

Certified Public Manager Applied Research

Volume 1 | Issue 1

Article 5

4-23-2020

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Recommended Citation

Whitsell, John. 2020. "Public Improvement Districts: A Worthwhile Investment?." *Certified Public Manager Applied Research* 1, (1). <https://scholarworks.sfasu.edu/cpmar/vol1/iss1/5>

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Public Improvement Districts: A Worthwhile Investment?

John Whitsell
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Executive Summary

Public Improvement Districts (PIDs) are a financing mechanism used to fund new developments and infrastructure improvements. PIDs are relatively easy to create and can be done by the local municipality. A majority of property owners within the district may petition a local government to create the district. Bonds can then be issued to fund a development or infrastructure improvements. Through an industry analysis and view of the current political environment, PIDs are certainly a beneficial mechanism to fund projects otherwise not feasible due to constraints on city budgets. Local elected officials will want PIDs monitored and only used in proper circumstances. This article explores this process through a potential developer.

Industry Analysis

In order to understand exactly where we stand today, we must look at a cross section of several different industries. The banking industry, the housing industry as it relates to new developments, and the current state of municipalities all come together in this discussion. Once we understand how each play a role in the development of our cities, we can then look at how PIDs might impact our future.

The housing market changed drastically when “the financial crisis of 2008 created the biggest disruption to the U.S. housing market since the Great Depression.”¹ Here in East Texas we have a very strong presence of local community banks that take a very conservative approach to lending. We did not experience the full effect of the housing downturn; however, we are experiencing the effect of the downturn when it comes to availability of lending to local developers. David Monk, President/CEO Citizens State Bank, wrote the following regarding the situation:

I believe the sharp economic downturn that became very visible in the third quarter of 2008 revealed deficiencies in underwriting methods employed by many banks across the country, particularly those in states experiencing rapid development growth. Insufficient ‘hard’ equity, coupled with fairly lax lending standards and inadequate appraisal reviews, allowed many development projects to move forward that simply did not exhibit adequate financial or collateral strength to withstand any prolonged period of economic suppression or impairment in cash flow. . . . Balance sheets must show greater liquidity and ability to sustain longer periods of cash flow restriction and higher debt service margins.²

Consequently, if a developer wants to start a new development today, they must be more financially sound than in the pre-2008 market. Liquidity, loan to value ratio and credit history are scrutinized more stringently. Also, the appraisal process has changed completely in order to avoid those situations where inadequate reviews cause under-collateralization.

The 2019 legislative cycle brought additional challenges to local governments. 2019 Senate Bill 2 and 2019 House Bill 2439 have brought challenges to creating infrastructure for new developments as well as taken away some controls the local municipalities have traditionally had. These bills will be addressed more in-depth later. The State Legislature has also made it more difficult to annex new areas into incorporated city limits. Municipalities with populations of under 5000 cannot annex a new area unless through a voluntary request by the property owners.

Public Improvement Districts

Public Improvement Districts were first legislated in 1987 through the creation of Local Government Code 372. The first publicly issued PID was created in 1992. This mechanism for financing and development was not widely utilized until some years later. It was not until 2014 that Texas saw a spike in the usage of PIDs.³ If one made a heat map of current PIDs in the State of Texas, it would show a higher concentration in the very urban areas of the state. They have not become commonplace in more rural areas such as ours here in East Texas.

A Public Improvement District is created when a majority of the landowners in the proposed district vote or petition the local municipality to create the district. Once the district is created, financing mechanisms can be put into place and used for many types of improvements. Typically, bonds are sold, and proceeds are used to fund the associated improvements. Tax collections on associated assessments can also be used to fund projects without the issuance of bonds. These improvements may target streets and sidewalks, public safety and security, water, wastewater, drainage, health and sanitation, landscaping, mass transit, public libraries, parks, recreational and cultural facilities, and/or parking facilities. The municipality may also focus on improving methods of acquisition of right of way, and acquisition, renovation and/or construction of affordable housing.⁴ PIDs can be created in existing neighborhoods or developments for their ongoing maintenance needs or improvements.

