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The Delaware Historic Preservation Tax Credit Program:

Good for the Economy, Good for the Environment, Good for Delaware's Future

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Introduction

In 2001, the Delaware legislature passed House Bill One (HB1) creating tax credits for the rehabilitation of Delaware's historic properties. The results of this legislation can be seen in every corner of Delaware—restored buildings on main street, revitalized commercial districts, quality housing units in every price range, and reinvestment in historic homes. The Delaware Historic Preservation Tax Credit Program has created jobs, increased the local tax base, and encouraged reinvestment in areas already served by infrastructure and public services.

But the Delaware Historic Preservation Tax Credit is an incentive program. And in times of economic downturns, financial strains, and budget shortfalls, it is appropriate to look at all state programs including incentives. The Delaware Historic Preservation Tax Credit Program is no exception. This report was commissioned to give the state legislature, preservation activists, and economic development officials an understanding of how this program has worked in its first ten years.

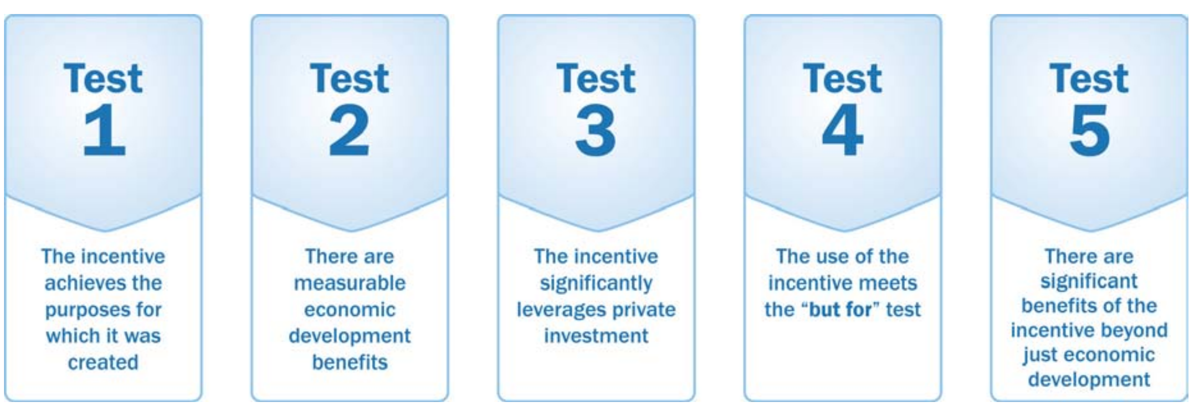
Good economic development incentives meet four tests:

1. The incentive achieves the purposes for which it was created
2. There are measurable economic development benefits
3. The incentive significantly leverages private investment
4. The use of the incentive meets the "but for" test: *"But for this incentive the investment would not happen"*

The best economic development incentives meet an additional test:

5. There are significant benefits of the incentive beyond just economic development

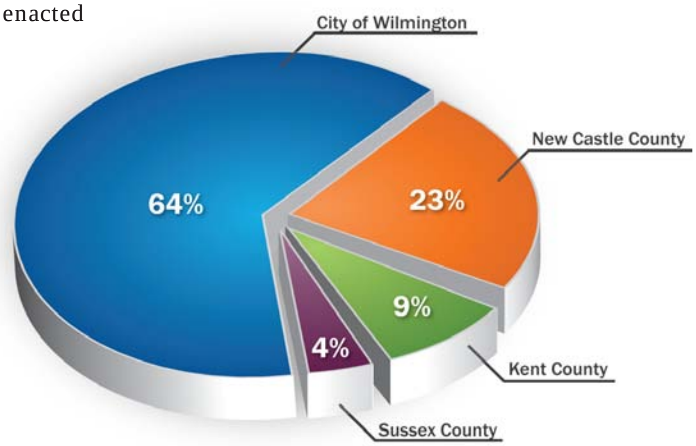
The Delaware Historic Preservation Tax Credit Program meets all of these tests!



