity for each target area, which the intensity bonus must not exceed.

According to the enabling legislation, the bonus FAR of a residential project cannot exceed the amount of the base FAR of the area, and the building height cannot exceed twice the base height. A Conditioned Building Intensity program cannot waive or make less restrictive other development standards.

It's important to note that the extent to which an intensity bonus is truly a "bonus" depends on the demand for intensity increases and the base and maximum densities allowed in the municipal development regulations. For the intensity bonus to be truly a "bonus", the base intensity should be sufficiently low, but not so low that the integrity and honesty of the development regulations are called into question. Likewise, intensity bonuses should be large enough to attract new residential development but not so large that new densities cannot be served by municipal infrastructure and services.

Step 3. Determine public benefits

Again, it's important to listen to residents, businesses, and other stakeholders when choosing potential improvements, as well as utilize the data from market and infrastructure carrying capacity studies.

- What kinds of public improvements are needed in each targeted area? Does an area lack parks or social housing? Do residents complain about the condition of sidewalks or streets? Will increased intensity require new school classroom construction?
- What kinds of public improvements might incentivize development or raise property values in areas where more development is needed or where property values are low? Areas with low or moderate pressure on land use and where land is less highly valued may be prime target areas for a Conditioned Building Intensity program.

If the municipal planning authority determines that a suitable public improvement is not immediately feasible, or otherwise not practical, it should require, instead, a payment to the municipality of a cash sum.

Because the funds gained from a CBI program might be relatively small in some areas, these funds should not be spread over a wide variety of public improvements, but should be focused on achieving a smaller, definable list of benefits. In addition, a narrower list of options will increase predictability of the development process.

Step 4. Evaluate the interaction/compatibility of CBI with other programs and regulations

All local land use and development regulations or programs should be evaluated and adjusted as necessary to work with the CBI program. Regulations or programs working at cross purposes will not be effective in capturing land value as desired.

- Does a CBI program compete or conflict with other development incentive programs in the municipality? For example, CBI offers developers the same incentive (increased residential intensity) as Transfer of Development Rights in Albania. How might the two programs be distinguished? Similarly, with careful planning, a CBI program might be used in coordination with Tax Increment Financing to, for example, regenerate an historic structure or an area in need of additional development; however, without adequate foresight, a CBI program might end up competing with TIF.
- Do other building regulations, such as setbacks or lot coverage, inhibit increased intensity in targeted areas? A CBI program can authorize increases in intensity, but cannot waive development standards in targeted areas.

Step 5. Determine market value and developers' payments

According to the enabling legislation, the value of the additional intensity is based on the market value of properties in the area where the construction will take place. Albanian law appears to provide at least two methods for determining market value: the methodology used for property compensation and restitution, and values for property transactions published annually by the National Housing Agency.

According to international property valuation (appraisal) standards, real estate market values are typically determined by comparing recent property sales prices, estimating market potential (the value before and after improvements), or, more commonly for larger projects, examining a project's income capitalization. Developers should be required to provide the municipality a *pro forma* or comparable financial analysis which details the developer's estimate of a project's financial returns.

Local governments must have enough information to make informed decisions, including detailed data on construction expenses and revenues. Program applicants should be required to provide such information when they are requesting public incentives and bonuses.

Such information typically is shared with confidentiality agreements. For larger projects, the municipality may wish to hire a consultant to help analyze the content and accuracy of the developer's project financial information.

Annex B explains several basic and standard property valuation methods.

According to DCM 408/2015, the amount of cash, land, or in-kind payment a developer must make is determined by:

- Open competition organized by the municipality, or
- Auction organized by the municipality, or
- Direct negotiation between the developer and municipality.

According to the law, developers must compete to participate in the program. In a free market, competition is the best means of ensuring a better choice of public improvements, lower prices, and higher quality for residents, as well as a fair and level playing field for developers.

Regardless of how the payments (cash, land, in-kind) are decided (competition, auction, negotiation), international best practices suggest the decision to approve the payment should be made by the competent municipal authority, based on:

- The cash value of the public improvement.
- The adequacy with which the additional intensity fits the site and how it relates to adjacent uses and structures.
- A detailed explanation of how the public improvement helps implement the physical, social, or cultural policies of the general local territorial plan.

Additionally:

- Payments should be received before building permits are issued.
- Time limits and performance standards should be placed in the construction contract for public improvements, with provisions to recover costs if developers who received intensity bonuses do not meet their obligations.
- The payment approval process must be transparent.

Step 6. Budget for administration and monitoring

A Conditioned Building Intensity program requires well-documented development standards and inspection and compliance standards to ensure the quality of the public improvements provided.

It also requires good record keeping by municipal finance, planning, and procurement personnel.

There is a danger with CBI programs that the bonus approval process becomes viewed by the public as a matter of site-specific negotiations, in which the developer arranges with the local government to buy its way out of development control regulations. Programs should include performance monitoring elements that document and verify its effects. These elements should be reported to the public periodically. They should include, but not be limited to:

- Areas, amounts, and values of additional residential space added as a result of intensity bonuses.
- Location, character, and value of public services provided by developers in return for intensity bonuses.
- Annual changes in land values in targeted areas.
- Feedback from residents of targeted areas.
- Costs of program administration.

Based on the results of the program performance monitoring, adjustments to the program should be made to reflect changing needs and priorities, in consultation with the public.

BOX 5

Auctions and Conditioned Building Intensity

The value of the public amenity a developer must provide in order to build at a higher density through a Conditioned Building Intensity program is determined by either: (1) direct negotiation between the developer and municipality; (2) an open competition organized by the municipality; or (3) an auction organized by the municipality.

Studies overwhelmingly conclude that open competitions yield higher prices than negotiations, and auctions yield higher prices than competitions. For example, a World Bank study found that auctions increased proceeds from land sales in Egypt more than tenfold over previous administrative sales of similar land. Studies of auctions of development rights in Brazil, suggest they result in markedly higher prices in municipalities with a robust real estate and city administrators with the requisite expertise.

Moreover, auctions do not require the municipality to calculate in detail the value of a public amenity. The theory behind fair and open auctions is that the developer will factor the maximum price of the required amenity into his or her final bid.

For Albanian municipalities, the financial amounts at stake in property-related auctions are potentially very significant; consequently, the difference between an efficient auction and an ad hoc auction, or no auction at all, is also significant.

It is beyond the scope of this paper to study and report on the efficient use of auctions. But it is clear that municipalities in Albania would benefit from best-practice guidelines for planning and conducting public auctions.

3.5 TAX INCREMENT FINANCING

Tax Increment Financing (TIF) is designed for value-based property tax systems. It allows local governments to use future property tax revenues to pay for public improvements in a targeted area, like improved roads or new water lines, or to attract needed development. Within the area of the municipality served by a TIF, the value of the property prior to public infrastructure investment is established as the “base” amount. Each year, as long as the TIF exists, the municipality calculates the “current” value of properties within the area served by the TIF. The difference between the base value and the current value is the incremental property value. Property taxes paid each year on the base amount continue to go to the municipality’s general operating fund. The additional property tax revenues generated above the base tax revenues by the rise in property values—the tax “increment”—are placed into a special fund to be used by the municipality to finance the improvements it made in the TIF area. The assumption is that the public improvements made by the municipality in the area and related private investment will cause property values to rise.

To illustrate how TIF works, let’s assume a municipality wants to redevelop an area that is currently a mix of small buildings and vacant parcels. Let’s also assume that the value of the property in the area is ALL 200 million. The municipality determines that by making an immediate investment of ALL 10 million in new sewers, private developers will make significant investments in new development, resulting in a rise in total property values in the area from ALL 200 million to 500 million over ten years:

Base value 2015:	ALL 200 million
Current value 2025:	ALL 500 million
Value increment:	ALL 300 million

If the municipality taxes at a rate of one percent of property value, corresponding property tax receipts would be:

Base property taxes 2015:	ALL 2.000.000 (200 million x 0,01)
Current property taxes 2025:	ALL 5.000.000 (500 million x 0,01)
Property tax increment	ALL 3.000.000 (300 million x 0,01)

The property tax increment is estimated to increase each year for ten years until it reaches ALL 3.000.000. The municipality uses the annual increment to finance its original investment. After the initial investment is paid off, the increment could be dedicated to additional improvements in the area, resulting, hopefully, in even more property value growth in the area, or the increment could go into the municipal general funds for the benefit of the entire municipality. All property taxes are collected annually, or as specified by the municipality. Current property values are re-calculated each year for the life of the TIF to capture the annual change in property values.

Tax increment financing could similarly be applied to a single site, such as a vacant industrial building, to stimulate redevelopment.

