CAPITAL FINANCE

Are there effective public-private strategies for building early care and education facilities?

Background

The most significant barrier to child care facilities development is the lack of access to capital resources. The capital cost of developing an appropriately designed and equipped child care facility is high: roughly $15,000 per child.[1] But few child care programs, especially those serving lower-income neighborhoods, are able to pay for an investment of this scale, since public reimbursement rates and parent fees are not sufficient to cover the full cost of quality care.

Most child care programs struggle to generate sufficient revenues to pay for all of their operating needs like staff, training and supplies. Securing additional funds to purchase or renovate facilities seems impossible. Instead most child care programs rely on low-cost, donated or surplus space that was constructed with a different purpose in mind. Even when the capital resources are available, few providers have the organizational capacity or technical expertise to adapt a building for child care use.

Financing Approaches

Since revenue streams are so limited, most child care programs have historically cobbled together a patchwork of **grant** funds for any needed capital investments. Some states, like Arkansas and Vermont, as well as local foundations, have offered small start-up grants for new sites. Certain states, including Connecticut and Minnesota, have provided larger grants through **general obligation (GO) bonds**. Grants like these can reduce the cost of making improvements, but one-time capital grants are hard to raise and seldom substantial enough to provide a sufficient capital subsidy relative to the total project cost.

Another way to raise grant funds or equity is through **tax credits**, such as the federal Low Income Housing Tax Credit, Historic Tax Credits or the newly introduced New Markets Tax Credit. With this approach, the public sector offers a credit on taxes owed to generate private sector investment in projects. The most promising tax credit for child care facilities is the Housing Credit, thanks to a recent change in federal law that allows the program to finance a portion of the cost of a new facility in or near a housing project.

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[1] The U.S. General Services Administration, which developed 100 child care centers in Federal office buildings, found that the child care space cost 43% more to construct than the rest of the building in which it is located. This is because of the amount of plumbing, child-sized fixtures, protective finishes, built-in cabinetry and other features that contribute to a high quality children's space.

Generally, however, tax credits are complicated for child care providers to understand and use, and have high transaction costs that cannot easily be supported by small, tightly financed child care projects. Several states have also introduced tax credits to induce employers to create child care for its workers on site or nearby, but these credits have been small and not widely used.

Given the high cost of facilities and the fact that they are long-term investments, **loans** should be part of any capital investment strategy – to spread the cost over the asset's useful life. The Community Reinvestment Act (CRA) has motivated banks to consider the financing needs of child care programs in lower-income communities. But banks only make loans that are viable and profitable, and most providers cannot meet their strict underwriting requirements because of thin operating margins, year-to-year revenues and weak collateral.

Credit enhancements, or **loan guarantees,** can reduce the risk of making loans and so can be part of a financing package for conventional lenders who are very risk averse. However, if a loan guarantee is the only strategy, and is not coupled with a source of appropriate capital subsidy, it is not likely to have a major impact on facility development. A more effective approach would be to link loan guarantees with a child care operating subsidy **rate enhancement** for providers seeking to build or renovate a facility. This could induce private banks or other lenders to invest in facilities both by ensuring that providers can generate the revenues necessary to repay each year and by guaranteeing at least part of the loan as extra insurance. If rates were augmented over a period of years, resembling a long-term contract, it would greatly increase the likelihood that a bank would be willing to make loans for child care facilities, and guarantees would not be necessary.

A number of states have also started their own direct loan funds, but have encountered low demand by providers and major challenges in administration. As a result, some governments (along with banks and foundations) have instead invested in facilities funds managed by specialized **nonprofit community development lenders** – many of whom are members of the National Children's Facilities Network. These development "intermediaries" have historically helped community organizations to rebuild the affordable housing stock of hundreds of low-income urban and rural areas, and are now providing low-interest loans to the child care field with more flexible criteria than private banks. Intermediaries bring their management capacity and lending expertise to the table, and enable the public sector to leverage private sector resources. In addition, nonprofit facilities funds provide intensive and specialized technical assistance and training to help providers undertake complicated and time-consuming facilities projects. Perhaps most important, intermediaries work to stimulate systems change to address the underlying conditions that contribute to the lack of appropriate facilities – by improving child care revenue streams for debt repayment, and introducing sources of capital subsidy to the field.

The most successful supply-building programs have involved a combination of grants and debt capital, ideally by joining together the resources and expertise of public and private partners.

One of the most exciting new areas of child care facilities finance is **501(c) 3 revenue bond debt.** The State of Illinois, working with the nonprofit Illinois Facilities Fund, agreed to pay the debt on a $12.7 million revenue bond to fund the construction of seven new centers serving 1,385 low-income children. With technical assistance from the Local Initiatives Support Corporation, the State of Connecticut expanded this model by committing $2.5 million a year to support 80% of the debt on $41 million in child care revenue bonds to finance 22 facilities.

This **"debt service support"** model was implemented on the local level through a partnership with the nonprofit Low Income Investment Fund. The City of San Francisco earmarked $10 million of Section 108 borrowing authority under the Community Development Block Grant (CDBG) program[2] and pledged general funds to repay 80% of the debt on these loans –generating both a pool of debt capital, and a viable debt repayment strategy.

The experience to date suggests that:

- Public-private partnerships – including lenders, philanthropies, public officials and child care practitioners and advocates – can most effectively combine resources and expertise.
- Successful supply-building programs provide both grant and debt capital and specialized technical assistance on both facility design/construction and financing.
- Experienced nonprofit development intermediaries can be strong vehicles for building and strengthening the child care system's physical infrastructure.
- A systems change agenda is needed to improve child care revenue streams and generate appropriate sources of capital subsidy for facilities development.

[2] The U.S. Department of Housing and Urban Development provides CDBG funding to cities and towns for affordable housing, economic development and community facilities for low-income communities. Section 108 of CDBG authorizes HUD to issue loan guarantees backed by future CDBG receipts.

Discussion Questions

1) **How can we elevate the importance of quality facilities and get the issue on the agenda of more policy makers? What strategies can be pursued to encourage more public sector leaders to invest in the industry's physical infrastructure and adopt proven cost-effective models for facilities development?**

2) **What can be done to promote more effective and lasting public-private partnerships for facilities financing at the state or local level?**

3) **Is it feasible to establish a child care operating subsidy rate enhancement linked to facility development? If so, what would such an initiative look like? How would this approach affect efforts to raise the base reimbursement rate for all programs?**

Suggested Resources

- *2001 Edition of Financing Child Care in the United States*
  Mitchell, Stoney, and Dichter:
    - Connecticut Child Care Facilities Loan Fund, pages 72-73
    - Capital Investment Partnerships, pages 154-163

- *Building for the Future: A Guide to Facilities Loan Funds for Community-based Child and Family Services*
  Carl Sussman, The Finance Project
  www.financeproject.org

- *Using Tax Credits to Finance Child Care Facilities Development, Noonan and Gillman,*
  Spring 2002 edition of the Journal of Affordable Housing and Community Development Law

- *Removing Barriers to Childcare Facilities Development*
  Gretchen Anderson
  www.designchildcare.com/book.html

- *When Housing and Child Care Meet: Lessons Learned from Seven Child Care and Community Development Partnerships*
  Meyer et al, The Enterprise Foundation. April 2002
  http://www.enterprisefoundation.org/resources/publications/resourceCatalog/