PUBLIC HEARING ON

BILL 15-104, THE "DISTRICT OF COLUMBIA NEIGHBORHOOD ECONOMIC DEVELOPMENT AND INVESTMENT AMENDMENT ACT OF 2003"

Before the
Committee on Finance & Revenue
Council of the District of Columbia

Councilmember Jack Evans, Chairman

June 23, 2003
10:00 a.m., Room 412
John A. Wilson Building
1350 Pennsylvania Avenue, NW

Testimony of
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Good morning, Chairman Evans and members of the Committee on Finance and Revenue. I am Natwar Gandhi, Chief Financial Officer of the District of Columbia. I am pleased to be here today to testify on Bill 15-104, the "The District of Columbia Neighborhood Economic Development and Investment Amendment Act of 2003."

The purpose of this legislation is to enhance economic development in the District. Such development is the key to the financial viability and economic health of our city. Success requires use of a variety of tools including tax increment financing (TIF) – already available in the District – that is often very attractive and may be particularly effective for certain kinds of projects. It also must be used with great care, because it can unintentionally constrain or even reduce our tax base, and because each project sets a precedent and expectations among developers as to opportunities for subsidy in the future.

We understand the importance of economic development to the future of the District and we strongly support a carefully constructed toolbox of development assistance payments. There are many good ideas and components of this proposed legislation. However, we have concerns with some elements of this bill. We look forward to working with you, Mr. Chairman, and with Deputy Mayor Price over the course of the summer to resolve these issues.

Before beginning our discussion of the proposed legislation, let me state clearly that our analysis only addresses the impact on the District over the next five years – which is our Congressional mandate for fiscal impact statements in the District of

Columbia. That said, our analysis assumed no net increase in tax revenue associated with funded projects, since the legislation permits the approval of projects that may result in a net decrease in tax revenue during that five-year period. To the extent that funded projects result in a net increase in taxes, the cost of the legislation would be reduced in the out-years; however, it is not possible to forecast these offsets, if any, in the absence of the consideration of specific projects. I believe it is important to underscore that it may very well be that over the long term – 10 to 20 years, for example – the proposals contained in this legislation could actually result in a significant increase to tax revenues.

Description of Proposed Legislation

As a general rule, for a project to receive a subsidy under this bill, the Mayor must determine that the project would generate a net increase in tax revenue or that the project would be in the general interest of the District. In most cases, the Mayor would also establish the criteria for using these economic development tools, negotiate deals, and present those deals to the Council for approval.

The legislation has four major parts:

1. A replacement of the present day program.
2. A Payment in Lieu of Taxes (PILOT) program that would exempt parcels of land from real property taxes.
3. A special assessment district program to secure bonds that would finance public infrastructure improvements.
4. Tax abatements and credits, including a five-year real property tax abatement, recordation tax abatement, employee tax credits, and sales tax abatement for certain District businesses.

1. A replacement of the present day program. The bill repeals the current TIF legislation and replaces it with new language that would facilitate the establishment of TIF areas. The creation of TIF areas and the approval of projects for funding would be separate actions under the legislation, although it is likely that approval would occur simultaneously in many cases. The creation of a TIF area would be recommended by the Mayor and approved by the Council. Approval of a TIF area would trigger the base period for sales and real property taxes for the area from which the CFO would calculate incremental changes in tax revenues. Once a project is approved, incremental tax revenue would be deposited into an account for use in funding economic development projects in the area. The money could then be used for TIF bonds, or directly for project-related purposes. At the end of each tax year, in the absence of TIF bonds being issued, any remaining funds in the TIF account would revert to the General Fund.

The bill caps the total amount of outstanding TIF bonds or direct support at $300 million. The bonds issued under the current TIF statute would count against the cap, meaning that about $173 million in additional bonds or direct grants could be issued. The cap could be exceeded upon the recommendation of the Mayor and approval of the Council.

2. A Payment in Lieu of Taxes (PILOT) program that would exempt parcels of land from real property taxes. Owners of these parcels would pay a PILOT amount that would be negotiated with the District. The legislation proposes a new program that permits the exemption of otherwise taxable parcels and authorizes payments in lieu of taxes to be dedicated to economic development purposes. The program directs that the portion of the PILOT payment attributable to the value of the parcel at the time that the property is designated as a “PILOT parcel” be transferred to the General Fund annually. The remainder of the PILOT payment could be used to secure bonds or directly to fund economic development projects. The Mayor would negotiate the terms and conditions of funding for any project based on what the Mayor deemed to be in the best interest of the District, and any agreement would be subject to approval by the Council.

