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# INNOVATIVE INSTRUMENTS TO FINANCE URBAN DEVELOPMENT IN COLOMBIAN CITIES

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## EXECUTIVE DOCUMENT

### COLOMBIA: FINANCING INFRASTRUCTURE FOR URBAN REDEVELOPMENT

CO FINANCING INFRASTRUCTURE FOR URBAN REDEVELOPMENT (SNTA)  
PROGRAM (PHASE II) TO DEVELOP A TAX INCREMENT FINANCING (TIF)  
INSTRUMENT IN MEDELLIN, COLOMBIA

#### **PROJECT P160485| TFOA2865**



May 2020

World Bank – PPIAF, Public-Private Infrastructure Advisory Facility  
Urban, Disaster Risk Management, Resilience, and Land Global Practice  
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## Introduction

### 1.

Since 2011, through the **Colombia: Financing Infrastructure for Urban Redevelopment Sub-National Technical Assistance Program**, the World Bank has helped the Government of Colombia to structure innovative instruments to leverage private finance for urban infrastructure and urban redevelopment projects. This support included the use of TIF as an instrument to finance urban renovation knowing its potential to channel funding to areas that otherwise would not be subject of private or public investments such as low-income neighborhoods, abandoned transport stations, or high polluted industrial areas.

### 2.

**TIF is a land-based finance instrument commonly used in the United States to turn underutilized land into more productive uses.** However, legal, administrative and market conditions of cities in United States differs from Latin America case. Supporting a pilot program in Medellin, Colombia, the Bank's technical assistance analyzed these differences for the Colombian case, the TA identified the legal, urban technical, and financial aspects that allow them to be overcome and support the development of the TIF instrument in the country. The Result has been for the first time in LAC, the development of a regulatory framework for TIF in Colombia and an eligibility criteria for cities to use TIF. Also, the definition of a road map for cities willing to implement the TIF as an instrument to finance specific urban redevelopment projects.

## What is TIF and how it works

### 3.

**Tax increment financing (TIF) is a land-based financing instrument that enables local governments to use the additional expected income from taxation during a period on a designated territory to finance investments needed in urban infrastructure.** Projects are structured based on future tax revenues resulting from the development of a specific area and the revenues produced above a specified baseline property value established at the inception of the project.

### 4.

**Local governments can use TIF for a specific project or a designated area. When there is an absence of financing, TIF can allow a project to reach financial closure or to use an off-balance instrument as an opportunity to lessen the fiscal impact.** The TIF mainly complements the traditional financing instruments promoting urban development and allows carrying out long-term development projects. It enables the articulation of the public and private sector, where the local government leads the investment and leverages resources from the private sector, and it can be considered as an instrument that promotes the depth of capital markets in municipal financing.

### 5.

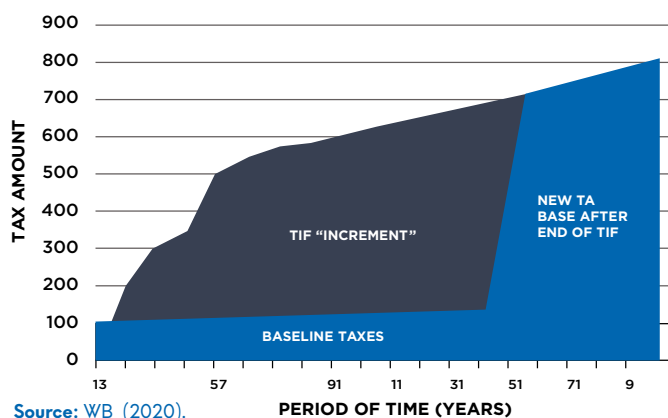
**TIF provides an innovative alternative to use tax income for investments.** The estimated increase in land value resulting from a proposed package of public infrastructure investments and private investments in

real estate development, is captured through property (or other) taxes in the redevelopment area. Local government can issue bonds backed by a percentage of the projected future revenue (tax collection) within the designated geographic area in order to raise the resources needed for the public infrastructure at the time the project begins. Bond proceeds pay for present-day public improvements, creating the economic conditions that lead to the incremental increase in tax revenue. Advanced TIF structures can also be set up to securitize other projected revenue streams, including hotel occupancy taxes (e.g. tourism-oriented redevelopment), sales taxes (e.g. retail-oriented development), parking taxes, income taxes, and/or development fees. (WORLD BANK, 2014)