The type of projects that could most benefit from a TIF program include, but are not limited to:

- Redevelopment of substandard or vacant buildings
- Financing public infrastructure improvements, such as streets, sewers, and water, especially in areas needing regeneration
- Cleaning up polluted areas

- Providing infrastructure needed to develop a site for new industrial use
- Rehabilitating historic properties

3.5.1 Realizing the Benefits of TIF

Tax increment financing offers a way to dedicate a specific revenue source to stimulate development without using a municipality's general operating funds or raising property taxes. TIF programs are administered at the local level and can be combined with other financial instruments for land development.

Receiving the full benefits of tax increment financing requires a value-based property tax system which is regulated and administered locally, effective and transparent public financial management procedures, and an efficient and accurate process of land valuation.

3.5.2 Program Design

The following best practice guidelines can help authorities establish an effective TIF program:

1. Conduct a preliminary feasibility analysis.
2. Create a redevelopment plan.
3. Adopt.
4. Implement.
5. Evaluate and terminate.

Step 1. Conduct a preliminary feasibility analysis

A feasibility analysis is a preliminary assessment of the need for, and potential economic benefits of, a TIF program. It serves as a basis for the more formal, detailed, and costly planning required for a redevelopment plan. It's based on the experience and professional judgment of local government officials, developers, local residents, and others. Below are a few questions a group of stakeholders might ask to determine whether or not to proceed with a TIF program:

- Are the improvements proposed by the municipality essential for property values to rise more than typical market-driven growth?
- Is the private developer's financial capacity strong and likely to remain strong so it can complete its proposed projects?
- Are the proposed public and private improvements consistent with the municipality's General Local Territorial Plan?
- Is TIF the municipality's only or best financial instrument for improving the area? Do the benefits of TIF outweigh the risks?

Step 2. Create a redevelopment plan

If the preliminary assessment suggests a TIF program will be feasible for an area, the next step is to create a redevelopment plan. A TIF program is unlikely to be financially successful without a formal and detailed plan describing the actions the municipality will take to improve the area and a budget and implementation schedule for the area. This planning is important since the municipality

incurs substantial risk when it spends its own funds to establish the TIF and when it secures debt to finance public improvements.

A redevelopment plan should include:

- A. A description of the boundaries of the area recommended for redevelopment. There is no ideal size for a TIF area. Generally, however, a broad geographic area increases the likelihood that the area targeted for redevelopment will experience economic growth, allows the municipality to capture more incremental revenues compared to a smaller TIF area, and, if debt financing is used, may result in a reduction in perceived credit risk and a corresponding increase in the bond rating and lower interest rates for repayment.

A single site, rather than a larger area, is often owned by the municipality and transferred to the developer at its market value in accordance with the redevelopment plan.

- B. A narrative of why the area needs redevelopment and how the redevelopment conforms with the General Local Territorial Plan. This should include the municipality's redevelopment goals and objectives for the area, how these goals and objectives support the policies of the General Local Territorial Plan, and an explanation of why economic growth likely will not occur in the area without a TIF program.

- C. A budget for the life of the TIF. The budget, at minimum, must establish the base assessed property value and base property tax revenue, project incremental assessed value and incremental revenue, and determine a way to pay for public improvements. The budget should present results in a year by year projection of the municipality's total costs and revenues for all projects in the TIF area.

To estimate overall annual revenues, the municipality needs to perform an analysis of individual parcels in the TIF area and their respective contribution to revenue growth. In addition to determining the revenue impact of individual TIF parcels, the municipality must determine project "timing", that is, it must estimate how quickly construction will occur. It must also estimate market "absorption", or how quickly new space will be sold or leased, as well as the "lag" time from when properties reach the market to when they are assessed and taxes collected. In this way, the tax increment can be calculated.

Projections of the municipality's costs and revenues will be highly informed by pro formas supplied by developers. A pro forma is a developer document that shows his or her expectations of a project's financial performance. When the TIF has only one developer and only one project, the pro forma can be inserted directly into the TIF budget. When there are multiple developers with multiple pro formas, the municipality must combine the data into one document. Developers expecting to participate in a TIF program should be required to share the information in the pro forma with the municipality. Although the developer prepares the pro forma, municipal officials should not assume that the financial information the developer submits is completely impartial. Municipal officials must perform their own due diligence on the developer's figures, comparing them to known construction costs, rental and sales data, vacancy rates, and other local real estate market benchmarks.

The budget must also specify how public improvements will be financed. There are two common options, "pay-as-you-go" financing and "pay-as-you-use" financing.

Pay-as-you-go financing involves setting aside tax increment revenue until enough has accumulated to pay for a public improvement. Pay-as-you-go financing avoids the costs and risks associated with debt financing, but it can be a slow process, and may make it difficult to provide the major, upfront, public investments often needed to stimulate the private development that makes a TIF program successful.

Pay-as-you-use financing typically involves the municipality issuing bonds to finance public improvements and using the incremental tax revenues to pay the interest on the debt. While the municipality incurs long-term debt obligations, this option allows the municipality to undertake the costly public improvement projects that often are needed early in the TIF program. Alternately—to reduce the municipality’s financial risk—the developer could purchase all or most of the bonds issued by the municipality. Or the developer could finance the public improvements, and the municipality could then reimburse the developer as it obtains incremental tax revenues.

The budget must also specify what TIF funds may be used for. Expenses, such as property expropriation, professional services (architectural, engineering, legal, financial planning, etc), demolition, and the administration of a TIF program can be significant, and it must be clear which costs are eligible.

- D. A timetable for redevelopment of the area. A timetable for redevelopment—essentially the lifespan of the TIF program—can be determined by the anticipated pace of development, or it can be set by the term of the bonds issued to support the TIF projects, usually ten or twenty years.
- E. A description of the process to amend the plan. If market conditions change, it may be necessary to amend the redevelopment plan, including boundaries and financial projections. The process for amending the plan should be clear.

Step 3. Adopt

Formally adopting the redevelopment plan and establishing a TIF area typically requires the municipality to formally enter into legally-binding public-private sector agreements which specify the obligations of the two parties, as well as conduct public hearings so that residents and other interested parties can express their thoughts on the proposed TIF program. In most countries, since property tax administration is a local responsibility, the establishment of the TIF is a municipal function, and no national government approval is required.

Step 4. Implement

Implementation generally begins with the start of public improvements and private sector construction. Project financing also takes place at this point: establishment of the tax base and tax rates, issuance of any debt, and generation of the tax increment necessary to retire debt.

A TIF implementation team should be established to manage the TIF program. The team should include the municipality’s senior staff or their delegates. The team should be charged with overseeing and administering the TIF area, monitoring daily TIF performance, and ensuring compliance with municipality-developer(s) agreements. The team may rely on external advisors to establish, monitor, and report on TIF performance.

Step 5. Evaluate and terminate

The TIF process requires careful monitoring by the municipality. Annual performance reports, available to the public, should compare the actual performance of the redevelopment plan with projected performance, including, but not limited to, actual versus projected public and private development and actual versus projected tax revenue changes.

Ultimately, the municipality will terminate the district at the end of its legal lifespan and evaluate its performance. At this point, the total revenues (base and incremental) would be available to the municipality's general fund. A TIF may be terminated early if a deficit occurs because projected annual tax revenues are lower than expected and expenditures are not met. Usually, a deficit must occur for at least two consecutive years before a TIF can be terminated.

BOX 6

Tax Increment Financing for Small Municipalities

Tax increment financing is the most widely used local government program for financing economic development in the United States, but it is rarely used elsewhere in the world, presumably because of the financial risks involved. TIF programs support public infrastructure, land acquisition, demolition, site preparation, and other programs that reduce a developer's upfront capital costs, but bring in no new revenues and require careful planning to ensure that the tax increment covers program costs. However, TIF does give local governments considerable power to create a distinctive urban development vision and to attract the developers necessary to bring that vision to life, and these aspects make it the compelling "entrepreneurial" approach to governance that is popular in the US.

In the US, for example, TIF has been used to create a theater district in the center of Chicago; internationally-recognized venues for amateur sports in suburban Indianapolis; a tourist resort in rural Colorado; the headquarters for Sears, Roebuck Co. in Illinois; major league sports facilities in Florida; the International Spy Museum in Washington, DC; as well as thousands of commercial and residential projects.

The city of Fort Kent, Maine (population 4,000) is a model for the use of tax increment financing by small municipalities.

According to Maine law, a business may approach a municipality with a proposal for investment for which a TIF area or district would provide financing. In 2006, a developer in Fort Kent asked the municipality for assistance in building a private elder care facility on a vacant private parcel that was not served by water and sewer. In response, the municipality created a TIF district that encompassed the parcel to be developed and public access routes to the nearest water and sewer mains. The developer purchased the land at a reduced rate since it was not served by sewer and water. The municipality paid to extend water and sewer lines to the parcel with a municipal bond and loan. Revenues generated from the TIF value capture were used to pay the interest and principle on the bond and loan:

• Developer's cost to purchase vacant, unserviced parcel	\$17,000
• Current market value of land and new elder care facility	\$3,032,000
• Tax increment (value capture)	\$3,015,000
• Municipal bond and loan for sewer and water extension	\$330,000
• Annual TIF tax revenues applied to bond and loan	\$52,000

The elder care facility created 65 new jobs. It also opened a new area for residential and commercial development along the new sewer and water lines, and sixteen new private homes were built (\$3+ million valuation).