The legislation would authorize the issuance of up to $250 million in bonds outstanding or direct assistance at any one time through the PILOT program. While this cap would limit the amount of bonds that could be outstanding and the amount of direct cash assistance that could be provided, it does not include any implicit tax abatement that could be negotiated by the Mayor as part of an economic development agreement. Implicit tax abatement would result whenever the Mayor negotiated a PILOT payment that is less than the property tax that would otherwise be on the property if the parcel remained on the property tax rolls.

The PILOT program circumvents General Obligation bond escrow requirements by redirecting incremental growth in real property tax revenue from the General Fund, where at least some portion of it must be used for GO bond obligations, to a PILOT fund to support economic development. Under the program, one possible outcome could be to decrease the amount of tax revenue available for repayment of GO bonds, which would hurt the District's future borrowing ability and negatively impact the District's bond ratings.

3. A special assessment district program to secure bonds that would finance public infrastructure improvements. The legislation authorizes the Mayor, with the approval of the Council, to create special assessment districts. Under the proposal, money raised from a special assessment tax could be used to support the issuance of bonds for purposes of funding public infrastructure improvements. Public infrastructure improvements would be limited to improvements owned by the District, dedicated to the District or any other government entity.

Although the legislation is somewhat unclear on this point, we believe that the drafters of the legislation intended to deposit special assessment revenue in a special fund outside of the General Fund. As a result, special assessments would neither increase General Fund revenue nor increase debt supported by General Fund revenue.

The amount of debt outstanding or direct spending backed by special assessment levies would not be subject to a cap.

4. Tax abatements and credits, including a five-year real property tax abatement, recordation tax abatement, employee tax credits, and sales tax abatement for certain District businesses. This section of the proposed legislation includes:

- Allocation of Fees Related to Issuance of Revenue Bonds: The legislation would require fees earned in connection with revenue bonds issued by the District to be deposited into a non-lapsing account outside the General Fund controlled by the Office of the Deputy Mayor for Planning and Economic Development. These funds could be used to pay for administrative costs, as well as economic development grants, loans, credit enhancement and other purposes.

- Real Property Tax Abatement for Certain Businesses: Subject to approval by the Council, the Mayor would be authorized to abate the real property tax liability of any Qualified Business for a period up to five years. A Qualified Business includes businesses whose retention or expansion within the District or whose relocation to the District would help to retain or increase employment and expand the tax base in the District, according to the Mayor's determination. LSDBE-certified businesses, businesses located in enterprise zones, and certain other businesses would automatically qualify for the designation.

The real property tax abatement could be subject to a cap of $25 million within every two-year period, commencing with the passage of the legislation. The abatement would decrease the amount of tax revenue available for repayment of GO bonds. Abatement of recordation tax would count against this cap (discussed below).

- Employment Tax Credit: In addition to being eligible for real property tax abatement, the legislation provides that Qualified Businesses would be entitled to an employment tax credit against corporate franchise tax liability of up to $3,000 per qualified employee, so long as the business hires 10 or more District residents as part of a business expansion in the city. Unlike the real property tax abatement, this credit would be available to the taxpayer without approval by the Council. The employment tax credits would be allocated over a 36-month period and could be carried forward for up to five years.

- Forgiveness of Recordation Tax Liability: The legislation would authorize the Mayor to waive recordation tax payable by a Qualified Business upon passage of an approval resolution of the Council. As noted previously, the recordation and real property tax abatements for Qualified Businesses would be subject to a cap of $25 million within every two-year period. Abatement of real property tax would also count against this cap (discussed above). The abatement would decrease the amount of tax revenue available to the General Fund and the Housing Production Trust Fund.[1]

- Sales Tax Exemption on Construction Materials: With the approval of the Council by resolution, the Mayor would be able to grant an exemption from the sales tax for purchases of construction materials and related tangible personal property used to construct, equip, or furnish a facility owned, used, or occupied by a qualified business.

  Under the proposal, the sales tax abatement would not be subject to a cap. Last year, the District collected about $20 million in sales and use tax on construction materials. If the sales tax abatement were granted to all builders, the potential reduction in sales taxes collections would be significantly higher than we estimated in the fiscal impact statement. The $5 million annual cost estimate equates to the exclusion of about $87 million from the sales tax base each year.