Once the district has been approved and created, it takes a team approach to secure financing and then start the development or improvements. This must be viewed as a partnership between the municipality and the developer or the petitioner. The city will have the responsibility of selling the bonds and ensuring that all state laws and reporting requirements are followed. The developer or petitioner will have the ultimate use of the money. There will also need to be other participants throughout the process. The developer and the city will need to employ bond counsel, a financial advisor, a special assessment consultant, an appraiser, and a trustee who will hold the bond funds.

As mentioned earlier, the banking industry has changed significantly. Mr. David Monk mentioned how insufficient hard equity in developments had helped lead to the crash of the housing industry. PIDs generally have a 3:1 value to lien ratio. This will help ensure that developments are well collateralized and do not get upside down. The conservative value to lien ratio should help ease the fears of any council as they consider action on the request to create a new district.

As with everything positive, there are always drawbacks or opportunity costs. The formation of the public improvement district can be very time consuming for staff and elected officials and taxing on the local municipality. Once a public improvement district is put into place, the city is then responsible for ongoing reporting. This is certainly a reason for cities to be leery and not want to subject their employees to the increased workload. Travis County has recently increased the application fee that they charge to create a PID to one hundred thousand dollars.⁵

This fee is meant to cover the staff costs of the initial application and approval process as well as the ongoing expenses throughout the life of the bond repayment period.

Successes and Failures

The increased usage of PIDs has seen both successes and failures. Public Improvement Districts not only can be used to fund new construction and developments, they can also be used to update and fix infrastructure on existing developments and neighborhoods. Following are some examples of successes and failures.

The PIDs created within the City of Celina, Texas have proven to be successful with city growth. The city has seen a huge increase in population and valuation while being able to maintain a steady tax rate. A recent case study presented information as follows:

- City of Celina's Use of PIDs:
 - Eleven PIDs within the City
 - City has issued bonds for all 11, sometimes multiple series
 - Population has nearly doubled since 2010 (to near 18,000)
 - Median household income of \$92,000
 - Average home value of \$429,705
 - Economic growth tool
 - 2014 AV (Assessed Value): \$554,892,312
 - 2019 AV: \$1,886,517,751
 - 336% increase in AV in 5 years
 - Tax rate has stayed constant at \$0.6450 since 2007 I&S (Interest & Sinking)/M&O (Maintenance & Operations) levies have alternated.⁶

Public Improvement Districts can serve functions other than just financing new developments. There are currently PIDs in Grand Prairie, Texas that are used to upkeep and maintain amenities such as screening walls and landscaping.⁷ The writer of a recent newspaper article discusses how a potential homeowner searching for a new house was astonished to learn that the older neighborhoods with PIDs actually looked better than many of the newer neighborhoods that did not have them. These neighborhoods can pay for amenities that neighborhoods not in PIDs cannot because of the lack of city funding. Citizens are buying these homes knowing that they will have to pay a higher property tax rate but are willing to do so because of the extra amenities that are offered. Property owners within PIDs also view their development as more aesthetically pleasing than others.

Farmers Branch, Texas was able to take land that had sat vacant since the 1990s and create a successful development. This particular property had environmental issues resulting from a battery plant that had previously occupied the property. The city provided a PID with a tax increment reinvestment zone to create the Mercer Crossing development. The development has proven to be a success, and two years after the bonds were issued, the developer only retains ownership of about 20 percent of the property.⁸

Not all PIDs are successful. City administrators have the responsibility of informing the city council of the pros and cons of each issue. Sapphire Bay in the City of Rowlett, Texas is a perfect example of a PID coming apart. Sapphire Bay was to be a one billion dollar planned

development with a massive manmade crystal lagoon. The city council and staff worked with the developer to make it happen, but they were never able to make any progress in getting the development started. According to reporter Bill Hethcock, “Rowlett City Manager Brian Funderburk in January called Bayside’s tactics ‘a textbook bait and switch.’ He said the city agreed to economic development incentives, approved density variances, secured state tax support for a convention center and made other decisions based on the initial agreed-upon vision for the project, which changed substantially.”⁹

The City of Rowlett eventually notified the developer that they were in default of the agreed upon incentives. Included in the incentive agreement was the creation of a Public Improvement District. This is a situation that city administrators want to avoid. Rowlett has since been able to revive the project, albeit in a slightly different form, with a new developer.

