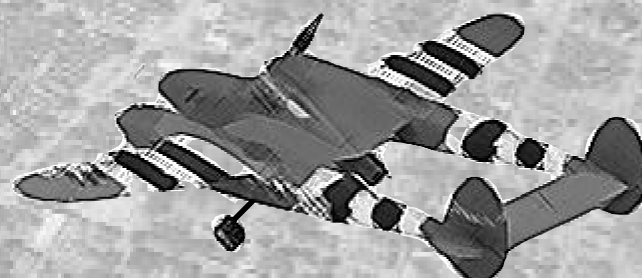
A Report from the Bureau of Governmental Research

Protecting New Orleans' Tax Base:

Which PILOTs Should Fly?

March 2007



BGR

We report to you.

New Orleans has certainly seen better financial days. The property tax base is down 15% from its pre-Katrina level. Revenues from total taxes and other locally generated sources are down 28%. The City's 2007 budget is heavily dependent on federal and state grants and is "balanced" by borrowings. At the same time, the needs remain great. Restoring and improving the infrastructure, already in deteriorated condition before the levee breaks, will require substantial local investment.

Against this backdrop, the Industrial Development Board of the City of New Orleans, Louisiana (IDB), an economic development entity created decades ago by the City Council, is receiving requests from developers for significant tax breaks. In December, it approved a 20-year tax break in connection with the construction of a Home Depot store in Central City. It currently has pending 11 other applications containing requests for tax abatements. (See Appendix A for a list of pending projects.) The Housing Authority of New Orleans intends to apply for tax abatements in connection with the redevelopment of 10 public housing properties.

The Home Depot store would be located in the center of what is perhaps the biggest construction site in North America. According to recent news accounts, three of Home Depot's stores in the metro area were each expected to generate $100 million in sales in 2006 — double the amount of a typical Home Depot store — placing them in the top 10 among the company's 750 stores in the Southeast. It was also reported that a competing store in New Orleans, Lowe's, has become the best-performing site in the 1,375-store chain.

The purpose of this report, however, is not to pass judgment on particular subsidies, but to examine the IDB's process for evaluating and awarding requests for this type of subsidy. The IDB itself has recognized a need for review and has established a committee to revise its policies and procedures. BGR has offered to work with them in this endeavor.

Given the City's needs, its diminished tax base, and its mounting debt, it is imperative that the City rebuild its tax base as it rebuilds itself. Now more than ever, it must invest its resources carefully and avoid unnecessary subsidies to private enterprise. This can be done only with a cohesive vision for economic development and carefully crafted policies and procedures for evaluating subsidy requests. Short of that, taxes become negotiable for large developers and businesses and more inequitable for other taxpayers.

WHAT IS A PILOT?

The term "payment in lieu of taxes" (PILOT) can refer to a number of mechanisms. These include payments that nonprofit, tax-exempt property owners, such as universities, voluntarily make to governments to help offset the cost of providing them with services. It also may refer to payments made by a private company to compensate tax recipient bodies for property tax losses that occur when a public entity takes title to a property to facilitate bond financing for the private business.

Sometimes the payment is set at a level that compensates tax recipient bodies for 100% of lost property taxes. Sometimes it is set at a lower amount than the enterprise would have paid in taxes, providing the private enterprise with a subsidy. In this report, BGR focuses on the latter, discounted form of PILOT. It refers to them as PILOT subsidies.

THE IDB AND PILOTS

The IDB is a nonprofit public corporation established by the City Council in 1973, acting pursuant to state legislation authorizing municipalities and parishes to establish industrial development boards. The IDB has 15 members who are selected by the Mayor and City Council for six-year terms. There are no term limits. As a matter of practice, each City Council member makes two appointments and the Mayor makes one. No professional qualifications are required for board membership. Members may not be employees of the City. The members serve without compensation.

The IDB serves as a conduit for the issuance of revenue bonds to finance eligible projects. Originally, only industrial projects were eligible under the state authorizing legislation, but eventually the universe of eligible projects was expanded to include almost all types of development.

Bonds issued by the IDB are exempt from state taxes and, depending on the transaction, may be exempt from federal taxes. The bonds are subject to approval by the secretary of the Louisiana Department of Economic Development and the Louisiana State Bond Commission.