Fiscal Impact

We estimate that the proposed legislation could potentially result in unbudgeted spending of up to $270 million in the next four years. In other words, this spending is currently not envisioned in the current 5-year Proposed Budget and Financial Plan. Our estimates are comprehensive in that they are based on the assumption that the TIF expenditures would be made to the fullest extent permitted under the legislation. Thus, they reflect the fullest impact associated with

[1] Fifteen percent of recordation tax collections will be allocated to the Housing Production Trust Fund, beginning in FY 2004.

subsidized economic development. Some of these costs would be covered by the economic activities supported by the bill; however, it is quite unlikely that all would be self-financing. Those projects most likely to succeed without the subsidy should not be financed by the bill; the market would support them and tax revenue could flow to the District from them, rather than the other way around. Because projects assisted by economic development subsidies should always be risky – otherwise the market itself would cover the project – the Council and Mayor need to be prepared for some to fail to cover their costs. Unfortunately, we do not know at this point the extent of the needed budgetary support, but we can expect the exposure to be large.

Money from both the TIF and the PILOT programs could be used for grants and to pay for the debt service on the sale of bonds. The caps add these two kinds of support together. For the TIF program, the impact on the operating budget – that budget generally considered in fiscal impact statements – is not additive. To understand the operating budget impact, we must add the expected grant payments to the debt service payments that would be required to support TIF bonds.

The impact of the additional debt would be reflected in the capital budget. What this increase in bonds would mean is that other capital projects would not be done. We have not attempted to estimate the capital impact in estimating the cost of this bill.

The proposed creation of TIF districts imposes an additional complication in estimating the fiscal impacts of this legislation. As soon as a district is created and a project is approved, all incremental sales tax revenue and available real property tax revenue are taken from the General Fund for support of the TIF project. All unspent monies are returned to the General Fund at the end of the fiscal year; however, given our Congressional mandate, such monies cannot now be spent and go directly into the fund balance.

In determining the cost of the bill, we have assumed that $25 million in TIF grants and about $5 million in TIF debt service payments would be spent each year. Debt service on the TIF bonds would ramp up as new projects were funded.

The PILOT part of the legislation would have a double impact on the budget, which we estimate would cost the District approximately $25 million per year. First, it would remove incremental real property taxes from the General Fund, and it would further impact revenues because 60 percent of the money would be used to support grants and bonds for development projects, which would otherwise have gone to pay GO debt service.

The construction sales tax exemption proposed under the legislation is open-ended. Construction materials are not widely taxed by state and local governments, because it simply adds a cost to construction that we generally want to happen. While difficult to measure directly, our models indicate that we raised about $20 million from this tax on commercial construction in the last fiscal year. Rather than stir up discontent by giving the break to some but not all, if we no longer want this tax, we could work toward doing away with it. The OCFO will prepare a whitepaper for the Mayor and Council on the costs and benefits of this change in policy.

The costs of the rest of the legislation are much smaller and are explained in the fiscal impact statement.

Concerns

Our first concern is that the bill does not specify any criteria or priorities for the use of these various subsidies. There is no requirement that the money be spent in distressed neighborhoods or even a "but for" test that the money be given to projects that require the support in order to go forward.

We have examined other TIF programs and most have spending criteria. Chicago's program provides a good example. In Illinois, the state sets the qualifications for creating TIF districts. To be declared a TIF district, areas must be considered "blighted" or "in danger of becoming blighted." To be considered blighted, areas must meet five of 13 criteria, and to be considered in danger of becoming blighted, areas must meet three of the 13 criteria. These criteria are: deterioration; inadequate utilities; obsolescence, dilapidated buildings; building code violations; illegal use of structures; vacant buildings; lack of ventilation, light or sanitary facilities; overcrowding of structures; undesirable land use; environmental cleanup; lack of community planning; and stagnant or shrinking property values. This state-imposed set of criteria helps force TIF funds into distressed areas.

Also of note, the process for establishing TIF districts and approving TIF projects in Chicago has more steps and checks than the process set forth in this legislation. Under this initiative, TIF areas are proposed by the Mayor and approved by the Council. There is no further approval structure. TIF projects must either be found by the Mayor to result in a net increase in tax revenue or to result in other documented benefits to community residents. In Chicago, by contrast, in addition to meeting the blight criteria, proposed TIF areas must go before the city's Community Development Commission and Joint Review Board before going to the city council for approval. Each proposed TIF project also must go through the same process. These additional steps in the approval process again help ensure that the money goes where it is most needed.