## 6.

TIF implementation starts with the local government establishing a "TIF District", which is a geographic area whose purpose is to "capture" (a portion of) the increases in the value of the property tax derived from new investments in infrastructure. These resources are collected into a specific fund and are committed only to the repayment of TIF debt obligations. To develop a TIF, the local government uses the value of the property on a specific date as a baseline. Local governments set a period for the TIF, over which all the expected increases in the value of the property relative to the baseline, are going to be considered the income that can be reinvested in public infrastructure.

Figure 1: Basic Tax Increment Financing Model



Source: WB (2020).

## Colombia as a Case Study Why Colombia?

### 7.

Colombia has experienced a rapid urbanization process resulting in over 75% of the population living in cities today. Nowadays the country has 57 cities whose population ranges between 100,000 and 1 million people, and there are six cities with more than 1 million inhabitants (MVCT, 2017). It is estimated that by 2050, over 85 percent of Colombia's population will live in urban areas, bringing 20 million new urban dwellers demanding infrastructure, urban services, jobs and improvements in quality of life.

### 8.

The need for large infrastructure investments exceeds the budgets available. National Government has been supporting municipalities to explore new instruments and strategies to finance urban infrastructure. It is estimated that over the next 25 years a municipality in Colombia with a population with over 1 million inhabitants will require US\$107 per capita (Sistema de Ciudades DNP, 2014). Between 1993 and 2006, over 80 percent of infrastructure investments in urban services such as water, sanitation and transport were financed solely with public funds (AFD, 2014).

### 9.

Colombian has a strong legal and institutional framework conducive to the use and development of innovative financial instruments for cities. Through its

principal regulation, Law 388 of 1997, Colombia has created a national and local framework for the definition of Land Value Capture (LVC) instruments which include land management and urban financing instruments.

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## 10.

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**Colombian legislation provides basic elements and a wide array of urban development instruments that enable cities to use tax increment financing for urban infrastructure.** Legislation (i) provides municipal autonomy in property tax management, including granting tax exemptions and discounts, (ii) allows municipalities, with the authorization of municipal councils, to acquire and issue debt (municipal bonds) earmarked for investments in infrastructure, (iii) allows public infrastructure financing partnering with private sector, (iv) cities are fully independent to promote urban development plans using partial plans, (v) municipalities have created strong institutions that act as urban operators with budget and legal autonomy to transact in land, invest in the territory and define mechanisms to include public and private capital for project development and for bond emissions.

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## 11.

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**For TIF implementation, the National Government is currently in the process of issuing a decree for TIF use of cities in Colombia.** It is expected to be enacted by June 2020. Law 388/1997 also allows for medium-term territorial planning instruments or partial plans (PP) that permit the development of new areas and the re-development of deteriorated or strategic areas.

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## 12.

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**Main cities in Colombia have a steadily growth real estate market and there is interest from developers and the private sector to partake in these types of instruments.** The construction sector accounts for 6,5% of the national GDP (DANE 2018) and shows the highest annual growth rates compared to other sectors, such as services or mining. Colombia’s property market has experienced a strong house price growth over the last thirteen years. Interest in large-scale urban projects involving services, offices and retail, has skyrocketed in the main cities, in particular those with mass transportation systems (metro, Bus Rapid Transport System –BRT-).

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## 13.

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**The cadastral system in Colombia is sufficiently advanced to enable the main cities to accrue future revenues and to capture land-value increments.** In larger cities such as Bogota, Medellin, Barranquilla and Cali, cadasters (which are independent) are efficient and reliable enough to back TIF operations. A Multipurpose Cadaster is currently being conducted with a view to updating the cadastral system of over 300 municipalities in its first phase.