In most cases, the IDB takes title to the property and leases it back to the business until the bond financing is paid off. At that point, the title reverts to the lessee. Under current Louisiana law, as long as the property is owned by the IDB, it is off the tax rolls. To offset the loss of property tax revenue that would be payable but for the transfer of title to facilitate the financing, the IDB is authorized to require an annual PILOT. However, state law does not require a PILOT, and there is no minimum payment. (This was not always the case. Prior to 1972, state law required industrial development boards to collect PILOTs equivalent to the full amount of property tax that would otherwise have been payable.)

In the 1970s and 1980s, the IDB typically set PILOTs at an amount equivalent to what would have been paid in property taxes if title to the property had remained in private hands. More recently, the IDB has set several PILOTs at a lower level, providing private enterprises not only with financing assistance through the bonds, but also with a subsidy in the form of a property tax abatement. The IDB has become a vehicle for significant property tax breaks, accessible only to enterprises large enough to pursue bond financing. See Appendix B for a list of PILOT subsidies that are currently in effect and the amounts at which the PILOTs are set. For an illustration of how PILOT subsidies work, see the sidebar.

How a PILOT Subsidy Works

BGR has prepared the following illustration of a hypothetical 15-year payment in lieu of taxes (PILOT) arrangement on a 30-year bond issue. It chose these lengths of time because they are similar to requests the Industrial Development Board (IDB) has received.

A company requests that the IDB issue 30-year bonds on its behalf to finance the construction of a plant on land the company owns in New Orleans. For the IDB to issue the bonds, the company transfers legal title to the land and the future improvements to the IDB. The IDB retains title to the land and improvements until the bonds are repaid and, during the interim period, leases the property back to the company. The company's annual lease payments pay the debt service on the bonds and the PILOT.

Assume that the IDB and the company negotiate a discounted annual PILOT. The PILOT payment is equivalent to 25% of the 2007 property taxes which the company would owe if title was in the name of the company instead of the IDB, which is exempt from taxes. The company agrees to pay the discounted PILOT for the first 15 years of the lease. Thereafter, the company will begin making a payment equivalent to the full amount of property taxes.

Assuming a 2007 land value of $1 million and a plant value of $10 million, the company's 2007 taxes would have been approximately $280,000. The PILOT amount is approximately $70,000. Over the 15 years, assuming a 2% annual increase in assessed value and a constant millage rate, the company would remit slightly more than $1 million in PILOTs and save $3.8 million in tax payments. The net present value of this savings, discounted for 3% annual inflation, equates to slightly more than $3 million.

THE PITFALLS OF PILOT SUBSIDIES

PILOT subsidies, like other tax subsidies, are intended to spur development that would otherwise not occur. The goal is to facilitate private sector investment, improve blighted properties and areas, and generate tax revenues that would otherwise not exist.

Translating the theory into reality is difficult, however, for a number of reasons. First, it is challenging to determine whether development would have occurred without a subsidy. Second, because the cost-benefit analyses used to examine PILOT subsidies depend on assumptions and long-term projections, the projected results may not materialize. Third, it is difficult to identify and assess offsetting negative impacts from lost revenues at competing enterprises. Misjudgments in any of these areas can result in a poor investment decision by the local government and an unnecessary reduction in future tax revenues.

Apart from the analytical challenges, PILOT subsidies and other tax incentives create inequities that need to be weighed carefully against expected benefits.

Negative Impact on Other Businesses

PILOT subsidies can confer benefits on certain businesses at the expense of others, giving the beneficiary of the subsidy an unfair advantage. While this type of risk would appear to be minimal where the tax subsidy is supporting a manufacturing or industrial project, it is far more likely in the retail arena, where the subsidized development will draw business away from other retail businesses in the area. The advantages provided by the public subsidy raise serious equity issues, particularly when, as is the case with the PILOT subsidies, the subsidy is available only to businesses of significant size.

Transferring Costs

To the extent that other businesses lose revenue, the tax base of the local government is reduced. In addition, depending on the nature of the development and the terms of the PILOT, a subsidized project can increase a government's operating costs, such as police and fire protection or street maintenance, without providing sufficient operating funds to the local government. The end result in that case is a transfer of the additional operating costs to others – including competitors. Other taxpayers, including competing enterprises, also effectively subsidize the beneficiary to the extent to which it does not contribute its fair share to the needs of the City.