One other potential problem that we will consider is the ongoing assessment. A new owner may be aware of the increased tax rate when purchasing the home. However, what about the next purchaser, or what about the ability to sell the home altogether? We have seen the housing market change drastically over the last ten to fifteen years. There is no way that we can project what that market will look like in the future. The City of Leander, Texas’s City Council has addressed this to some extent already. Reporter Abby Bora writes the following:

Leander City Council has approved three PIDs since 2014 – Oak Creek, Deerbrooke and Crystal Springs. At a meeting August, 16, 2018, some council members indicated their uneasiness with the way PIDs are implemented after several residents said they were not properly informed of what they were buying into when they purchased their homes.

“City Council has expressed extreme dissatisfaction with the PIDs that are coming forth,” Leander City Council Member Andrea Navarrette said at the meeting. “It just sounds like they’re still not [informing residents]. There has got to be some kind of tool we as council can put in place to make [the developers] abide by.”¹⁰

Situations can arise when home buyers are unaware of the PID and the increased taxes through the assessments. This could make the new homeowner struggle financially. PIDs could cause homes to become harder to sell and possibly creating a negative outcome for someone forced to move. Of course, there is the option to pay off the amount of the assessment in one lump sum. A seller therefore could pay off the assessment at the time of the closing if that would make the sale more attractive to a potential purchaser. This would put all the burden on the original homeowner and not spread it out over the life of the amortization.

New Developments

New developments are very costly propositions. Cities require that any developer build their own infrastructure. This infrastructure consists of water and sewer lines, proper storm drainage, streets complete with curb and gutter, and any other amenities such as parks and recreational areas that may be required through local ordinances. In our area, providing a very simple design of water, sewer, streets and drainage will cost a developer no less than three hundred twenty-five dollars per linear foot. That does not include the acquisition cost of the land, the development costs that go into the design and engineering, or any of the hundreds of other costs that will arise throughout the process.

Developments are also a risky venture. With development costs so high, if the housing market shifts at all, the developer can be left holding the bag and responsible for the repayment of any debt that they have incurred while building the development. As an example, I reference the housing downturn in 2008. Banks tend to get very particular and cautious when lending on new development ventures. The creation of the Public Improvement District can provide the funding needed in order to get the development completed.

In our general geographic area, there are several cities that are experiencing exponential growth. Some cities do not have property with lots available for the widespread sustained growth that occurs in their neighboring cities. New homes are built in areas that are owned and controlled by local developments. Builders do not have the ability to purchase a lot and build a speculative venture home for a prospective buyer. Local developers may want to build a new multi-hundred lot development on land that he currently owns. These developers evaluate the best route he can take in order to get this development to fruition. When city administrators are approached by developers with the words PID and bonds there can be an immediate shut down. If administrators would fully understand the process they can become more receptive to his proposition.

Once the landowner, and usually the developer in the case of a new development, approaches the municipality to create a Public Improvement District, a legal process must begin. Once everything is approved and the district is legally created, the municipality will sell bonds that will ultimately be used for the development. This is the end of the process initially for the municipality as the developer will then take the money and start building.