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## 14.

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**The Colombian financial legal framework has been effective for the adequate fiscal and the macroeconomic management of the country but still holds obstacles to municipalities on other actions.** Cities still face autonomy limitations on debt management, centralized approvals for the use of financing instruments and legal limitations for SPVs to capture resources such as property taxes. Due to these restrictions, the cities started to consider instruments such as the TIF that are off-balance, allowing municipalities to manage their debt capacity and provide flexibility for the use of financing mechanisms (such as securitization).

## The Project – The Innovation District of Medellín

# 15.

**Medellin is a large urban metropolis that has become and urban innovator in the Region.** Because it is surrounded by mountains, the city is constrained and faces a shortage of urban land that has forced it to seek densification and a more efficient use of the existing serviced land. To develop this consolidated urban growth model, the city proposed two urban large regeneration projects in the old center of the city “Macro Project of the Medellín River” and “*Macro Project of the Innovation District of Medellín*”. These projects are located in areas that are fully served by basic urban infrastructure, are relatively low density and have not been renovated in decades.

# 16.

**Medellin has urban development and innovation agencies that guarantee the execution of strategic projects.** The Urban Development Agency of Medellín (EDU) is responsible for urban redevelopment planning and projects, land management (land assembly and land readjustment, among others), and execution of social infrastructure housing projects. The Innovation Agency of Medellín (Ruta N) is a public-private corporation created by the City of Medellín, the utility company EPM and the telecom company UNE to promote local economic development through science, technology and innovation.

# 17.

**The Innovation District of Medellín (IDM) project is a downtown district to create a new hub for innovation and high-tech industry, including mixed-use land and affordable housing.** EDU and Ruta-N formulated the 4 urban guidelines for the IDM: Sevilla, Chagualo, Jesús Nazareno, and San Pedro. The IDM master plan included the redevelopment of 180 hectares targeting to develop 1.4 million sqm over a 12-year period included in 4 partial plans. The development plan includes 600,000sqm for housing (almost 30% affordable housing), and 600,000 sqm for commercial use.

# 18.

**The dimension and size of the IDM project, the tight constraints of urban regulations vis-à-vis its development and the cost of infrastructure and land, limited financing and the execution of the Project.**

Figure 2: The Innovation District of Medellín



Source: EDU, Ruta N,

According to the market analysis, profitable land uses of the IDM included services, office and commercial areas; however, 50% of the total development area of the IDM was defined for social housing, without the mixed-use that would improve the project’s selling conditions. For the area to be redeveloped, the project requires major public infrastructure investments in order

to be feasible. Therefore, the city considered including the assessment of other financing sources, such as TIF, which may guarantee the project’s financial closure and the participation of private capital in financing the project’s supporting infrastructure.

## 19.

In a first phase (2014- 2016), the Bank, the City and the national government conducted a step-by-step analysis to assess the pre-feasibility of implementing a Tax Increment Financing operation in the IDM. Conducting a real estate market analysis and estimating the potential tax increment revenue arising from the proposed real estate development, the study recommended to scale down the project to approximately 950,000 sqm considering the potential demand. It also recommended defining scenarios for the project development in short-, medium- and long-term phases.

## 20.

In a second phase (2017-2020), the support provided by the Bank, delimited the TIF District, the scenarios for the issuance of a bond and adjustments to be made on the legal framework to allow the development of the instrument.