Both the TIF and the PILOT could be restricted to help jump start economic development in distressed neighborhoods. Cranes have already replaced monuments as Washington's downtown skyline, implying that money for more downtown development is not as badly needed as is economic activity in more distressed parts of the city. As shown above, in Chicago's TIF program, often cited as one of the nation's best, TIF districts and projects in them are limited to areas of demonstrated or potential blight. As a result, Chicago has many dozens of small TIF districts that fund more than 100 small TIF projects (70 percent are less than $5 million).

The "but for" test under current TIF law could be included in the TIF component of the proposed legislation, thereby helping to ensure that money is not given to projects that do not need it. Offering TIF when it is not needed for financial success of a project sets a powerful precedent, making it much harder to limit the expectations of other developers. Public policy goals can cause the market problem. For example, the site of the Mandarin Hotel was driven by a policy requiring that a hotel be built there, although an office building could probably have been built there without a TIF. A previous developer had begun site preparation for a hotel and stopped before construction for lack of adequate finances. To fulfill the public policy, public support was needed. Other hotel developments, without this unique policy requirement, may not meet a "but for" test; even so, the expectations for support in the hotel community are very high.

Risks also could be reduced by following the Chicago model and offering only TIF notes, which do not require the issuance of TIF bonds, that are sold to the developer and to offer these only as financing after construction is complete. This accomplishes several ends. First, bonds do not have to be sold, reducing administrative and acquisition costs and relieving one potential concern of Wall Street about how much debt the District supports. Second, the developer is guaranteed repayment from the diversion of tax from the footprint of the development; generally, payment could take as long as needed to return the amount of the note to the developer. Third, the developer would have to fund construction before the District produces its committed funds, thereby reducing our risk during the construction period. In funding up front, we could be left, for example, with an empty hole and the obligation to repay bonds for the construction cost. By limiting our pledge of subsidy to the post-construction period, there is much less risk and cost on the District, even if the developer is promised the same net support for the project.

Restricting the use of the PILOT program to currently tax exempt properties could also reduce the direct and indirect costs. There are no criteria for use of the PILOT in the bill. Tax assessments on currently taxable properties could be frozen, with all future growth deemed exempt. Not only does this eat away at the tax base, but it opens the floodgates for special treatment to a very few. All across this country the real property tax is the most hated of all taxes, as demonstrated by numerous state and local policies that limit growth in real property tax assessments. Giving one site a tax freeze while others do not receive it will generate enormous discontent among those who do not have favored treatment. And although the District has just received an upgrade in its bond rating by Fitch to A-, an outcome earned by very hard work on the part of the Council and the Mayor, such activity would seriously concern Wall Street.

Let me cite an excellent example of how the PILOT concept can profitably be used. The District's PILOT concept was born as a way to help finance the Anacostia Waterfront development. Initially, the PILOT sites, principally street surfaces that would be closed to traffic and built upon, were all expected to be tax exempt. The problems identified above are substantially managed by limiting PILOTs to tax exempt properties in this single development area. Wall Street can better understand dedicating the "tax" on exempt properties for such a major, pivotal project. Developers can temper their expectations because the use of PILOTs is clearly limited to specific types of properties and specific public priorities. And the public will have a powerful tool to help fund this critical project.

This legislation will raise red flags for Wall Street. It will potentially increase debt backed by our tax base by $400 million or even more. At the same time, properties providing revenue to pay debt service on our general obligation bonds could be withdrawn from the tax roles. Together these two activities can only make the people who loan us money nervous.

Finally, the bill removes certification from TIF bond transactions and does not impose a certification regime on PILOT bonds. Currently, TIF bonds require certification that expected incremental revenue from the project will be sufficient to cover debt service costs on the TIF bonds or notes. Without certification there would be no assurance that incremental taxes from these projects would be sufficient to pay debt service. Because any shortfall would have to be made up from the General Fund, the financial plan would be directly impacted and funds that could be used to provide other public services such as police and education would be diverted to pay debt service, making budgeting and financial planning more difficult.

These are some of our concerns. I remain very hopeful that working together we will resolve these concerns. I am pleased to answer any questions.

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