3.6 BUSINESS IMPROVEMENT DISTRICTS

A Business Improvement District (BID) is a public/private partnership by which property and business owners elect to contribute financially to the development, maintenance, and promotion of their commercial district.

Business Improvement Districts deliver a range of private services, in coordination with municipal public services, and invest in the long-term economic prosperity of their districts. The services provided by the BID are supplemental to the services provided to the district by the municipality. For example, if a BID provides street cleaning, it will still receive the same level of street cleaning from the municipality as it did before the supplemental services were added.

Supplemental services and investments may include, but are not limited to:

- Capital improvements, such as improved streetlights, trash receptacles, decorative street signs, and wider sidewalks, as well as planting trees and flowers and developing parking areas.
- Maintenance, such as street cleaning, sidewalk cleaning, and graffiti removal.
- Marketing, such as sponsoring festivals, installing holiday decorations, developing promotional materials, and providing tourist assistance.
- Land use planning in cooperation with the municipality for long-term public and private capital investment in the district to, for example, preserve and leverage unique assets, accommodate more visitors, and improve the commercial mix.

Property and business owners take the initiative of forming a BID for their commercial district. Funds to pay for BID services and investments are determined and raised through a special assessment paid by the property or business owners. The assessment is typically independent of the property tax. In many instances, however, the assessment is often billed and collected in a dedicated account by the municipality at the same time as annual property taxes are billed and collected. The funds are then disbursed to the BID, which in turn delivers the district's services. In other cases, the BID bills and collects the funds directly. The amount paid by each property owner is determined by a formula that each BID creates for its district during the formation process. Formulas are based on property size, building frontage, or property value.

BIDs may also raise revenues through grants or donations. However, these funds tend to be single occurrences and unpredictable, and should not replace an annual assessment. Annual assessments provide a sustainable financial foundation for BID activities.

Less common—but also effective—a municipality increases the property tax rate on properties in the BID district and make the increased tax revenues available to the BID.

Each BID is governed by a Board of Directors that is elected by the members of the district, and may include property owners, tenants, public officials, and residents. The Board has a fiduciary responsibility to the BID and hires an administrator to manage the BID on a day-to-day basis.

3.6.1 Realizing the Benefits of BIDs

Several visible and meaningful results can be achieved when commercial stakeholders work together to provide supplemental services with steady and reliable funding: the ability to respond

quickly to the changing needs of the business community; the potential to increase retail sales and property values; and, ultimately, a more attractive and better functioning business district.

It is important to note that, to fully realize these benefits, BIDs require a majority of businesses with successful business models (adequate cash flow, established business identity, goals and strategy for future business sustainability) and capital to invest in a special assessment to finance meaningful improvements.

3.6.2 Program Design

Although there is no national enabling legislation for Business Improvement Districts in Albania, BIDs operate in Korca, Shkodra, Berat, and Kruja, and others are contemplated in Tirana, Durres, Elbasan, and Vlora. An evaluation of the performance of the existing BIDs, conducted by the Albanian American Development Foundation and two consultants, is underway. A preliminary report issued in January 2015 finds impressive results and makes recommendations for BID enabling legislation.

The following activities take into consideration the recommendations of the preliminary report, as well as international best practices, for successfully designing enabling legislation and creating Business Improvement Districts:

1. Conduct a preliminary feasibility analysis.
2. Form an organizing committee.
3. Draft a BID business plan.
4. Implement.

Step 1. Conduct a preliminary feasibility analysis

A preliminary feasibility analysis results in a decision of whether or not to proceed with the creation of detailed business plan for a BID. A small group of property owners, business owners, and municipal officials discuss such questions as:

- Can a BID be economically sustainable?

A BID that is sustainable generates most of its revenues from special assessments levied on the properties. If an area has many vacant store fronts or the owners can't afford even a modest assessment, then perhaps stakeholders should press the municipality to use capital investments and other financial instruments to economically strengthen the area before considering a BID.

- Do municipal officials support a BID?

Official municipal support is crucial because many of the services provided by the BID are likely to take place on public spaces.

- What are the immediate concerns that a BID could reasonably address? More parking? Better public places? Attracting tourists? Marketing the area?
- What are the municipality's long-term plans for the area, and how could a BID influence them?

For example, some municipalities have advanced public improvements that otherwise would not have been made because BIDs agreed to maintain them with BID funds at a high standard.

Step 2. Form an organizing committee

A group of 10-20 respected individuals who represent all the interests of the area, mostly property owners, but also business owners, municipal officials, residents, and representatives of local community organizations, should assume responsibility for progressing the idea of a BID and, ultimately, drafting a BID business plan. Responsibilities of the organizing committee include:

- A. Select a chairperson. The chairperson should be someone with extensive knowledge of the area, a deep personal and professional stake in the future of the area, an openness to change, and an ability to build consensus within the organizing committee.
- B. Formulate a vision for the district. What kind of place do members of the organizing committee want the area to be? How do they want the area to look and feel? What is the area's greatest potential?
- C. Identify organizational costs. Forming a bid requires time and money to organize and educate stakeholders and write a business plan. Typical funding sources for BID organization include: financial and in-kind contributions from members of the organizing committee and other individuals and organizations in the area to be served by the BID, grants from the municipality or other levels of government, and grants and other assistance from nonprofits.
- D. Determine general boundaries. It's important to have a general idea of the district's boundaries, because this will help identify the properties included, which will help project assessment revenues. The boundaries may change as planning progresses. The boundaries should support the vision for the area. For example, if the vision is to be a destination for tourists, then perhaps a hospital should not be included in the district. On the other hand, if the district focuses on technology or health care, then a hospital could be essential. In projecting the boundaries, there should be few or no gaps between the properties that are included in the district so that services may be provided evenly. For example, if some properties on a street are not included in a BID, it will be impossible to provide street cleaning services on the street without those properties benefitting from services for which they don't contribute.
- E. Create a database of property owners and tenants. Collect information on individual properties, as well as contact information for owners and tenants, from the Immoveable Property Register, site visits, and other sources.
- F. Survey property owners and business tenants to find out their needs. What is their impression of conditions in the area? What problems exist in the area? What services are needed? Property owners and tenants must be asked these questions.
- G. Hold public meetings. After the business plan is drafted, one or more public meetings should be held to inform the public about the BID, hear their ideas, and gain their support and contributions toward the BID formation process.

Step 3. Draft the BID business plan

A business plan is based on the previous work of the organizing committee and should contain:

- A. A description and map of the boundaries of the district. These should identify the individual parcels within the district.
- B. The proposed services and improvements and their maximum cost. The services and improvements provided by the BID should be determined based on the needs survey conducted by the organizing committee. The level of service delivery will likely be decided by its cost. For example, if the BID chooses to provide sidewalk maintenance services, it will have to determine how many workers to hire directly and how many hours a week they will work, or it will have to get cost estimates from companies willing to provide the services to the BID.
- C. First year budget for improvements, maintenance, and operation. The services and improvements that the BID will provide and their costs will be the basis for developing a budget for the first year. Program costs in the budget, beyond the costs of the services, should include staff salaries, office rent, office supplies, and other general and administrative expenses.
- D. Formula and method of assessment. The assessment formula determines the amount a property owner must pay each year. The total assessment must cover the budgeted costs. Assessments are typically based on the length of the property fronting a public street or based on gross building floor area. The frontage method is usually applied when most of the benefits of BID services will be enjoyed by ground-level retail or restaurant. The gross floor area method is usually applied for districts with significant above-ground commercial activity.
- E. The proposed time for implementation and completion of the district plan. Generally, a BID operates for a fixed term, such as five years, after which property owners and tenants must vote to continue the BID.
- F. Any proposed rules and regulations to be applicable to the district. Generally, BID enabling legislation specifies that all of the rules a BID develops apply to all of the property owners. This is especially important regarding assessments; that is, all property owners in the district must pay the annual assessment whether or not they support the BID. Other rules applicable to all property owners might include, for example, standards for exterior property maintenance or the requirement that all property owners must display in ground floor windows a “brand” or marketing logo for the district that the BID management develops. The regulations should describe a process in which a member who is unhappy with the performance of a BID can appeal it decisions. Regulations should also include a process to expand the BID or amend the business plan, including revisions to the annual assessment.
- G. A description of the district’s procedures regarding a Board of Directors. A mechanism should be described for allowing property owners and tenants in the district to vote for a Board of Directors. The general responsibilities of the Board should also be described. The Board will manage the BID, including hiring an administrator. The Board is ultimately responsible for the BID’s actions and performance.