**Table 1: Characteristics of the TIF District**

TIF District Area	
Developed Land Area	26,700 sqm
Number of UAU	45
Proposed Development	419,986 sqm
Development Period	16 years
Land Use (Residential)	121,000 sqm
Land Use (Retail)	38,000 sqm
Land Use (Offices)	225,000 sqm
Land Use (Industrial)	62,000 sqm
Total Cost of the Project	US\$ 860 M
Total Sales of the Project	US\$ 1,170 M

Source: EDU, Ruta N,

Redefinition of the IDM project included: i) the delimitation of the TIF District or area, ii) the prioritization of strategic projects and execution scenarios, iii) the TIF District’s pre-feasibility considering the small-scale catalytic projects within the District, iv) the estimation of the TIF District Bond and the potential issuance scenarios and, v) the guidelines for the urban operator/SPV to manage the cash flows generated by the project.

**Figure 3: The TIF District of the IDM**



Source: EDU, Ruta N,

## 21.

Within the Innovation District of Medellin Project, the city has prioritized an area of 26 hectares divided into 45 strategic areas (Urban Development Units-UAU) to create the TIF District. The criteria to define these units were: i) number of units that guarantee the financial closure of the real estate project, ii) areas where landowners have approved the land’s development, iii) units with provision of public services and networks. The project was set to be developed in three phases: phase 1 composed of 8 UAU (2021-2024), phase 2 composed of 13 UAU (2021-2030), and phase 3 composed of 24 UAU (2024-2035).



# 22.

For the TIF District, the pro forma / financial model of the Project was adjusted from the “Project Finance” approach, in which the financing phases were associated with the implementation phases in the short, medium and long-term scenarios of the Project. The value of sales and costs of the project, and the availability and real capacity of public resources to finance the project's infrastructure showed the city did not have the resources to finance the costs of the infrastructure of the main network and the social management for the land of the TIF District, which require direct investment in the short term, and guarantee the launch of the project. The city decided to allocate the TIF resources in two main uses (i) investment in residential water public service and (ii) social compensation for the land acquisition process to enable flexible infrastructure in order to avoid full-fledged gentrification in the area.

## Financing the Project - TIF Structure of the IDM

# 23.

Estimation of incremental tax revenues and TIF duration used the cadastral base presented in 2017 for the TIF

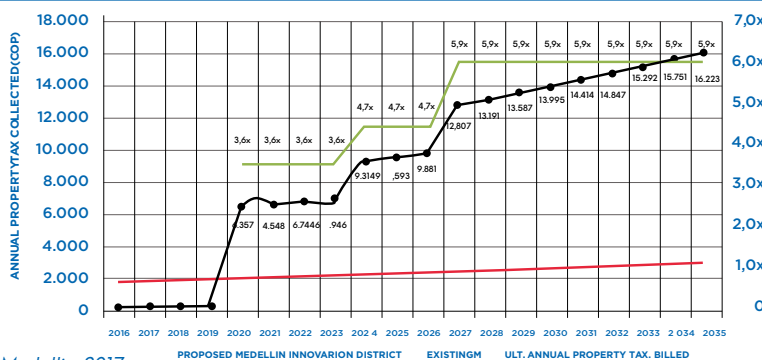
District of the IDM. The city of Medellin defined a base-line based on a collected amount of US\$397,000 for 2017 and a growth rate of 3%. Considering this growth, the TIF-District could raise US\$9,25 million by 2035. However, with the development of the project, the city calculated a property tax collection during the same 16 years of US\$48 million, representing an increase of 418% concerning what was collected if the project was not developed (EDU,2017)

# 24.

The city defined a TIF for a 16-year term from 2021 to 2035 which it would use to raise tax increment financing, through financing by phases. The analysis carried out by the city was based on three phases: short (8 projects), medium (13 projects), and long-term phases (24 projects) for a total of 45 units over 16 years. For each phase, what would be collected by internal and external urban costs of the units of square meters of each project was calculated, and what would be collected by the property under that phase was projected. During the first execution stage, the municipality is expected to capture 3.6 times above the base, 4.7 times above for the second emission, and 5.9 times above base for the third phase base<sup>1</sup>. Figure N5 presents the cashflow annual property tax collected by Medellin in the TIF District.

1. This increase, which is above the property base, was defined as the future cash flow of revenues resulting from the project and city assume as the repayment resources for debt obligations (bonds).