Test One: The Incentive Achieves the Purposes for Which It Was Created

The Delaware Historic Preservation Tax Credit Program was enacted to meet two goals:

1. To attract private investment into the state's historic buildings
2. To be a tool for economic development

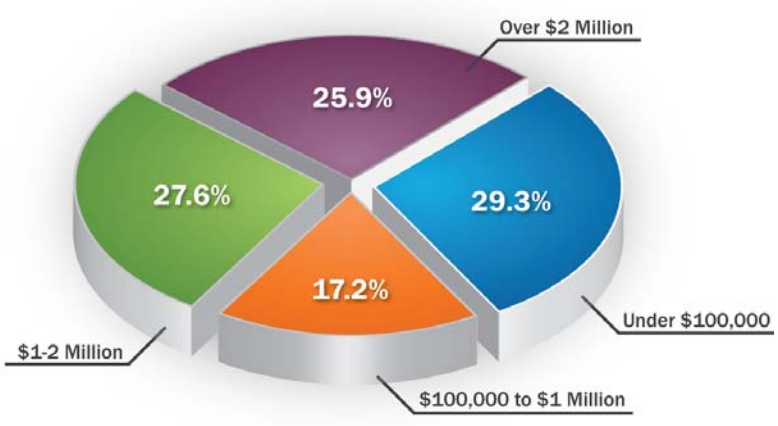


Delaware Historic Preservation Tax Credit Projects by Location

It is clearly evident that the first goal has been met. In the decade since the incentive was passed, some seventy-five historic buildings have been rehabilitated using state tax credits. While, predictably, many of these were in Wilmington, in fact every corner of the state saw historic buildings brought back to life.

While the program was designed so that it could be used by developers for large projects, it was also meant to be used on a smaller scale by small business owners for their main street buildings and by homeowners. Nearly 30 percent of all projects using tax credits were less than $100,000! Nearly half were less than $1 million.

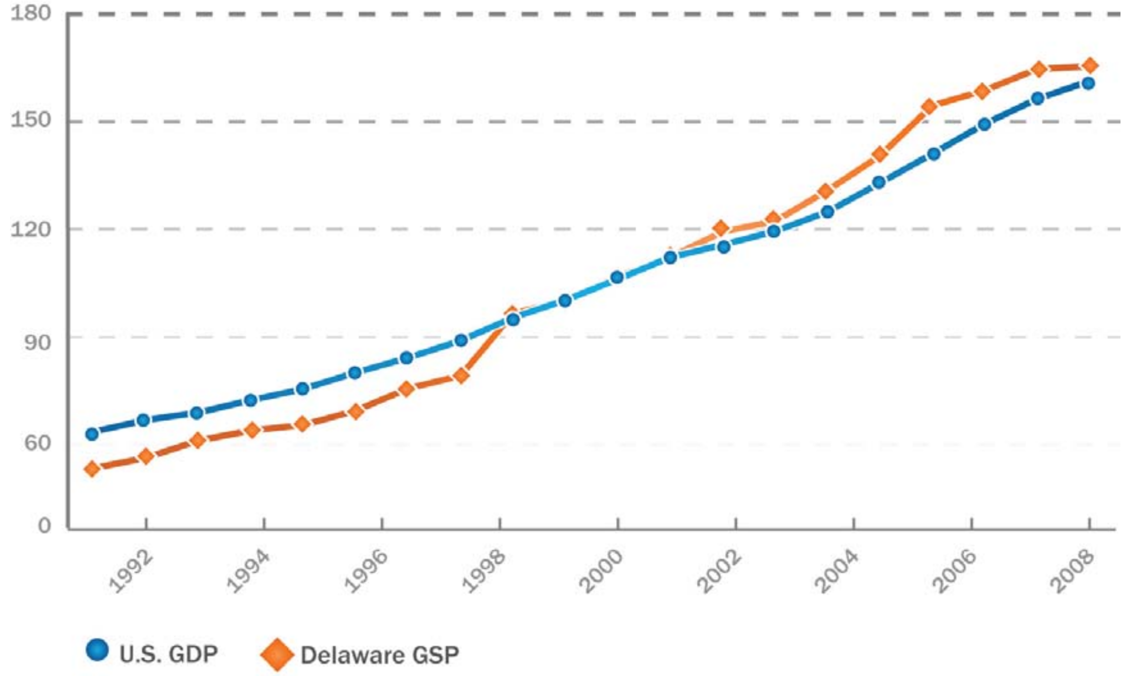
But the existence of a variety of historic preservation projects throughout the state does not, by itself, prove that the Historic Preservation Tax Credit Program was effective—perhaps this activity was simply a function of national or state economies. To understand the impact that the tax credit program has had, it is useful to look at comparisons of the national economy and the Delaware economy. The year 2000 was the last year before the tax credit program in Delaware was adopted, so that year is used as the base year with an index of one hundred.[1] As can be seen in the graph on the top of the following page, the growth in the Delaware gross state product (GSP) largely paralleled that of the national gross domestic product (GDP).