Step 4. Implement

Implementation typically involves:

- A. Electing a Board of Directors. The Board should include a representative mix of property owners and tenants in the district, municipal elected officials, and representatives of community organizations who are elected in a vote of property and business owners in the district. Most of the Board members should be property owners.
- B. Entering into an agreement with the municipality. Since much of the BID's work will likely involve improvements to public spaces, or close planning and coordination of activities with municipal staff, or maintenance and development agreements with the municipality, it is often advisable—indeed, legally required—for a BID to enter into a legally-binding formal agreement or a memorandum of understanding with the municipality.
- C. Hiring an administrator. The Board will hire an administrator responsible for the BID's daily operations.

BOX 7

BIDs in Albania

In 2011, the nonprofit Albanian American Development Foundation partnered with local governments in Korca and Shkodra to make infrastructure improvements in central districts of the municipalities. The AADF provided 60% of the infrastructure investment, and the municipality, 40%. The municipalities and districts were chosen by the AADF for their tourism potential, and the improvements were designed to attract visitors and business customers.

The AADF, municipalities, and businesses in the target areas then created business improvement districts to maintain and leverage the improvements. A similar process was used to create business improvement districts in Berat (2013) and Kruja (2014).

Characteristics of these four BIDs in Albania include:

Connection to local government. The BIDs are established through a memorandum of understanding between the local government and the AADF.

Funding and revenues. Most BID revenues come from the existing business tariff, which the municipality transfers to the BID with the understanding that the BID will generate other income. Businesses may pay voluntary dues (ALL 500/month, or less). BIDs also seek sponsorships and grants. Annual revenues for a BID generally total ALL 1.8 to 2.4 million.

Formation, governance, administration. The BIDs are formed by agreement of a majority of businesses in a target area. Businesses democratically elect a Board of Trustees, which is empowered to oversee operations, including finances, procurement, and development of a strategic plan for the district. A Board has 5-7 members, including one member from the municipality (usually a vice-mayor) and a representative of the AADF. The Board hires an administrator to manage the BID's daily operations.

Size. The sizes of the BID memberships are: Korca, 58; Shkodra, 65; Berat, 65; Kruja, 52. Expansion of the BIDs is being actively pursued.

(continued)

BOX 7

BIDs in Albania (*continued*)

Programming. Services provided by the BIDs, either directly or in partnership, include:

- Security patrols
- Special events/community building
- Economic development
- Commercial sector development
- Marketing and promotion
- Tourism promotion
- Capital improvements
- Business retention and expansion
- Creating public spaces

Capacity building. The AADF offers business advisory services and small grants to members of a BID to increase sales, build stronger brands identities, and create sustainable business plans. These services are also available to other businesses in the municipality to leverage the potential of the BID.

Performance. According to the Albanian American Development Foundation:

- *Investment.* The AADF has made a total investment of approximately \$10 million in the existing BIDs in Albania and in planning for a future BID in Tirana. The Government of Albania has invested approximately \$20 million in the districts. Documented private investment is about \$10 million, primarily business owners upgrading their own businesses. The amount of private investment is expected to double in the next few years.
- *Marketing.* The Korca and Shkodra BIDs are each responsible for over 20 community events annually. For the most part, these are events that did not exist before the BIDs were created.
- *Jobs.* The Shkodra BID has created 120 new permanent jobs, and the Korca BID has created 50 new permanent jobs. The AADF is providing incentives to businesses in Kruja to make the souvenirs they sell, rather than import them, with an expected increase in jobs.

Challenge. A Business Improvement District is a new concept in Albania, and getting political and business support can be daunting. The lack of a formal, legal process in Albania for organizations to follow to become a business improvement district makes initial BID formation difficult and, once formed, leaves BIDs politically and financially vulnerable.

3.7 BETTERMENT FEES

Betterment fees are charges a local government levies and collects because its investments in roads, water lines, or other facilities have rendered affected private lands “better” for development. Betterment fees, like infrastructure impact taxes, are one-time charges related to the impact of public infrastructure. They may be collected before or after investments are made, or during the development process. Unlike infrastructure impact taxes, which aim to recover some of the costs that new development imposes on public infrastructure, betterment fees are tied directly to a developer’s or property owner’s gain in land value.

In India, for example, betterment fee regulations are established by the national government, but are instituted by local governments at their discretion. In a municipality that has chosen to charge the fee, the market values of properties in an area targeted for development (the designated betterment area) are determined. A local detailed plan for the area is prepared. When the plan is finalized, the properties in the area are automatically approved for development. The property owner pays a

betterment fee to the municipality when the property is sold to a developer at a new, and higher, market price. The betterment fee is assessed at up to 50 percent of the increase in the property's market value. Infrastructure is then provided by the municipality utilizing these funds.

Many, if not most, of the countries in the world have implemented variations of betterment fees, with mixed results. Denmark ended a 50% betterment fee program in 2006 in the face of public opposition. Britain for many years imposed a betterment fee of 40% of the land-value gain attributable to public investment; this program, too, was repealed in response to public resistance. A successor program that attempted to differentiate fees according to "greenfield" and "brownfield" lands also succumbed to negative public opinion. In both Britain and Denmark, the fees were assessed on the sale of any property converted to urban land. In contrast, Spain and Latin America have a long history of successful betterment fee programs.

3.7.1 Realizing the Benefits of Betterment Fees

There is a logic in capturing betterment that is generally understandable to taxpayers, property owners, and developers. For municipalities and taxpayers, betterment fees bridge the economic gap between the need to build or expand public infrastructure to accommodate new development and the funds available to do so. Moreover, the increase in land value resulting from development accrues to the original property owner whenever the land is sold and developed for higher intensity use.

To realize these benefits, the rules for allocating betterment fees must be clear and certain; that is, the land value gains must be readily quantifiable, and the fees must not appear excessive. They should be well-justified and affordable. Otherwise, betterment fees tend to be rejected by the courts as arbitrary and unfair applied and by the public as merely a new tax.

In the United States, these objections are often overcome by utilizing a form of betterment fee called a Special Assessment District. These are programs in which property owners and municipalities agree on the costs of a small-scale project and on the rules for assessing fees before a project begins. Special Assessment Districts are described in the next section.

3.7.2 Program Design

There are many different designs of betterment programs. Some require a local development plan; others are triggered by the conversion of any rural land to urban land. Some have a set fee; others a fee that is negotiated between municipalities and developers.

All successful program designs meet the following conditions. It is important to note that the weight given to each condition varies according to the legal system and traditions of the country in which it is applied.

1. Define the benefits (betterments) conferred by a local, regional, or national government.
2. Identify one or more private-sector beneficiaries.
3. Accurately quantify the benefits.
4. Utilize a transparent and public mechanism to implement the betterment fee.
5. Implement and support the program with strong political leadership.

Step 1. Define the benefits (betterments) conferred by local or national government investment

Construction or improvements that increase, or potentially increase, the value of land should be defined.

- Can a distinction be made between the general, non-specific provision of public infrastructure and what is site-specific?
- Will facilities constructed by all levels of government be included, or only facilities constructed with local taxes?
- What kinds of public improvements will be included? Only roads, sewers, and water lines? More specialized improvements such as publicly-constructed irrigation systems that increase the productivity of agricultural lands? Telecommunications facilities?
- Will public capital expenditures be depreciated? Will only public works that occurred before or after a certain date be included?

Step 2. Identify one or more private-sector beneficiaries

The beneficiaries—the property owners—who benefit from the infrastructure and thus pay the betterment fee, should be clearly identified.

- What criteria will be used to define a betterment zone?
- Can the land value increases be quantified with precision, parcel by parcel?
- Do all parcels within a designated betterment area benefit equally from the public investment?
- Is the distribution model applied fairly?

Step 3. Accurately quantify the benefits

Underlying land value gains should be captured with reasonable certainty for a program to be defensible legally and legitimate in the eyes of the public.

- How much of the change in property values can be attributed to public infrastructure investment?
- Is the difference between before and after valuations an accurate measure of increases in land values, or did the market anticipate the change to a more intensive land use in current property values months in advance?
- Is there a clear link between the provision of public benefits and property owners' willingness to pay the fee?

Step 4. Utilize a transparent and public mechanism to implement the betterment fee

Betterment fees only function well when the general program and each specific project generate trust among citizens and thus have legitimacy in the eyes of the public.

- Do the program and project ensure affordability?
- Is the social value of the program and project publicized?
- Is public participation promoted during design and implementation?

Step 5. Implement and support the program with strong political leadership

- Do elected officials provide resources to ensure the institutional capacity exists to administer the program effectively?
- Do elected official authorize an agency to administer the fee according to the highest ethical standards?
- Do elected officials actively promote the program?