Through the creation of the district, the developer has shifted most of the financial liability from himself to the new property owners, if each of the new lots are sold as anticipated. At first evaluation, it appears as a way for the developer to make a lot more money. Because of the way that the bonds are repaid, it will cause the tax bill for the homeowner to be increased. Therefore, the long-term costs for the homeowner will be higher than if they purchased a home that was not in a PID. The supply and demand and the amount of home inventory will dictate what the ultimate price of the lot is. If there are areas of the state where homes are being sold faster than they are being built, then the developer can probably charge market rates. At below market rates, the purchaser will have to be willing to incur the additional costs at tax times just for the ability to get in a new home. If there is a more balanced curve of supply and demand, then the developer will probably have to charge a lesser amount for the lots that will be created in the development. The development costs have been shifted from the developer to the property owners, so the developer could lower the lot cost and still maintain profitability.

Once debt is incurred, who has the long-term responsibility for the repayment of the bonds? That falls on the owner of the property within the district. Once the development is finished and the homes are sold, the developer no longer owns any of the land and therefore is not responsible for the repayment of the debt. In a case where a PID is created for a new 300 plus home housing development, then there will be 300 plus new homeowners that are responsible for the annual debt payments. These payments are made through a tax assessment.

Let's assume that a buyer purchases a two hundred fifty-thousand-dollar home in a new development that is in a Public Improvement District. The portion of the debt is twenty thousand dollars payable over the next twenty years. The bonds sold are at a three percent interest rate. This means that your annual payment would be around \$1,118.64 per year and would equate to an ad valorem rate of .4475 per \$100 of valuation. Homeowners that escrow their insurance and taxes will have higher mortgage payments each month. If taxes are paid annually, then you will have to ante up \$1,118.64. The tax rate will vary based upon the valuation of the home. The assessment is

a set amount, therefore if the valuation of the home rises over time the tax rate to cover the assessment will decrease, but the amount due would remain the same.

To sum up the effects to the homeowner, the out of pocket expenses incurred at the time of purchase can be much less than they would normally be without a PID, but the ongoing taxes or escrow payments will be higher. New homebuyers with a lesser amount of savings but a higher income, this could certainly be an advantageous situation. There is another situation, though, where a market price could be paid for a property and could still have to pay the PID. In this scenario, the homeowner would end up paying much more over the lifecycle of the home ownership than if it were in an area that was not encumbered by a PID.

Public Improvement Districts can certainly provide for growth and improvements for any city. Cities should explore the idea of a Public Improvement Districts as scenarios that could be of real benefit. First, it would provide for development within the city. Cities that are begging for buildable lots could use PIDs to get the treat. Secondly, it would increase our tax base and our population. It would also give us a means to provide a structure and some control over the development.

Legislation

The 2019 Legislative session in Texas was not kind to local municipalities. One of the bills passed was House Bill 2439. This bill explicitly forbids cities from regulating certain building materials. The bill, in its own words, “prohibits or limits, directly or indirectly, the use or installation of a building product or material in the construction, renovation, maintenance or other alteration of a residential or commercial building if the building product or material is approved for use by a national model code published within the last three code cycles that applies to the construction, renovation, maintenance or other alteration of the building.”¹¹ This prohibition of the regulation of building materials opens up the ability of a person or builder to not conform with the rest of the neighboring structures. It could also allow someone to possibly build a lesser quality structure in the middle of a development. Through the PID agreement, a municipality can negotiate a development agreement that will once again give them the ability to regulate the type of construction. This should pique interest in learning more about what a Public Improvement District could do for our community in having building standards.

Tax caps have been a hot topic among state legislators for a couple of legislative cycles. In the 2017 legislative session, legislators presented the caps as a means of controlling rising tax rates. This legislation was not successful at that time. The 2019 session was much more successful for these determined senators and representatives and they were able to pass their tax cap legislation with Senate Bill 2. Cities are only able to increase their tax rates three and half percent over their effective rates, (Prior to this legislation the rate was eight percent.) therefore limiting the amount of increased revenue that they may generate.

In today’s world, it is not the norm for a municipality to develop a residential or commercial area for growth. A city may have a vision and create a road or thoroughfare in order to spur a potential development, but the development itself would be up to a third-party developer. Senate Bill 2 probably put a further damper on this type of speculation. We may see the need for Public Improvement Districts evaluated differently as time goes on.