Figure N5. Cashflow Annual Property Tax Collected – TIF District of IDM



Source: City of Medellin, 2017.

## 25.

**Due to the size of the project, the TIF financial model calculated two possible emission scenarios were analyzed for the same 16-year period.** The short-term scenario corresponds to the issuance of the first phase of the IDM TIF District, encompasses only the priority projects that the City believes can be redeveloped in a short timeframe - Route N2 and the three identified priority UAUs. The long-term scenario is based on a larger TIF size that encompasses the identified 45 re-development units on 26 hectares and the infrastructure costs of the total project<sup>2</sup>. A financial model created by the city of Medellin concluded that secured financing<sup>3</sup> will allow the transaction to attain more financially attractive. Considering a conservative scenario with a tax increment of 50% of the property base (JLL, and Rebel) studies recommended i) for the short-term scenario, in the 16-year period, the maximum capacity of the Bond corresponds to US \$ 16M. and ii) for the long-term scenario, in the 16-year period, the maximum capacity of the Bond corresponds to US \$ 22M.

## 26.

**Due to a lack of municipal's legal and regulatory framework for this innovative instrument, the project conducted a legal analysis to explore ways to ease this restriction.** It concluded that: i) a TF (Trust Fund) mechanism could be used to separate the additional tax revenue from the general city property tax income that would be linked to the issued Bond, ii) this would require the temporary exclusion of the additional income from the general income of the city to avoid registration in the city's budget, iii) this temporary exclusion would require approval from the Ministry of Finance and Public Credit because there is no legal framework currently in Colombia for such structured finance transactions, and iii) that due to the restrictions of the municipal debt from the national regulation it is convenient that the issuance of a TIF bond could be done as an off-balance sheet. Discussions around these restrictions

emerged also in certain criteria of projects to be developed by cities using TIF. These discussions also concluded on the relevance of having a possible partial or complete guarantee for bond issuing according to the opinion of the market.

## Results to Date

## 27.

**The project resulted in the first national and subnational legal and technical framework for the use of TIF by subnational for urban infrastructure in Colombia and in Latin America.** The national legal framework that was established under this project was born as a response to the limitations for municipalities to consider instruments such as TIF as an option for financing. The framework consists mainly of two important elements. The first, the National Development Plan (2018-2022), included an article to allow the use of instruments such as TIF to finance urban renewal projects. This article states that municipalities can finance urban infrastructure during the period required by capturing the future anticipated increase in tax revenues generated by the improvements in specific areas in which municipalities collect property taxes. The second, after several technical discussions among national entities and local governments, a draft of the decree was developed. The main elements covered by this decree are: i) the efficiency criteria of the unified property tax collection that must be met by the territorial entities, ii) the procedure to allocate the property tax delta to the SPV, and iii) the minimum requirements ( pre-feasibility) to be met by an urban redevelopment strategic project to use TIF . This decree is in process for approval by the Government of Colombia.

2. Main pros of this scenario include, larger transaction size makes it more attractive from a financial point of view, taking into account that transaction costs are relatively fixed. Main cons of the scenario include, larger size TIF means that more redevelopment will be needed to repay the financing. If there is a high level of uncertainty that some of the redevelopment will not occur within the estimated timeframe.

3. A TIF instrument that benefits from a government backstop has the full faith and credit of the respective government or an unconditional guarantee secured financing.

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## 28.

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**The establishment of eligibility criteria at the project and city level for the implementation of a potential TIF was the second relevant outcome of this support provided to Colombia and the city of Medellín.** These criteria are included in the decree and state: (i) only some cities can use the instrument (category 1 and 2 under Colombian classification); (ii) only cities with a direct cadastral management or through a Territorial Associative Mechanism; (iii) only cities that comply with efficiency criteria in the unified property tax collection and; (iv) only projects that are considered Urban Regeneration Strategic Projects and that are included in both municipal planning instruments (POT) and PDT (Local Development Plan). Finally, a roadmap for municipalities was developed to support eligible cities to develop TIF instruments.