BOX 8

Betterment Fees in Poland and Colombia

Poland

In 1997, the Poland's new land management law enabled local governments to implement betterment fees on property owners. The fees were based on the market value increase of property due to the installation of local public road, sewer, water, electric, natural gas, and telecommunications facilities. Most local governments in Poland implemented the fee, which could recover a maximum of 50% of public project costs.

It proved extremely difficult to assess the incremental land value created by public improvements. Appraisers were hired by municipalities to estimate before and after land values, parcel by parcel, within betterment districts designated by the local government. However, the courts set aside many of the independent valuations, finding wrongful determination of land value increases. Administrative costs to municipalities were found to be as much as 30% of revenue collections.

Szczecin, a city of 415,000, imposed a betterment fee at the maximum rate of 50% in 1998. A 2004 study found that only 26 parcels had been assessed for land value gains, and that total revenue collected amounted to 0.6% of public infrastructure investment in the betterment areas. The betterment statute was annulled in 2005, primarily because the controversy over land value determination outweighed the revenues generated.

(continued)

BOX 8

Betterment Fees in Poland and Colombia (*continued*)

Colombia

Also in 1997, Colombia revised its betterment fee to increase flexibility. According to Colombian law, which has been in effect since 1921, land parcels within special planning districts, where the municipal government authorizes conversion of land from rural to urban use or rezones land for higher intensity, can be subject to a betterment fee of 30% to 50%. Payment of the betterment fee is due upon realization of the land value gain at the time of land sale or development. Proceeds are dedicated to infrastructure investment to support the newly urbanized territory. The 1997 revision gave municipalities discretion over the percentage of infrastructure costs that can be recovered.

Manizales, a city of 400,000, uses betterment fees primarily to build roadway infrastructure. Four major road projects were funded between 2008 and 2011, during an economic recession, with a single betterment fee of 80% assessed on properties in designated areas. Collections amounted to US \$24.6 million. The city legislature delegates authority to administer the fee to the Instituto de Valorización de Manizales (INVAMA). There are eight steps in Manizales' betterment fee process:

- 1. Define the area of influence.** INVAMA defines the “area of influence”, that is, the betterment area where the project will provide benefits. The criteria used to establish the area of influence and the level of benefit include proximity and accessibility to the project, which affords greater use of the road and thus increases property values as measured by the project's impact on the assessed values and economic conditions of properties in the area.

To reduce the average amount of the fee, an effort is made to include the largest possible number of parcels within the area of influence. When the fee finances multiple projects, the boundaries of the entire area of influence are defined by superimposing the individual areas of each project and adjusting them to account for the complementary effects of the benefits from the combined projects.

- 2. Calculate the benefit and generate a value-added map based on a sample of parcels.** A sample of the parcels is taken, representing the dominant, nonspecific characteristics of the properties in the area. The sample size is calculated statistically; typically, 100 to 200 properties are appraised, depending on the size and heterogeneity of the betterment area. Information collected in this sample is used to generate a map of land values before the project is constructed. A second value-added map is then developed with the new, anticipated property values, and a third map plots the differences in values between the first and second maps. This third map is used to allocate the betterment fee.
- 3. Estimate the benefit.** To determine the added value or benefit accruing to a parcel, a team of professionals (municipal staff and/or consultants) carries out several related studies: an economic study to define the formulas for the value-added criteria; a road network study to quantify the benefit, measured as a reduction in travel distance for the population in the affected neighborhoods; an urban study to measure the potential for different land uses in the area; and a real estate study to compare and quantify the level of benefit in specific areas.

For a recent road project in Manizales, the benefit factors were: (a) greater mobility, which translates into greater travel speeds, lower travel time, lower transportation operating costs, and higher quality of life; (b) general urban planning benefits, as the project normalizes the road network and rationalizes the use of public space; (c) changes generated in land use and the stimulation of productive and commercial activities; (d) greater market value of nearby properties; (e) integration of the project into the urban structure of the city; (f) optimization of circulation and mobility; and (g) recovery of deteriorated or depressed areas.

(continued)

BOX 8

Betterment Fees in Poland and Colombia (*continued*)

4. **Allocate the benefit.** Each of the following factors is given a weight: potential change of use, which generates the most added value even though it affects a small number of parcels (weight of 40%); improved access to higher value areas or commercial areas (20%); savings in travel time during peak commuting hours (20%); and reduction in pollution or traffic congestion at specific areas where these problems occur (20%).
5. **Establish the focal point level of benefit.** The area of highest betterment in the entire area of influence is known as the “focal point”. This is the parcel or area that benefits most from the project because of a confluence of the most important value-added factors. The expected added value is calculated for this parcel and the corresponding percentage is multiplied by the initial market value of the parcel. With these values, the added-value map for the entire betterment area is built.

Studies in several Colombian cities found that road projects generate an average added land value of 10% to 15% within three years following project completion. Assuming a 15% incremental value for the “focal point” parcel with the highest benefit, it follows that a parcel with 70% benefit has an anticipated added value of 10.5%.

6. **Allocate the fee.** Once the cost of the project has been defined and its value-added impact has been calculated, INVAMA allocates the fee within the area of influence using models appropriate to the project. Manizales uses benefit factors to allocate the fee, as do most cities in Colombia. The method is based on defining a “virtual zone” obtained by multiplying the weighted factors given to property characteristics by the level of benefit and the physical area of the parcels. Criteria to define benefit factors for allocation purposes may vary, but the reference point is always the total value of the property based on the area of the parcel plus construction.
7. **Determine affordability.** The fee is assessed by taking into account the financial capacity of property owners to pay, and therefore may be allocated differently depending on socioeconomic level. Affordability is based on data from household income and expenditure surveys. In some cities in Colombia, a comparative analysis is made between the betterment fee and other charges, such as the property tax and utility charges paid by property owners.
8. **Set the collection period.** In Manizales, the collection period generally coincides with project execution. The legal maximum period in Colombia is five years following project completion.

Betterment fees arguably work better in Colombia than anywhere else in the world. There is a long history of using such fees in Latin America, and local governments have the authorization and capacity to make periodic adjustments to keep the fees relevant. In recent years, according to several studies, developers in Colombia remain willing to pay the fees; however, property owners have become less willing to sell because of a perceived negative impact of the fees on their expected returns.

3.8 SPECIAL ASSESSMENT DISTRICTS

A Special Assessment District (SAD) is a way of financing a specific public improvement project, in which property owners who directly benefit from the project share its cost. Local public improvements that are most often paid for through special assessments include sanitary sewers, storm sewers, water mains, road paving or widening, sidewalk construction, and street lighting. Other public improvements can also be financed through special assessments, such as parking facilities, parks, waste treatment facilities, schools, and hospitals.

Inadequate local government revenues can make it hard for local governments to provide all the facilities their residents need. When property owners want new public improvements, they can request a SAD to pay for and administer them. For example, let's assume a group of property owners would like their properties to be serviced by a new public water line. They could ask the municipality to form a Special Assessment District. The municipality, with the approval of the majority of the property owners, constructs the water main and then charges the property owners who are directly connected to the main an annual fee for a fixed number of years to pay for the project. Alternatively, the municipality could propose a public improvement project, but only if affected property agree to form a SAD.

The enabling legislation for a SAD specifies who is eligible to request that the local government form a SAD. This might be the majority of property owners in the proposed district, or the majority of registered voters residing in the district, or property owners representing a majority of the land area in the district. Once a Special Assessment District is formed, all property owners or voters are included within the district and subject to assessments, whether or not they support the SAD.

Special assessments are independent of property taxes. In many instances, however, the special assessment is billed and collected annually in a dedicated account by the municipality at the same time as property taxes are billed and collected.

3.8.1 Realizing the Benefits of SADs

A Special Assessment District shifts the financing of public improvements from all residents and businesses of the municipality to those who specifically benefit from them. It also directly links public improvements with installation costs, which can facilitate rational political decisions and accountability.

To realize these benefits, assessments must offset the public investment and not be used for general revenue purposes. Assessments must include only reasonable overhead and indirect costs. And assessments must be affordable to those who must pay them.

3.8.2 Program Design

Generally, the creation of a Special Assessment District requires the following actions:

1. Initiate the process.
2. Determine costs.
3. Determine assessment method, costs, and terms.
4. Form the Special Assessment District.

Step 1. Initiate the process

Special Assessment Districts can be initiated either by the mayor or at the request of a property owner whose property would be included in the district to be assessed.

For example, a property owner who wishes to initiate a SAD, or the mayor, must obtain the approval (by signature) of at least 51 percent of the property owners in the district based upon the number of parcels within the district or the total frontage of the parcels, depending upon the nature of the project. For example, for the installation of a new sanitary sewer where each parcel would receive one connection, the appropriate number of approvals would be based on the number of parcels. For the installation of new sidewalks, where larger parcels would receive more sidewalk length, the appropriate number of property owners' approvals would be based in the total length of parcel frontage.