Fairness

Other taxpayers — including competitors of the new, tax-subsidized enterprise – pay their property taxes in full. PILOT subsidies are simply not available to the regular citizen or the small business owner.

EVALUATION OF PILOT SUBSIDIES

A PILOT subsidy represents an allocation of future resources and should be evaluated with a stringency worthy of other long-term investment. The investment should be made only if it furthers a defined public policy, is proven necessary, and is as efficient, effective, and equitable as possible for the community.

More specifically, the government should demonstrate that the investment furthers specific economic development priorities, which should be clearly articulated in a strategic plan. It should also require an analysis demonstrating that the investment is necessary, meaning that the market on its own will not produce a desirable outcome. PILOT subsidies should never compensate for financial weaknesses in a developer or inadequacies in the financial structure of a transaction (*e.g.*, inadequate equity investment). Nor should they offset the lack of demand for a service or product.

After the government establishes the strategic importance of a project and the need for a subsidy, the government should determine the minimum amount of subsidy necessary to make the project feasible. This determination requires independent market and financial analysis based on high-quality data and reasonable assumptions.

The government should analyze the potential benefits, particularly net tax gains, and the costs of the investment to determine its effectiveness. It should include in its examination of costs the foregone tax revenues, reductions in other tax revenues as a result of negative impacts on market competitors, and the costs of public services required for the project. In evaluating PILOT subsidies, the government should also assess other factors, including the relative value of the project and the "opportunity cost" of making the investment, investment risk, the developer's experience, and impacts on the surrounding neighborhood and local competitors.

PILOT SUBSIDIES IN NEW ORLEANS

New Orleans currently lacks the institutional framework for the efficient, effective and equitable use of PILOT subsidies. The City lacks a clearly articulated economic development plan and strategy to provide context for considering PILOT requests, and the IDB's system for evaluating and awarding PILOT subsidies is inadequate.

The IDB requires all businesses seeking revenue bond financing to submit an application that includes, among other things, a project budget, a three-year pro forma, and three years of corporate financials. The quality of applicants' responses varies, ranging from the detailed to the cursory. In one recently approved transaction, the budget consisted of three line-items.

In addition, when the applicant is seeking a PILOT subsidy, the IDB requires the applicant to pay for a cost-benefit analysis by an IDB consultant. Using the cost-benefit analysis, the IDB considers each PILOT request to determine whether, in its opinion, the PILOT will benefit the city. The IDB determines the amount of the PILOT subsidy through negotiation with the applicant. There are no formal criteria or standards to guide the decision-making process. The IDB does not require financial or market analysis to demonstrate that the PILOT subsidy is necessary.

Following committee review with the assistance of consultants, the IDB board holds a public hearing. It notifies assessors and affected tax recipient bodies, giving them an opportunity to lodge objections. It may proceed, however, over objections. There is no requirement for approval by the City Council or any elected official with responsibility for the City's finances, although as a matter of practice the IDB seeks the Council's approval.

The end result is an ad hoc, developer-driven process that allows large corporations to negotiate their effective tax rates down to a level far below that of small businesses in the city. New Orleanians have recently rejected the notion of making property taxes negotiable and the inequity that results. By an overwhelming margin, voters approved the consolidation of the system of seven assessors, a critical first step in professionalizing and rationalizing the property tax assessment system. One of the driving forces behind this change was increased citizen awareness of the inequities among taxpayers.

CONCLUSION AND RECOMMENDATIONS

BGR begins with the premise that property taxes are a cost of doing business and property ownership. They should be levied in a fair and equitable manner. Having said that, BGR recognizes that there may be instances in which tax subsidies are both necessary and beneficial.

The use of tax subsidies is particularly seductive for a city like New Orleans, which suffers from spatial challenges, decades of suburban extraction from the sales tax base, and difficult post-Katrina living and development conditions. But the IDB should not consider a subsidy simply because a project will enhance tax revenues or create jobs. It should begin to consider a tax subsidy only if it can be demonstrated that the subsidy is strategic, necessary, efficient, effective, and equitable. Otherwise, a subsidy is simply money down the drain and an unnecessary transfer of wealth to private entities. It is a waste that the City can ill-afford as it struggles to rebuild its tax base, services, and infrastructure.