### Lessons Learned

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## 29.

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**A project financing approach is needed to guarantee the transformation of urban renewal areas.** In the Colombian case, the allocation of resources for the development of big scale projects is carried out by separated sectors (water, waste, infrastructure or housing). Because, there is not a specific funding source for urban redevelopment, it is not possible to guarantee the total execution of the project. For this reason, it is needed the definition of instruments that guarantee financing the gap not covered by each sectors funding source.

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## 30.

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**For the optimal implementation of urban financing instruments, it is important that urban redevelopment projects apply a project financing approach in their formulation.** In the Colombian case, project structuring tools must be included as part of the formation of the small-scale planning instruments (partial plans, UAUs, others), with a view to being strategic in their execution.

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## 31.

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**In order to develop these instruments, it is pivotal to have solid urban development projects, which ensures their long-term feasibility<sup>4</sup>.** When structuring the instruments it is important to make sure that they are grounded on updated databases (cadasters), they are located in cities with a solid real estate market and possess the fiscal capacity and maturity to handle financing instruments (bond issuances, among others), and the capability to assess their infrastructure networks for development.

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## 32.

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**The financial analysis of the project must incorporate a solid risk analysis associated with the real estate project.** Identifying which risks are inherent to the development of the real estate project and which are risks inherent in the financial instrument allow for greater certainty in structuring and therefore security against the instrument. It is also important to identify which project risks are relevant to the TIF (uncertainty in the execution

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<sup>4</sup> In Colombia, the project's financing strategy is based on the "Distribution of Costs and Benefits" of each partial plan, which complicates the IDM's integrated planning and financing. Since each PP has an independent strategy, the IDM does not develop a comprehensive financial strategy, with a "project finance" approach that would compare the project's total costs (land, infrastructure, compensations, equipment) to the project's total revenues (sales, taxes, rates); therefore it does not specify: i) the construction of databases and information for the entire IDM area (market surveys, land appraisals, infrastructure costs, among others), ii) the type and cost of the main infrastructure (water supply, sewage, electricity) and the land management needed for the development of the IDM's total area, and iii) the updated market survey measuring the actual absorption capacity of the real estate development throughout the IDM's area.

of the project development stages, others), and what additional risks are created by the TIF, for example, those related to debt issuance and market appetite. A robust financial analysis will allow more predictable estimates, resulting in greater confidence in the project for the developer and investors.

## 33.

**At the local level, the methodology for the selection of strategic projects, as well as the planning instruments should include financial strategy as part of urban projects formulation.** TIF design requires of: i) clear urban project approval mechanisms (agency participation, city council approval, mayor's leadership), ii) the maturity of the municipality's finances (cadastral base update, tax collection efficiency, healthy municipal finances), iii) and clear TIF approval and implementation mechanisms. (definition of the GAP, approval of the allocation of the delta, creation of the issuer SPV, among others).

## 34.

**It is also essential to strengthen local government agencies (development agencies, urban operators, among others) that will back the development, and have clear rules on the participation of private sector.** For the development of the projects that supports the TIF bond emission, it is important to reinforce institutional arrangements that will guarantee private investments (SPV, PPP, among others). Also, aggregation and economies of scale for project developments must be ensured for the issuances (National second tier development banks such as Findeter or Enterritorial could support this idea).

## 35.

**This type of instrument is for cities with robust, technical, financial and market capabilities.** TIF is designed to be applied in solid urban redevelopment projects and to cover urban infrastructure of projects; it should be considered for development projects associated with reconversion of deteriorated areas, stations of the TOD transport system, others.

### Next steps for Medellin would include

## 36.

i) Implementation of the decree that allows the articulation of the payment source (revenue) to the project, ii) identify the need and sources of guarantees to mitigate possible financial risk or other risk mitigation measures, iii) implementation of the organizational structure for project management, and iv) structuring of the bond emission.

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