It's important to note that it is fairly straightforward to determine who would benefit by a new sidewalk, but less simple to determine all the beneficiaries of, for example, a public park. In cases where a specific improvement may attract users from outside the district, the costs of the improvement may be shared by the SAD and the municipality.

A method of opposing a SAD should also be specified. For example, if a property owner in the proposed assessment district is opposed to the SAD, he or she can obtain the signatures of at least 51 percent of the property owners in the district based upon the number of parcels within the district or the total frontage of the parcels, depending upon the nature of the project, who are also opposed to the formation of a SAD. Upon validation of the signatures by the municipality, the proposed SAD must be abandoned.

Step 2. Determine project costs

Upon receipt of the signatures requesting the formation of a SAD, the mayor would direct municipal staff to prepare a report which includes preliminary plans and an estimate of the cost and duration of the project. The report should also include an explanation of the necessity of the improvement and what part should be paid by special assessment and what part, if any, should be paid by the municipality at large.

Step 3. Determine assessment method, costs, and terms

SAD expenses may include the costs of construction plans, expropriation, public outreach, debt financing, construction and legal fees, as well as all other incidental project costs.

There are two basic methods for assessing project costs. In the first method, each property is assessed an equal share of the project cost, and each property owner pays an equal share toward the total project. The second method requires that any specific property owner's share of the project be based on the length of parcel frontage along a public road. With this method, the owner of a large parcel will pay a proportionally larger share of the project cost than the owner of a small parcel. It is the municipality's responsibility to determine the most equitable method of cost assessment for any given project.

Typically, the municipality will issue bonds to finance a project or pay the interest on bonds issued on its behalf by the national government. The term of the bonds determines the cost of the special assessment and the life span of the Special Assessment District. For example, the total annual principal and interest that the municipality has to pay on the bonds, along with incidental

administrative costs, is divided by the number of affected property owners. This becomes the annual special assessment for each property owner. Property owners pay until the bond is retired—usually 10 or 20 years—at which time no further payments are required and the SAD is terminated.

Alternatively, the municipality could pay for the project with general funds and negotiate repayment terms with property owners.

If additional properties are added to a SAD, usually through subdivision, the annual assessments are adjusted accordingly.

The municipality bills annual assessments, often with property tax bills, and the assessments are subject to the same penalties for late-payment or nonpayment as property tax payments.

If an annual special assessment proves insufficient to meet the cost of the improvement for which it was made, the municipality may make an additional assessment, provided that it does not exceed a certain amount, such as 15% of the original assessment. If the insufficiency is greater than the not-to-exceed amount, then general funds typically make up the difference.

Step 4. Form the Special Assessment District

The municipality forms the SAD by officially:

- Adopting a description of the project
- Specifically designating the boundaries of the SAD
- Recognizing the estimated cost of the project, divided into the portion paid by the Special Assessment District and that paid by the municipality at large
- Directing municipal staff to prepare construction documents and receive bids
- Issuing debt and specifying a maximum number of annual payments by property owners
- Certifying the actual annual assessment cost to individual property owners
- Holding a public hearing

4. RECOMMENDATIONS

Local governments in Albania must continue on their path towards fiscal decentralization and financial sustainability. This means local governments need more revenues and more revenue-raising authority from the national government. It means they must make the best use of all revenues through effective territorial planning and financial management. And it means local governments must optimize income from their investment in public facilities and use it to fund additional growth-inducing infrastructure. Properly implemented, financial instruments can leverage public investment to produce new revenues for local governments.

The question of how a financial instrument is to be implemented has been an integral part of the design of this policy paper. The following recommendations are intended to provide the practical guidance that is required to bring six revenue-producing financial instruments for land development successfully to life.

Each recommendation will require further investigation, consultation, and refinement by the national and local governments and their private-sector partners. They are not the finished product, but a step in the right direction towards creating stronger foundations for local infrastructure investment and growth management.

PRINCIPLE RECOMMENDATIONS

Recommendation 1:	Action steps
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The paper discusses the pre-conditions and capabilities that are necessary to successfully develop, implement, and monitor each of the six financial instruments. These basic requirements are summarized in the form of concrete, user-friendly action steps, which are included in the Program Design section for each instrument. The action steps represent the collective wisdom of international best-practice case studies, Government of Albania and PLGP experts, and, mostly, examination of the enabling legislation of successful programs for each of the instruments. The action steps are recommended for consideration and use in the design, implementation, and monitoring of each financial instrument.

Recommendation 2:	Review of enabling environment
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There is no dedicated national legislation related to any of the six financial instruments discussed in this paper, and few explicit references to them in existing laws. Relevant policy, legal, and regulatory frameworks should be assessed to identify and address any gaps that make it difficult for local governments to properly implement the basic requirements of any of the six financial instruments.

Recommendation 3: Revenues to local governments

Revenues from the six financial instruments discussed in this paper must accrue to local governments, and not be required to be shared with the national government. Local governments must have the authority to raise and control own-source revenues from financial instruments, and to link local revenues with local infrastructure provision. This is the essence of accountability and efficiency under decentralization.

Recommendation 4: Local own-source revenue model

Consider the following model funding framework for optimizing own-source revenue for infrastructure development in target areas, as identified in the GLTP. Target areas are those where regulatory changes: (1) result in significant increases in “by right” uses for property owners; or (2) allow land to be developed at higher densities; or (3) increase property values. They also may be fast-growth areas, such as urban cores. This model can ensure that the relative contributions of the national government, local government, and developers towards new or improved infrastructure in the target areas are equitable and reasonable. The model does not preclude the use of other financial instruments discussed in this paper.

1. An Infrastructure Impact Tax, due upon issuance of a building permit, to fund the provision of directly attributable infrastructure including roads, sewers, water supply, parks, and other public infrastructure.
2. A Betterment Fee, to capture a portion of property value increases, for re-investment in the area.
3. An annual charge, such as a property tax surcharge or special assessment, applied to all properties in the targeted area to be disbursed as agreed by the Municipal Council.

SUPPORTING RECOMMENDATIONS

Recommendation 5: Use of accountable property valuation methods

It is critical that property valuation, based on internationally-recognized and internationally-utilized methods, forms part of the usual decision-making process for real estate transactions and, thus, for the design and implementation of financial instrument programs. The property valuations presented in Annex B of this paper are standard and accepted methods that provide objective assessments of value and help eliminate the arbitrariness from buying, selling, and appraisal decisions that can increase risk, lead to financial shocks, and deter economic growth.

Recommendation 6: Information on best valuation practices

The use of market values and best-practice valuation methods to conduct transactions—in compliance with Albanian law and international investment financing norms—depends on the methodical collection of data. Specific data with details of a particular parcel or structure, as well as general national and local economic data, must be collected and analyzed to arrive at market values.

Local governments need general advice and information sharing on best property valuation practices and other issues related to valuation, including:

- Assistance with particularly difficult appraisals
- Guidance and support with geographic information systems to map and analyze targeted areas
- Cost schedules for use in the cost approach to value
- Capitalization rates for use in the income approach to value
- Contract review if the local authority contracts with private entities for some tasks.

Recommendation 7: Auction guidelines

Establish clear guidelines for public auctions. Auctions are prescribed for Conditioned Building Intensity programs and may be desirable to Transfer of Development Rights programs. The difference between the revenues generated through an efficient auction and an ad hoc auction, or no auction at all, is large. The World Bank reports that well-run auctions for land sales in Egypt increased proceeds by a factor of more than 10 to 1 over previous administrative sales.

Recommendation 8: Infrastructure Impact Tax amendment

Amend national authorizing legislation for the Infrastructure Impact Tax on New Construction so that it lays out: (1) purpose of, and criteria for, imposing the tax; (2) methodology for imposing costs among developers, based on project impact; and (3) criteria for dedicating revenues to capital infrastructure investment. The Infrastructure Impact Tax on New Construction is regulated by both Law No. 107/2014 *On Territorial Planning and Development* (Article 46) and Law No. 9632/2006 *On Local Tax System* (Article 27).

Recommendation 9: Legal definition of market value

Although the regulations governing financial instruments specify that property valuations must be based on market values, there does not appear to be a clear and unequivocal definition of market value in Albanian law. Without a clear understanding of how market value is defined and interpreted, it's difficult to know for certain the range of property valuations that might be applied legally in Albania. For example, it's not clear that Brazil's program of Tradable Development Rights, in which the municipality determines the floor price of development rights, would be legal in Albania.