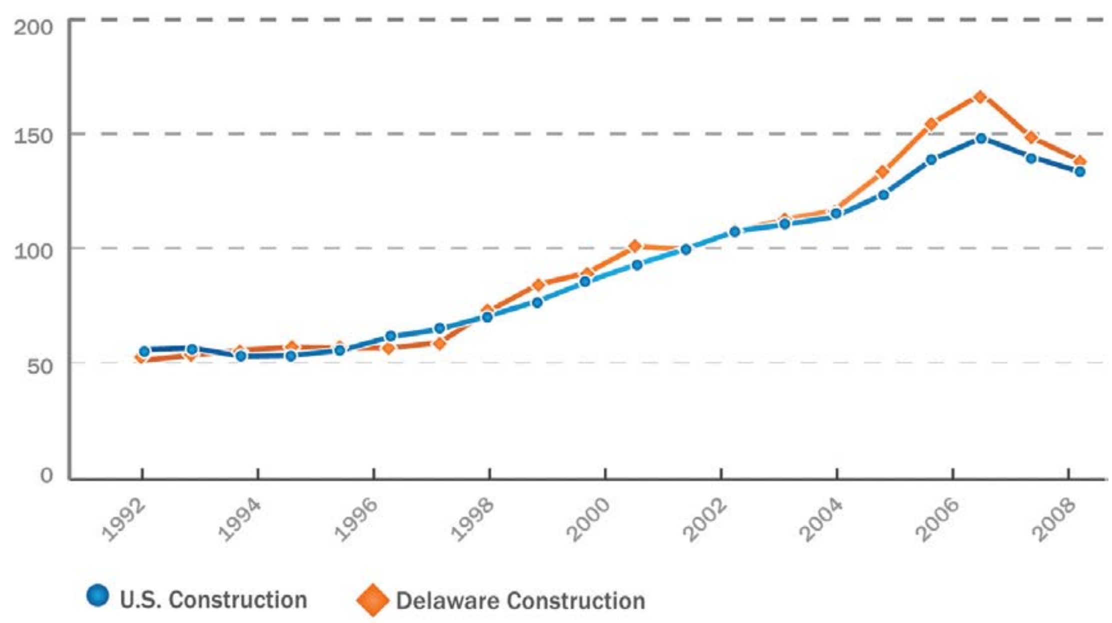
Project Size Utilizing Delaware Historic Preservation Tax Credits

1 Indexing rather than using raw numbers makes it easier to compare trends when the raw numbers are significantly different in magnitude.

U.S. GDP and Delaware GSP (Base Year 2000 = 100)



Construction Activity: U.S. and Delaware



Because the Delaware Historic Preservation Tax Credit Program applies to building rehabilitation, it is also important to look at the trend in construction activity over the same period (see the second graph above). As with the GDP/GSP comparisons, at first glance, the trend of construction activity in Delaware is largely parallel to the national pattern.

But what about historic preservation in Delaware? Wasn't the purpose of the state's Historic Preservation Tax Credit Program to encourage more preservation activity? If the growth in historic preservation activity simply mirrored the growth in the overall economy in Delaware, or the construction sector, it would be hard to make the case that the program had much effect.

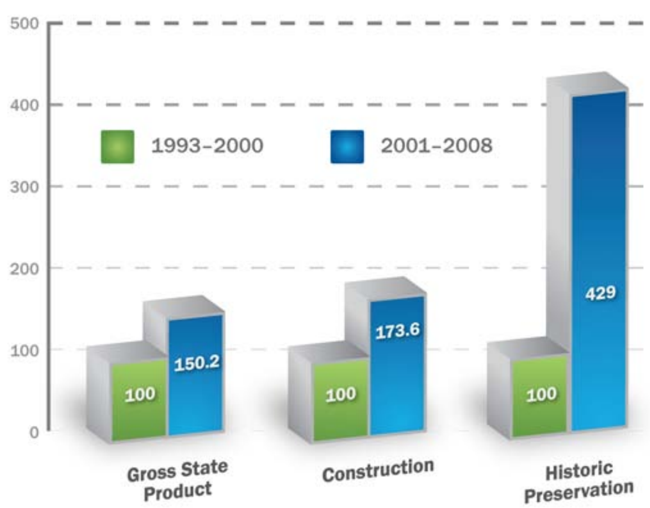
The graph below shows how remarkably successful the state tax credit program has been as a catalyst for investment. Again, so that widely different gross numbers can be compared, indexing was used. Each of the three categories (gross state product, construction, and historic preservation) was assigned an index value of one hundred, the index being the average amount of activity in the eight years from 1993 to 2000. A second index number was calculated using the average amount of activity in the eight years from 2001 to 2008.

