

# Capital Steps: Creative Financing Alternatives for Governmental Units

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Most state and local governments are struggling to make the most of limited resources. As author Michael Claytor explains, an increasing number of governments are leveraging the talents and resources of the private sector to provide cost-effective financing for critical capital improvements.



Cash-strapped governments are continually searching for alternative financing sources for schools, roads, utility projects, parks, and other capital improvements. Many of the most innovative solutions involve public-private partnerships (PPPs).

Partnering with private businesses offers many benefits. In addition to helping solve budget dilemmas, PPPs allow a government to tap the private sector's cost and operating efficiencies, technology, and know-how. They also provide an opportunity to spread the risk associated with a project.

This article reviews some of the traditional approaches to government financing, describes several examples of PPPs, and outlines some of the tax and public policy issues a government should consider as it weighs its options.

## Traditional Approaches

Traditional capital financing approaches include:

- Grants;
- Pay as you go;
- Cumulative funds (reserves); and
- Debt.

A limited amount of grant money may be available from the federal or state government, or from certain private organizations. Although grants are usually the cheapest source of funds, they are far from free. Applying for a grant can be costly and time-consuming, and, in many cases, grants come with conditions that increase the cost of a project. Also, even if a grant is awarded, obtaining the funds can take time.

The pay-as-you-go approach, which relies primarily on current tax and fee

revenues, often is appropriate only for smaller capital assets, such as computers, vehicles, and certain communications equipment. Although this approach avoids the cost of borrowing, using it for larger capital projects may divert funds away from other critical services.

Building up reserves to pay for future projects may appeal to one's sense of financial responsibility, but it raises some economic and public policy concerns. For one thing, if inflation outpaces the interest earned on accumulated funds, it may be cheaper to borrow.

From a public policy perspective, when a cumulative-fund approach is used for long-term capital projects, constituents may object that their tax dollars are going to projects that will primarily benefit future generations of taxpayers.

Long-term debt financing is often the most effective approach for funding

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larger capital projects. By taking advantage of tax-exempt financing, a government can keep borrowing costs low. And because the debt is paid over time, the obligation is spread over the generations of taxpayers the project is designed to benefit.

In some cases, a capital project benefits a specific group of users. For example, a new sewer plant may be needed to service an industrial park that is being developed. Several financing techniques shift some or all of a project's costs to its beneficiaries. Examples include impact fees, user charges, and tax-increment financing.

### Public-private Partnerships

PPPs offer a wide variety of creative financing alternatives for governments with limited resources. They make it possible to meet the community's critical needs by sharing the financial burden and risk with private enterprises. Here are a few examples:

**Build-operate-transfer (BOT) arrangements.** In a typical BOT arrangement, the government engages a private sector partner to build a facility according to agreed-upon specifications. The private partner usually finances some or all of the project's cost.

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Once the facility is complete, the partner operates it for a specified period of time, recovering its investment plus a reasonable return through user charges. At the end of the contract period, the government takes over the facility's operation.

A BOT arrangement allows the government to take advantage of the private sector's construction efficiencies, which in most cases means lower construction costs and faster completion times.

**Sale-leaseback.** In a sale-leaseback transaction, the government sells an asset to a private partner and then leases it back. Like a mortgage, it allows the government to tap an asset's equity and use the proceeds to finance other projects.

One creative use of the sale-leaseback is to provide funding for a project that is difficult to finance. Suppose, for example, that an important project is delayed because financing is unavailable until the government obtains clear title to the land. One solution is to do a sale-leaseback of another asset, generating cash that will allow the project to move forward without the ability to finance the subject property.

In some cases, a sale-leaseback allows a government to limit its potential liability for environmental or other risks by transferring ownership to another entity.

**Long-term lease.** This technique allows a government to unlock substantial amounts of economic value tied up in income-producing assets. A private sector partner pays a fee upfront for the right to operate the facility for as long as 99 years. In exchange, the private partner keeps whatever profits the facility generates over the lease term.

Famous examples of this approach include the Indiana Toll Road, which generated \$3.85 billion for a 75-year lease, and the Chicago Skyway toll bridge, which brought in \$1.8 billion for a 99-year lease.

Long-term leases can do wonders for a government's cash flow, but they should not be viewed as a panacea for all of its budget woes. When equity is extracted from a long-lived asset, the proceeds generally should be invested in projects that will provide long-term benefits to the community.

### Capital Issues

PPPs offer an appealing financing alternative, but they also raise some important issues to consider. One potential drawback is that the government must relinquish some control over the project. And there may be public resistance to a PPP project, particularly when critical services are involved, if people believe a private partner would sacrifice quality or safety to boost profits.

Tax issues may also play a role. Governments have an advantage when it comes to debt financing because of their ability to issue tax-exempt bonds. In many cases, this enables them to borrow at lower interest rates than those available to the private sector. When a PPP project is financed in part by tax-exempt bonds, there is a risk that they will be deemed "private activity bonds."

Tax-exempt private activity bonds are permitted only in limited circumstances and may be subject to a statewide volume cap. A bond is deemed a private activity bond if there is too much "private business use" of the facility coupled with "private payment" for the project being financed.

The rules are complex, but in general, an analysis must be done if private business use or private payment exceeds 5 percent of the project, or if private payment exceeds 5 percent of the payments on the financing.

The parties to a PPP can avoid these rules with a carefully structured management agreement that complies with strict regulations governing the agreement's term and compensation provisions. In some cases, however, tax-exempt financing of a PPP is not possible. For example, the management agreement regulations limit the agreement's term, so the Indiana Toll Road and Chicago Skyway projects could not have been structured that way.

### Creative Thinking

The potential strategies for partnering with the private sector are practically unlimited other than restrictions imposed by state law or local regulation. With a little creativity and an understanding of the public policy, tax, and legal issues, governments can leverage the private sector's talents and resources to meet their financing needs.

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