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ANNEX A. COMPARISON OF FINANCIAL INSTRUMENTS FOR LAND DEVELOPMENT

INSTRUMENT	DESCRIPTION	KEY REQUIREMENTS	OVERALL DIFFICULTY
Transfer of Development Rights	Property owners sell development rights from their land to a developer or other interested party who then can use these rights to increase the intensity of development at another designated location; transactions between buyers and sellers are voluntary	Inventory of land assets, effective market valuation and pricing, and strategic decisions about municipal growth at different locations; practical adjustments must be made as market conditions change; forceful leadership may be essential to ensure strong use and execution	Technical competence and staff resources needed for on-going valuation; may be difficult to establish appropriate prices and formulas for development rights; challenge to develop simplified approach that captures the core concept of managing growth, without overwhelming technical demands
Conditioned Building Intensity	Developer installs on-site or off-site “public” improvements at own expense, or provides in-lieu cash, in exchange for building at higher intensity; can accelerate private investment in important community needs	Clear and transparent regulations; planning and implementation capacity to link developer’s improvements to public needs; competitive developer selection procedures become critical to fair implementation and municipal revenue generation	Simpler than most other forms of public private partnership; danger of nontransparent or corrupt deals between local government and developer
Tax Increment Financing	Local government taxes land value gains resulting from public improvements in a defined area and uses the funds to pay for those improvements; one of the few available financial instruments for revitalizing underperforming areas in need of development or redevelopment	Value based property tax system that is locally regulated and administered; local ability to issue public debt desirable; efficient and accurate land valuation process	Limited on-going staff resources are required; however, recovering the cost of a specific infrastructure investment requires the technical competence to carefully estimate current and future property values, and current and future program costs and revenues

INSTRUMENT	DESCRIPTION	KEY REQUIREMENTS	OVERALL DIFFICULTY
Business Improvement Districts	Commercial property owners and tenants, through an annual assessment, pay the cost of supplemental services and improvements to public spaces to improve the physical and business conditions of their district	Majority of businesses should be successful; area with few vacancies; municipal support and agreement to work in key public spaces	Limited local government involvement; however, local governments should have a strategic and coordinated approach when working with BIDs; local governments may set standards for BID service delivery
Betterment Fees	Charge on the increase in the market value of a property due to public investor change in land use	Ability of municipality to calculate property values before and after change; dialogue with property owners to convince them that fee is not “just another tax”	May be difficult and costly to administer on a parcel-by-parcel basis
Special Assessment Districts	Municipality finances public infrastructure improvements by distributing the costs of a project among those property owners who directly benefit	Ability of municipality to issue debt desirable; ability of property owners to pay	Technically one of the most straightforward options
Infrastructure Impact Tax	Tax on value of new private investment in development; assessed at time permission to proceed is granted to mitigate impact of development on public infrastructure	Clear regulations; planning and implementation capacity to identify infrastructure cost implications of specific development	Relatively straightforward

INSTRUMENT	DESCRIPTION	KEY REQUIREMENTS	OVERALL DIFFICULTY
All	Methods of financing municipal public infrastructure and services through land value capture (TDR, TIF, Betterment Fees) or cost recovery/sharing (CBI, BID, SAD, Infrastructure Impact Tax), though the distinction is not always clear-cut	Extensive and meaningful public outreach and consultation; strong political leadership; compliance with General Local Territorial Plan; effective and transparent public financial management procedures; adequate training for policy makers, administrators, developers, and citizens	Cost recovery and cost sharing instruments are easier for local governments to implement and support than instruments designed to capture land values, according to general international experience

ANNEX B. BASIC PROPERTY VALUATION METHODS

Since all of the financial instruments discussed in this paper aim at capturing some of the financial value that public infrastructure investments add to private properties, and since the laws of Albania governing financial instruments define “value” as “market value”, it is important to be able to estimate accurately the market value of properties.

Below are basic, internationally-recognized and internationally-utilized methods for valuing properties. All of the methods are mathematical models of reality. They are based on many years of observations of actual real estate markets in many countries and many years of collecting and analyzing data on parcel and building sales.

The following examples should be used mainly as precursors to more comprehensive evaluations. They provide quick estimates of market values. However, in many cases, they will yield adequate information for policymakers and administrators to plan proactively and developmentally and to negotiate with developers and property owners to capture values for the public benefit.

General guidance is given about when the methods are typically applied, but there are no fixed rules. In fact, it is always good practice to utilize more than one method, when possible, to check the results of one against the other.

Comparable Sales Method

The comparable sale method is based on the assumption that no buyer would pay more for a property than what other similar (i.e., comparable) properties are selling for. It is an estimate of value derived from carefully comparing a specific property with recently sold properties of similar characteristics. It is most often used in valuing small structures and vacant land.

Step 1. Gather sales data for properties of similar size and location that have recently sold, including sale prices and property characteristics.

Step 2. Identify characteristics of the properties that could affect value, such as age, condition of buildings, number of rooms, parcel size, and parking availability.

Step 3. Estimate the market value.

Analysis. What is the market value of Property D? An analysis shows that three other properties (A, B, and C) sold recently. These properties are slightly different, but similar, to one another. A comparison of property characteristics shows that Property D is slightly newer, with a slightly larger building area, and with parking. The appraiser, based on his or her experience, estimates the sales price, or market value, to be ALL 6.0 million.

Table 1. Comparable Sales Method

Property Characteristics	Property A	Property B	Property C	Property D
Parcel size (m ²)	800	750	770	750
Building area (m ²)	100	105	125	110
Number of rooms	6	5	6	5
Parking spaces	0	1	0	1
Age	50	45	47	40
Sales price (ALL)	4.54 million	5.56 million	5.70 million	???

Cost Method

The cost method is based on the assumption that no buyer would pay more for an existing improved property (i.e., land and building) than what it would cost to buy a similar vacant parcel and construct a building on it that provides similar functionality. It is a separate estimate of the value of the land, the building, and any site improvements, factoring in depreciation, or the loss in value of a building and improvements due to physical deterioration or other negative factors. When multiple structures are involved, the values of the separate structures and land are estimated and then added together to arrive at a value for the entire property. The cost method is often used for properties that are not frequently sold or are not income-producing, such as government buildings, schools, religious buildings, hospitals, etc.

Step 1. Estimate the value of land as if it were vacant. The comparable sales method can be used since land can't be depreciated.

Step 2. Estimate the current cost of constructing the building(s) and related infrastructure and site improvements. The most common ways of estimating building costs include: (1) the cost per square meter to build similar recently-built structures is multiplied by the number of square meters in the building being analyzed; (2) the unit cost of furnishing and installing individual building components (labor and materials), such as windows, plumbing, pavement, etc., is totaled; (3) a detailed estimate of the quantities of materials, equipment, labor, and overhead needed to replace the building being analyzed is calculated.

Step 3. Estimate the amount of depreciation. Depreciation is any factor that may negatively affect the value of a building, such as, but not limited to, physical deterioration, poor maintenance, design features that are no longer desirable, lack of desired amenities, less-than-desirable location.

Step 4. Subtract the depreciation from the estimated construction costs.

Step 5. Calculate the market value. This is the cost to replace the functionality of the building in the current market, using current construction standards and methods.

Analysis. The property contains a building which is ten years old and an expected lifespan of fifty years before it becomes functionally obsolete. There are other improvements on the site, including sidewalks, paved parking, and lighting, and these are also considered in the analysis, which is summarized in the following table.

Table 2. Cost Method

Cost of land	ALL	5.000.000
Cost of building	ALL	100.000.000
Less depreciation (10 years)	ALL	(10.000.000)
Other site improvements / infrastructure	ALL	3.500.000
Less depreciation	ALL	(350.000)
Total replacement cost (market value)	ALL	98.150.000

Residual Valuation Method (Valuing Land with Development Potential)

The residual valuation method is based on the assumption that no buyer would pay more for a parcel of land than the total income that could be generated from a development on the parcel, less the costs to build the development and required profits. It is thus an estimate of the development potential of land, defined as the amount a developer can pay for a parcel of land and still make a reasonable profit on a development. The residual valuation method is often used to estimate whether or not a development project is financially viable. When compared to the value of the same land in the absence of development or potential development, it can provide an estimate of the “residual” or additional value that development adds to the land.

Step 1. Calculate the value of the completed development. This is typically the sales price or advertised sale price.

Step 2. Subtract development costs (construction, overhead, finance, etc.).

Step 3. Subtract the developer’s required profit.

Step 4. This is the value of the site.

Analysis. In the scenario below, a developer wants to buy a five hectare parcel of land to build a 100-unit residential project. What is the market value of that parcel? According to the residual valuation method, the developer will pay a maximum of ALL 18 million for the parcel. If she paid more, her profits would be reduced and the financial returns would not be considered adequate for the risks involved. In other words, the project wouldn’t be considered feasible at that price, and the developer would not buy the land. At the same time, the property owner would not sell the land for less because another developer would be prepared to pay ALL 18 million. Therefore, the market value of this property is ALL 18 million. (Please note that the equation can be rearranged to estimate the developer’s profit if the land cost is known.)