That Expensive Historic Preservation!

One often hears the statement, "That historic preservation might be nice, but it is just too expensive."

In spite of having to meet preservation standards for quality, over half the projects receiving tax credits were completed for less than $100 per square foot. The average for all projects was less than $160 per square foot.

For the gross state product, the index number increased to just over 150, meaning that on average the GSP in the later eight-year period was about 50 percent greater than the earlier period. Construction did even better, with nearly 75 percent more annual activity than in the previous eight years.



Delaware Change in Economic Activity
1993-2000 vs. 2001-2008

But historic preservation?

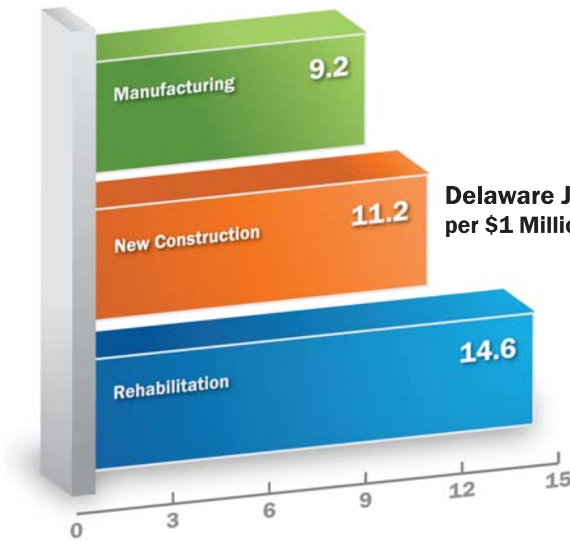
Over four times as much annual activity in the eight years after the adoption of the Delaware Historic Preservation Tax Credit Program than in the eight years prior to its passage!

So the first test of an incentive—does it achieve the purposes for which it was created? **The Delaware Historic Preservation Tax Credit Program passes that test with flying colors.**

Test Two: There Are Measurable Economic Development Benefits

In the end, economic development should be about jobs.[2] When economic activities are evaluated for their impact on job creation, there are actually two measurable factors: the number of jobs created and the household income those jobs generate.[3] Some kinds of economic activity—restaurants for example—have a large number of jobs created per $1 million of output. But since those are relatively low wage jobs, the household income generated is modest. Conversely, a nuclear power plant will generate impressive amounts of household income, as most of the workers there are well paid. But the total number of jobs created will be limited.

But in the combination of numbers of jobs and impact on household income, very few economic activities have a more impressive effect on a local economy than does the rehabilitation of historic buildings.

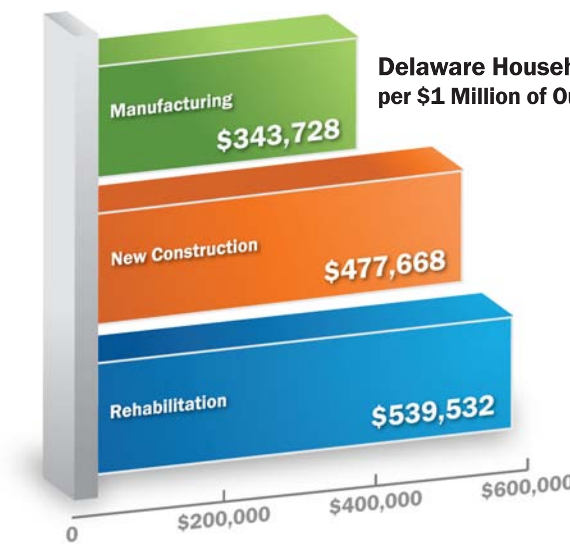


Delaware Jobs
per $1 Million of Output

As illustrated in the first graph, $1 million of output from a Delaware manufacturing firm will generate on average 9.2 jobs. A $1 million new construction project will generate 11.2 jobs. But $1 million invested in the rehabilitation of a historic building will create 14.6 jobs in Delaware.