Comparative Analysis

Other financing tools are available that compare to that of the Public Improvement District. There are also ways that one can lay Tax Reinvestment Zones over a PID and then buy down some of the assessments. My main objective in this paper was to only consider PIDs and how they would impact the homeowners and the governmental entities.

A Municipal Utility District (MUD) is another financing tool that is very similar to that of a PID. MUDs are created a little differently than PIDs and have some different requirements concerning repayment. This article advocates PIDs as a more beneficial in the type of new residential development that has been discussed. The PID allows for the city to provide oversight, it is a fixed repayment plan, and it has a defined term. While MUDs are certainly a viable option, they were not the focus of this paper. I have listed a comparison in Table 1.

Table 1

| | PID | MUD |
|------------------------------|--------------|-------------------|
| Entity to Establish District | Municipality | County, State |
| Regulating Entity | Chapter 372 | TCEQ, Water Code |
| District Oversight | Municipality | Independent Board |
| Revenue Collected | Assessment | Ad Valorem Tax |
| Timing of Collection | Annually | Annually |
| Cross Collateralization | No | Yes |
| Ability to Prepay | Yes | No |
| Amount | Fixed | Variable |
| Term | Defined | Undefined |

Source: Sloan and Banner (2019)¹²

Conclusion

Public Improvement Districts can certainly be a positive instrument for developers and municipalities to utilize. There are some pitfalls to mitigate, but a properly structured PID could produce a win-win situation. If there is a clear understanding of what city staff and elected officials must undertake, all parties can come through the other side with a nice new development. If we are to consider this further, we must also consider requiring proper disclosures, advertisements, and announcements to ensure that the new property owner is well aware that they are agreeing to pay a higher tax rate than what the surrounding developments and the rest of the city may pay. If this understood, then the new Public Improvement District should be a success.

Notes

¹Barbara J. Fields, "Here's how the US housing market has been impacted by the 2008 crash," *Business Insider*, February 2016.

²David Monk, e-mail message to author, October 31, 2019.

³ Drew Sloan and Linsay Banner, *What's So Funny 'Bout PIDs, Love and Understanding?*, Westin Riverwalk Hotel, October 9-11, 2019 (San Antonio, Texas: Texas Economic Development Council, 2019).

⁴ Rick Rosenberg and Bob Springer, "Enhancing Project Profitability Utilizing Public Financing," *Central Texas Commercial Association of Realtors*, October 25, 2017, https://cdn.ymaws.com/www.ctcaronline.com/resource/resmgr/docs/Public_Financing_Presentation.pdf.

⁵ Drew Sloan and Linsay Banner, *What's So Funny 'Bout PIDs, Love and Understanding?*

⁶ Ibid.

⁷ "Texas' public improvement districts can boost neighborhoods, at cost of extra taxes," *Dallas Morning News*, January 22, 2010, <https://www.dallasnews.com/news/2010/01/22/texas-public-improvement-districts-can-boost-neighborhoods-at-cost-of-extra-taxes/>.

⁸ Drew Sloan and Linsay Banner, *What's So Funny 'Bout PIDs, Love and Understanding?*

⁹ Bill Hethcock, "Rowlett re-launches \$1B-plus Crystal Lagoon development," *Dallas Business Journal*, August 2, 2019, <https://www.bizjournals.com/dallas/news/2019/08/02/rowlett-crystal-lagoon.html>.

¹⁰ Abby Bora, "Leander council questions public improvement districts," *Community Impact Newspaper*, October 16, 2018, <https://communityimpact.com/austin/leander-cedar-park/city-county/2018/10/16/leander-council-questions-public-improvement-districts/>.

¹¹ Texas Legislature, House of Representatives, HR 2439, 86th Legislature, passed June 14, 2019, <https://capitol.texas.gov/tlodocs/86R/billtext/html/HB02439F.htm>.

¹² Drew Sloan and Linsay Banner, *What's So Funny 'Bout PIDs, Love and Understanding?*