Table 3. Residual Valuation Method (Valuing Land with Development Potential)

Scenario	Calculations	
1. Developer wants to buy five hectares of land to build 100 apartments.		
2. Each apartment can be sold for ALL 1.500.000.	Selling Price / Apartment	ALL 1.500.000
3. Each apartment will cost ALL 1.200.000 to build (not including land).	Less Total Development Cost / Apartment	(1.200.000)
4. Developer requires a 10% profit	Less Profit / Apartment	(120.000)
<i>What is the market value of the land?</i>	Amount Left to Pay for Land / Apartment	ALL 180.000
<i>What is the price the developer will pay for the land?</i>		
<i>What is the price for which the property owner will sell the land?</i>	ALL 180.000 x 100 Apartments	ALL 18.000.000

Residual Valuation Method (Local Detailed Plan)

Article 22.14 of the Law on Territorial Planning and Development regarding Local Detailed Plans states that “the process of drafting and LDP shall be followed by the preparation of a preliminary feasibility study, which shall estimate... the *increased value of land as a result of planning or public investments*” [italics added]. The residual valuation method may be used as a basis for calculating the increased land value, according to the requirements of the law.

Step 1. Identify area subject to a Local Detailed Plan.

Step 2. Obtain existing land values.

Step 3. Conduct a preliminary feasibility analysis.

Step 4. Calculate the residual land value based on development potential.

Step 5. Calculate the difference between the residual land value and the existing land value. This is the increased value of land.

Analysis. In the scenario below, a local detailed plan is being prepared for a 10 hectare parcel of vacant land. A developer proposes to build 200 residential units on the property, and a study determines this is feasible. What is the value that the proposed development would add to the current value of the land? The local government must then determine how much of the increase should go to the developer and much can be captured for the public good.

Table 4. Residual Valuation Method (Local Detailed Plan)

Scenario	Calculations
1. A local detailed plan is being prepared for 10 hectares of vacant land.	10 hectares = 100.000 m ²
2. A feasibility analysis finds that 200 residential units can be built on the 10 hectares, and each unit can sell for ALL 1.000.000.	Selling price / Residential unit ALL 1.000.000
3. Each residential unit can be built for ALL 850.000 (not including land).	Less development cost / Residential unit (850.000)
4. Developer requires a 10% profit	Less profit / Unit (85.000)
5. Amount left to pay for land per residential unit.	Amount left to pay for land / Unit ALL 65.000
6. Developed value of land per square meter.	ALL 65.000 / Unit x 200 Units = ALL 13 Million ÷ 100.000 m ² = ALL 130 / m ² Developed land value ALL 130 / m ²
7. Current cost of land without development is ALL 30 /m ²	Less current land value (30 / m ²)
8. Value added by development	Increased value ALL 100 / m ²

Income Capitalization Method (Large Income-Producing Properties)

The income capitalization method is based on the assumption that all property represents an investment, and no buyer would pay more for a property than the rental income generated by a property at a required rate of return. It is thus an estimate of the value of a property based on cash flows. The income capitalization method is used to determine the market value, or capitalization, of larger income-producing commercial, industrial, and residential properties.

Step 1. Estimate the total annual revenues. This will be mostly rental revenues (from apartments, office space, retail space, parking, vending machines, etc.).

Step 2. Deduct vacancy (usually estimated at 5% of rental income).

Step 3. Deduct total annual operating expenses (taxes, utility fees, property management and maintenance fees, etc.). This will provide the Net Operating Income. (Please note that operating expenses for high-quality residential properties are typically about 35% of revenues.)

Step 4. Divide the property's Net Operating Income by the Capitalization Rate to determine the property's market value.

Step 5. Deduct the total development cost from the market value.

Step 6. Deduct the developer's required profit. This will yield the amount available for public benefit.

Analysis. A developer proposes to build a new 500-unit, high-quality apartment building through a Conditioned Building Intensity program. In order to build at a higher intensity, the developer must provide a public amenity. What should be the value of that amenity? As part of the application for the CBI program, the developer was required to provide the municipality with a *pro forma*, or estimate of the project's financial performance. Pro formas are used internationally and include detailed estimates of a project's expenses and revenues and expected profit. The municipality has determined that the Capitalization Rate for a first-class residential building in the area designated for CBI is 5.0%. (See section on capitalization rates.) An analysis of the financial information provided by the developer finds that ALL 425.000.000 are available for public benefits, and this becomes the basis of negotiations between the developer and municipality

Table 5. Income Capitalization Method (Large Income-Producing Properties)

Annual rental revenues from apartments when building is fully rented. (This is the building's only income.)	ALL	1.700.000.000
Less vacancy (5%)	ALL	(85.000.000)
Less annual operating expenses	ALL	(480.000.000)
Net Operating Income	ALL	1.135.000.000
Capitalization rate		5.0%
Market value of property (net operating income / cap rate)	ALL	22.700.000.000
Less total development cost	ALL	(20.250.000.000)
Less developer's required profit (10%)	ALL	(2.025.000.000)
Difference available for public benefits	ALL	425.000.000

Income Capitalization Method (Small Properties)

A metric called the Gross Income Multiplier (GIM) can be used to estimate the market value of smaller income-producing properties. The GIM relates the sales price of a property to its annual rental income. The GIM is not a percentage, but a multiplier. Like the cap rate, the GIM will be different for different groups of properties in different areas. Unlike the cap rate, the GIM does not account for operating expenses.

Step 1. Select sales and rental income from at least three properties that are similar in terms of size, location, price, and rents, and determine the average sales price and average annual rental income.

Step 2. Calculate the Gross Income Multiplier by dividing the average sales price by the average annual rental income.

Step 3. Multiply the rental income, or potential rental income, of a subject property by the GIM to get the property's market value.

Analysis. A subject property earned ALL 145.000 in annual rental income, but the market value was not clear. A comparison of sales and rental information for four similar properties in the area was conducted, and the Gross Income Multiplier for the area was calculated. The market value of the subject property was determined by applying the GIM.

Table 6. Gross Income Multiplier

	Property A	Property B	Property C	Property D
Sale price (market value)	ALL 12.800.000	ALL 13.500.000	ALL 13.100.000	ALL 13.000.000
Annual rental income	ALL 140.000	ALL 160.000	ALL 150.000	ALL 140.000
Average sale price (properties A-D)	ALL 13.100.000			
Average annual rental income (properties A-D)	ALL 147.500			
Gross Income Multiplier (average sale price / average rental income)	88.8			
Market value of subject property (annual rental income of ALL 145.000 x GIM)	ALL 12.876.000			

Capitalization Rate

The capitalization rate, or cap rate, is one of the most popular and powerful metrics that financiers, developers, real estate professionals, and government administrators use to value property. Fortunately, it is also one of the simplest to calculate and apply. UNHabitat recommends that Albania and other developing nations utilize cap rates when implementing financial instruments for land development.⁷

Capitalization rates are expressed as percentages and are calculated as follows:

$$\text{Cap rate} = \text{net operating income} / \text{sales price}$$

The net operating income (NOI) is all the income a property receives in a year (mostly rent) minus all annual expenses. NOI is before debt, and does not include mortgage expenses.

For example, if the NOI is ALL 1.000.000 and the sales price is ALL 10.000.000 the cap rate is 10% (1.000.000 / 10.000.000).

Cap rates are calculated for categories of property (i.e., residential, office, industrial, hotel); for the income they produce (i.e., premium rent, high rent, average rent); and for locations (i.e., center of Tirana; Durrës; Elbasan).

Real estate professionals, bankers, consultants, or government staff typically analyze sales and income information for similar properties in a particular market area and calculate capitalization rates. For example, a residential building in the center of Tirana that commands premium rents may have a cap rate of 4%; a premium office, 8%; and a premium hotel, 14%. These cap rates will then be applied to all new comparable construction in the center of Tirana.

Cap rates are a measure of investment risk; that is, the higher the risk that a development will not provide adequate financial returns, the higher the cap rate. Hotels, for example, generally have higher cap rates than offices because the risk of running a hotel is directly related to travel, tourism, and what is happening in the local, national, and international economies. Residential properties generally have the lowest risk, and thus the lowest cap rates.

Location is also an important factor in determining cap rates. For example, a building in the center of Tirana will have a lower cap rate than an identical building in Berat. Tirana has more people and rents are higher, therefore the risks of development are lower.

The higher the risk, the higher the cap rate, and that will bring down the value of a property. A difference between a 4% and a 12% cap rate makes a huge difference in the value of a property. Similarly, as a property ages and maintenance expenses increase, the net operating income decreases and the cap rate goes up.

In summary, capitalization rates reflect market trends. A cap rate is a metric which captures the type of property, its location, and its condition. In countries with value-based property tax systems, large real estate companies publish online the cap rates for the major cities, which are then utilized to determine market value.

⁷ Walters L. Land and Property Tax: A Policy Guide, p.75.

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