New Orleans' current system for assessing PILOT subsidies lacks the structure and safeguards required for wise use of the subsidy. An unelected body, operating without adequate policies, procedures, criteria and analysis, has the power to give away portions of the future tax base. In the current framework, taxes become a matter of negotiation for large developers and businesses. For other taxpayers, they become more inequitable.

The IDB has taken a first step toward possible reform by establishing a committee to revise its policies and procedures. The discussion points put forth recently by the committee chairman provide a solid basis for beginning the review. BGR urges the committee to follow through with a major overhaul of the system, replacing the ad hoc, developer-driven approach with a strategic one and establishing high standards and rigorous policies and procedures for the review of PILOT subsidy requests.

BGR's recommendations are as follows:

Standards for PILOT Subsidies

- The City should develop and adopt a citywide economic development plan with clear goals, priorities and strategies. The IDB should consider subsidies only for projects that support the City's highest priorities and fit strategically with its plan.

- The IDB, or its consultant, should demonstrate through independent market studies and financial analysis that the subsidy is necessary, meaning that the market will not produce a desirable outcome for the site.

- PILOT subsidies should not compensate for financial weaknesses in a developer or basic inadequacies in the financial structure of a transaction (*e.g.*, inadequate equity investment). Nor should they offset the lack of demand for a service or product.

- The IDB should treat a rigorous and favorable cost/benefit analysis as one of a number of requirements, rather than the deciding factor, in the evaluation of projects.

- Once the strategic fit, need and favorable economic impact have been established, the IDB should consider other factors, such as the opportunity cost and the impacts on local competitors and the surrounding neighborhood.

- The IDB should provide only the minimal PILOT subsidy needed for the project to proceed.

- The IDB should approve PILOT subsidies only for projects that conform to the City's master land use plan.

Procedures for PILOT Subsidies

- The IDB should establish uniform policies, procedures and criteria for determining whether, and in what amount, a PILOT subsidy should be awarded.

- The IDB should consider PILOT subsidies only for projects supported by financial statements, business plans, projections and other documentation of the type and quality that a reputable third-party investor or lender would require.

- The IDB should refer PILOT subsidies to the Mayor's Office of Economic Development for review. The IDB should not approve any PILOT subsidy without a report from that office describing with specificity how the subsidy advances the City's stated economic development priorities as contained in the economic development plan.

- All IDB approvals of PILOT subsidies should be contingent on approval of the subsidy by a super-majority (five or more members) of the City Council and the consent of other tax recipient bodies.

Accountability

- To the extent feasible, the IDB should craft PILOT agreements that impose penalties if projected economic benefits do not materialize.

- On an annual basis, the IDB should prepare a report on the performance of approved PILOT subsidies. This will require the City and IDB to obtain commitments from developers to provide necessary data for measuring performance for the life of the subsidy.

APPENDIX A: PENDING PILOT REQUESTS

Developers for the following projects have submitted to the IDB applications indicating their intent to pursue a negotiated PILOT.

Name	Nature of Project	Location
750 Jeff Davis	Low income apartments	Jefferson Davis Parkway near Tulane Avenue
930 Poydras	Market rate apartments/ retail/parking	CBD: 930 Poydras St.
Canal Place III	Condominums/hotel/retail/parking	CBD: 333 Canal St.
Clio Village	Low income apartments	Multiple sites in the Central City area
Crescent Club	Mixed income apartments	Tulane Avenue near Jefferson Davis Parkway
Film Factory	Film studio	Lafitte corridor
IceHouse Residences	Condominiums/market rate apartments/retail/parking	Warehouse District
Peltier Gardens	Low income apartments	Chef Menteur Highway in eastern New Orleans
The Preserve	Mixed income apartments	Tulane Avenue near S. Carrollton Avenue
St. Julien Hotel	Hotel	CBD: 200 Carondelet St.
Walgreens	Drug store	S. Carrollton Avenue at S. Claiborne Avenue

In February 2007, the Housing Authority of New Orleans (HANO) approved by resolution the March 13 filing of applications for bond issues and negotiated PILOTs for 10 sites proposed for redevelopment. On March 1, the New Orleans City Council unanimously approved by resolution the issuance of up to $1 million in bonds by the IDB in connection with the redevelopment projects. The Council also approved PILOTs in unspecified amounts less than the amounts that would otherwise be paid in property taxes. HANO's resolution states that it has been exempt from property taxes and is requesting that the limited liability corporations established to own and manage the redeveloped properties remain exempt through the use of a PILOT for each site. The sites are identified in the HANO resolution* as:

- Fischer
- C.J. Peete
- B.W. Cooper
- Imperial Drive
- General Ogden
- Guste
- St. Bernard
- Lafitte
- Mazant Royal
- Tchoupitoulas

* *For some sites, the requested PILOTs will apply to certain phases of the redevelopment. Housing Authority of New Orleans, Resolution No. 2007-07, February 28, 2007.*

APPENDIX B: PROPERTIES WITH IDB LEASE AGREEMENTS IN EFFECT OR APPROVED AS OF MARCH 12, 2007

The following table summarizes the term of the PILOT, the annual PILOT amount, and BGR's estimate of the 2007 annual property taxes foregone under the PILOT arrangements. The calculations for each project are summarized in the footnotes below the table. The table does not analyze whether the tax savings are critical to the feasibility of the project, or whether the project generates significant economic, fiscal, and other benefits to the city.

Property	PILOT Term	Annual PILOT to Tax Recipient Bodies	BGR's Estimate of Annual Property Taxes Foregone (1)
Six Flags New Orleans (2)	75 year lease; option to purchase beginning in 2018	Zero	$903,851
Saulet Apartments (3)	15 years	$70,300	$702,438
Home Depot	20 years, beginning upon completion	$149,636.74	$439,942
River Garden Wal-Mart (4)	20 years	$25,000	$325,000
Crescent Crown Distributing (5)	20 years	$74,088	$298,671
Halpern's Furniture Plant	20 years	Amount equal to taxes that would be due if lessee held title	None
American Can Apartments (6)	10 years	$36,556	Could not determine due to lack of current assessment data
River Garden CS1 Apartments (7)(8)	15 years	$17,522	Could not determine due to lack of current assessment data
Desire Redevelopment (8)	20 years	$1	Could not determine
Fischer Redevelopment (8)	20 years	$1	Could not determine
Florida Redevelopment (8)	20 years	$1	Could not determine
Guste Redevelopment (8)	20 years	$1	Could not determine

(1) BGR was able to estimate annual foregone property taxes for only five leased properties: Six Flags New Orleans, Saulet Apartments, Home Depot, River Garden Wal-Mart, and Crescent Crown Distributing. In the cases of Six Flags New Orleans, Saulet Apartments, and Crescent Crown Distributing, BGR estimated annual foregone property taxes by multiplying the property's assessed value listed on the 2007 assessment rolls by the appropriate millage rate, and then subtracting the 2007 PILOT amount. In the case of Home Depot, which has not yet been built, BGR multiplied the estimated assessed value set forth in the cost-benefit analysis prepared for the IDB by the current millage rate, and subtracted the annual PILOT amount. In the case of the River Garden Wal-Mart, BGR assumed that the PILOT amount received by tax recipient bodies and the related payments directed to the support of River Garden debt approximate the taxes that would otherwise be due. It considers the payments directed to River Garden to be foregone taxes for that project. In the River Garden Wal-Mart calculation, BGR used the amounts payable in 2007.

(2) Formerly Jazzland Theme Park.

(3) Annual PILOT amount is $100 per unit for years 1 to 10, and $200 per unit for years 11 to 15.

(4) The payments directed to River Garden escalate over the 20-year term from $275,000 to $425,000 per year.

(5) Annual PILOT amount is set at the pre-development taxes, approximately $74,088, for years 1 to 10. In year 11, the PILOT is reset at 10% of the taxes that would otherwise be payable. The percentage payable would increase by an additional 10% a year (e.g., to 20% in year 12), with the full amount of the taxes payable in year 20.

(6) Annual PILOT amount approximates the pre-development taxes.

(7) First phase of rental apartments at River Garden, the redevelopment of the former St. Thomas public housing site. Annual PILOT amount is $1 per unit for the 122 low-income units and $100 per unit for the 174 market rate units.

(8) Prior to redevelopment, no taxes were payable on public housing sites owned by HANO.

BGR

The Bureau of Governmental Research is a private, non-profit, independent research organization dedicated to informed public policy making and the effective use of public resources for the improvement of government in the New Orleans metropolitan area.

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