As illustrated in the second graph, $1 million of output from a Delaware manufacturing firm will generate on average nearly $344,000 in household income. A $1 million new construction project will generate over $477,000 in household income. But $1 million invested in the rehabilitation of a historic building will mean nearly $540,000 in household income in Delaware.

Delaware Household Income
per $1 Million of Output



2 A *job* means one full-time equivalent job for one year.
3 These calculations are based on data from RIMS II, the Regional Input-Output Modeling System created by the Bureau of Economic Analysis of the U.S. Department of Commerce.

Jobs are created both directly and indirectly. In the case of rehabilitation, the carpenter installing cabinets is a direct job, whereas, the salesman at the lumber yard is an indirect job. Correspondingly, the household income can be calculated for both direct and indirect jobs.

The Historic Preservation Tax Credit Program and Good Jobs for Delaware Workers 2001 - 2009

	Direct	Indirect	Total
Jobs	1,347	1,082	2,429
Household Income	$53,529,000	$36,250,000	$89,779,000

So has the Delaware Historic Preservation Tax Credit Program produced measurable economic development? The over 2,400 jobs and nearly $90 million in household income is economic development in anybody's book!

Test Three: The Incentive Significantly Leverages Private Investment

Leveraging is the use of public funds to entice the investment of private funds. Leveraging is the means of cost effectively stretching scarce public dollars. Because Delaware Historic Preservation Tax Credit awards are based on 20 percent of project costs, every dollar of state tax credit generates a minimum of $4 of private investment. In fact, over the life of the credit, the leverage has been even better, generating $4.85 of private investment for every $1 of state tax credit.

But this figure actually understates the leverage. Tax credits are only available based on rehabilitation expenditures. Over the life of the credit, about $34.3 million in tax credits have spurred over $166 million in rehabilitation expenditures. But that number does not include the cost of acquisition, which is not eligible to receive tax credits. If the private investment in acquisition were added to the rehabilitation investment, it is likely that the leverage of private to public dollars would approach six to one.

Some economic development incentive programs hope for, but cannot mandate, private investment. Does the Delaware Historic Preservation Tax Credit Program meet the leverage test? **The state legislature wisely structured the tax credit program so that leveraging is guaranteed.** One cannot receive the 20 percent credit without first making 100 percent of the investment.

Leverage of the Delaware Historic Preservation Tax Credit

Aren't Federal Historic Preservation Tax Credits Enough?

Since the nation's bicentennial in 1976, there has been a provision in federal law for a tax credit for the rehabilitation of historic buildings. While the program has been altered over the last thirty-four years, it remains an effective tool to encourage investment in historic structures. It is fair, then, to ask the question "Isn't the federal tax credit sufficient?"

The answer is a resounding "NO"!

- Federal tax credits were available all through the 1990s yet the amount of activity in Delaware was less than a fourth of what it was once a state tax credit was available

- Federal tax credits are not available to homeowners for their personal residences. Delaware Historic Preservation Tax Credits are

- Non-profits can effectively use Delaware Historic Preservation Tax Credits. It is exceedingly difficult to do so with federal tax credits

- **Nearly a third of projects using Delaware Historic Preservation Tax Credits would not have been eligible for federal credits**

Test Four: The Use of the Incentive Meets the "But For" Test

Fiscally responsible tax incentives should have to meet the "but for" test. That is, "But for this incentive the project would not go forward." The following refrain was heard, time-after-time, in interviews for this report: "We simply could not have done this project if it weren't for the state tax credits." But why is that the case? A simple hypothetical but realistic example can answer that question.

An 8,000 square-foot historic building sits vacant in a Delaware downtown. It is available for purchase for $100,000, but the architect and the general contractor agree that it will take $125 per square foot, or $1,000,000 to rehabilitate the building. A local investor believes that, after rehabilitation, she could get gross rents of $15 per square foot per year, but that half of that would be needed for vacancy allowance and expenses, even before the mortgage payments were made. The local banker is willing to make a loan at 7 percent for twenty years, but needs to know there will be more money coming out of the building in net income than is required to make the mortgage payments.

The Investor's First Analysis:

Acquisition Cost	$100,000
Rehabilitation Cost ($125 x 8000 s.f.)	$1,000,000
Total Cost	**$1,100,000**
Gross Income ($15 x 8000 s.f.)	$120,000
Vacancy and Expenses (50%)	$60,000
Net Operating Income	$60,000
Mortgage Payments ($580,000 @ 7% for 20 years)	$54,000
Cash Flow	$6,000
Total Project Cost	**$1,100,000**
Available Mortgage	$580,000
Required Equity Investment	$520,000
Annual Cash Flow	$6,000
Divided by Equity Investment	$520,000
Annual Cash Return on Equity	1.1%

Investor's conclusion—I'd like to do this project, but it is simply too risky for a 1 percent return. I'll just leave my money in the bank.

Selling the Tax Credits?

If you listen to discussions by developers using Federal Historic Rehabilitation Tax Credits, you often hear the phrase "selling the credits." In fact, federal credits are not a salable commodity; they can only be used by the person or entity who owns the property being rehabilitated. "Selling the credits" is actually shorthand for a complicated and often expensive process of structuring a transaction, attracting private equity investment in exchange for receiving the credits, keeping the investor as "partner" for a minimum of five years, then re-acquiring that equity interest and closing out the partnership entity. A large-scale project with a sophisticated developer, and experienced tax- and legal-counsel can do all of that, but it will be expensive.

For small projects, owner-occupied properties, or non-profits, this process is usually too expensive, too complicated, or both. Fortunately, Delaware Historic Preservation Tax Credits can be directly sold. Credits may be used to offset tax liability from the bank franchise tax, or corporate or personal income tax.

Fortunately, the architect and general contractor have done historic preservation tax credit projects in the past and explain to the investor how those credits would change the analysis.

The Revised Analysis:

Acquisition Cost	$100,000
Rehabilitation Cost ($125 x 8000 s.f.)	$1,000,000
Total Cost	**$1,100,000**
Gross Income ($15 x 8000 s.f.)	$120,000
Vacancy and Expenses (50%)	$60,000
Net Operating Income	$60,000
Mortgage Payments ($580,000 @ 7% for 20 years)	$54,000
Cash Flow	$6,000
Total Project Cost	**$1,100,000**
Available Mortgage	$580,000
Federal Tax Credits (20% of $1,000,000)	**$200,000**
Delaware Tax Credits (20% of $1,000,000)	**$200,000**
Required Equity Investment	$120,000
Annual Cash Flow	$6,000
Divided by Equity Investment	$120,000
Annual Cash Return on Equity	5.5%

Investor's conclusion—This still isn't the highest return imaginable, but considering the importance of that building to my downtown, I'm willing to take the risk.

Why would someone want to sell their tax credits?

There are a number of possible reasons:

- The person might not have sufficient tax liability to be able to use the credits
- The developer is a non-profit organization who has no tax liability
- The developer can use the cash from the sale of the credits more effectively than using the credits directly

Tax credits are typically sold at a "discount," meaning that one would typically receive between $75 and $95 dollars for every $100 of tax credit sold.

The ability to sell the credits is one of the major reasons the Delaware Historic Preservation Tax Credit Program has been so effective.

Good tax policy requires that desired private-sector investment would not take place were it not for the incentive. **The Delaware Historic Preservation Tax Credit Program certainly meets that test.**

Test Five: There Are Significant Benefits of the Incentive Beyond Just Economic Development

The Historic Preservation Tax Credit Program was enacted to save Delaware's historic buildings and to serve as a tool for economic development. Those goals have certainly been met. What the legislators who passed the bill, and the governor who signed it, may not have realized was that they were also putting in place one of the most effective tools for another public policy priority—*Livable Delaware*.

Historic Preservation and *Livable Delaware*

In 1999, Delaware began a far reaching effort to preserve the state's environment while making the most efficient use of taxpayer dollars devoted to infrastructure investment. That policy initiative is *Livable Delaware* and is at the forefront of the national movement known as *Smart Growth*. In 2004, the State Planning Office issued a report entitled "Delaware Strategies for State Policies and Spending." This report both highlighted the accomplishments of the previous five years and effectively laid out the *Livable Delaware* agenda for the next five.

The report identified key pieces of adopted legislation that advanced the *Livable Delaware* agenda. Absent from the list was House Bill One which created tax credits for the rehabilitation of historic buildings. The omission was understandable, in that HB1 was drafted and enacted as an economic development tool. And it certainly has been that.

But it has also proven to be one of the most effective vehicles in implementing *Livable Delaware* goals. How does the rehabilitation of Delaware's historic buildings do that?

Heritage Tax Credits: Maryland's Own Stimulus to Renovate Buildings for Productive Use and Create Jobs

A study of Maryland's historic preservation tax credit concluded that every $1 million in tax credits saves $293,000 in infrastructure investment that becomes unnecessary because growth is accommodated in the existing developed area.

The Abell Foundation, March 2009

Livable Delaware Goals Achieved by the Historic Preservation Tax Credit Program:

1. **Invest taxpayers' dollars efficiently while slowing sprawl**
   Every $1 invested through the Delaware Historic Preservation Tax Credit Program leverages, at a minimum, $4 of private investment. How many historic preservation projects contributed to sprawl? None of them! But more than that...every time 10,000 square feet of a historic building is reused, another acre of sprawl is prevented

2. **Preserve farmland and open space**
   The rehabilitation of a historic building never requires converting farmland into a development parcel. The adaptive reuse of a historic building never means the loss of open space. When a historic building is rehabilitated, farmland and open space are always preserved

3. **Encourage infill and redevelopment that avoids greenfields**
It is axiomatic that the redevelopment of a historic building avoids greenfields—historic buildings are inherently located where infrastructure and public services already exist, and are often already paid for by earlier generations of tax payers. But historic preservation strategies also encourage not just infill, but quality infill. This happens in two ways. First, new construction that is part of a development using historic preservation tax credits has to meet standards for appropriate infill construction. Second, many of Delaware's heritage buildings are within local historic districts that establish design guidelines assuring that infill is appropriate to the historic context of the neighborhood

4. **Facilitate attractive affordable housing**
Affordable housing is certainly a critical need in Delaware. Unfortunately, not all affordable housing is attractive, and certainly not all attractive housing is affordable. But with the use of Historic Preservation Tax Credits, nearly 300 units of housing have been created that are both affordable and attractive. These are units that would likely not have been possible using only federal low income tax credits

5. **Preserve quality of life through sustainable development**
Sustainable Development is a phrase that is widely used, but often too narrowly defined. The international understanding of *Sustainable Development* is composed of three responsibilities: environmental responsibility, economic responsibility, and social/cultural responsibility

We can preserve wetlands and be environmentally responsible...but have no effect on economic or cultural responsibility. We can teach local history in the elementary school and be culturally responsible...but have no effect on economic or environmental responsibility. We can have an equitable tax system and be economically responsible...but have no effect on cultural or environmental responsibility.

But only through historic preservation are we doing all three simultaneously. The Historic Preservation Tax Credit Program advances both sustainable development and quality of life for Delaware communities.

Six Principals for Better Development

"Better Models for Development in Delaware" is a research report commissioned to help implement the *Livable Delaware* agenda.

Six principles for better development were established:

1. Conserve farmland, open space, and scenic resources
2. Maintain a clear edge between town and countryside
3. Build livable communities
4. Preserve historic resources
5. Respect local character in new construction
6. Reduce the impact of the car

The use of Historic Preservation Tax Credits, combined with the design guidelines of local historic districts, meets every one of these principles.

Historic preservation is a better model for development in Delaware.

Every fifth grader in Delaware has learned that saving the environment means reducing, reusing, and recycling. The Delaware Historic Preservation Tax Credit Program is reducing sprawl, reusing infrastructure, and recycling buildings. In fact, **historic preservation is the ultimate in recycling.**

Conclusions

The Delaware Historic Preservation Tax Credit Program works!

A commitment of approximately $35 million in tax credits has spurred private investment of over $166 million.

It has meant over 2,400 good jobs for Delaware citizens and added nearly $90 million in household income.

Dozens of Delaware's historic buildings have been given new life. And this has meant quality space for small businesses, tax revenues for local government, and a renewed sense of pride in local communities.

The Delaware Historic Preservation Tax Credit, enacted as an economic development tool, has become one of the most effective programs advancing the *Livable Delaware* agenda.

In times of economic downturns, financial strains, and budget shortfalls, the citizens of Delaware need programs that work.

The Delaware Historic Preservation Tax Credit Program works!

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