Making Tax Incentives Work

Lessons from Boston, MA

Ronald W. Rakow
Fellow
Lincoln Institute of Land Policy

85TH ANNUAL IAAO CONFERENCE & EXPOSITION

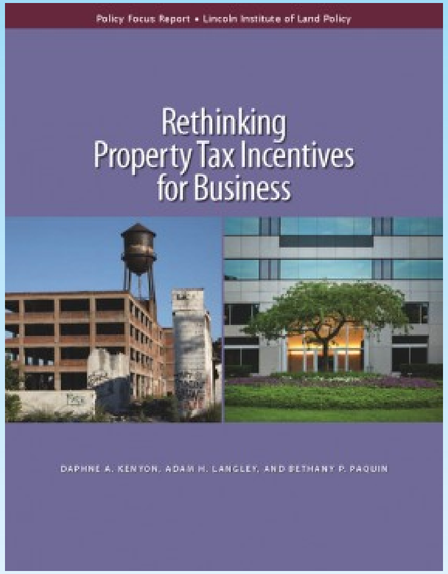
September 8-11, 2019 / Niagara Falls, Ontario, Canada

Celebrating 60 Years of International Partnerships

Background

Background

- Numerous studies warn tax incentives are often unnecessary or ineffective……



- Yet, the use of tax incentives remains widespread - even escalating

Should Communities Even Use Tax Incentives?

Yes, but…

- Communities should employ incentives that:
  - apply the most leverage for promoting growth
  - avoid needlessly eroding the tax base
- The Goal: policies and tactics that balance job and income growth with fiscal integrity and performance

Tax Incentive Program Core Practices

Establish Clear Guidelines

- Communities with clear incentive policies are:
  - less likely to use incentives in situations where they are not necessary
  - overextend in the heat of a competition

- Reliance on Property Tax drive of Boston's incentive policy:
  - New development is expected to proceed without incentives and pay full taxes.
  - Tax incentives are used an exception basis

Tax Incentive Core Practices

Boston considers incentives to.....

- attract a key industry or company that will yield significant gains in employment
- stimulate economic development in a strategic location
- assist a project with unique economic or construction challenges

Calculate the Full Tax Amount

Sharing the full tax calculation:

- allows community to demonstrate that it's competitive or a project is feasible without an incentive
- demystifies the assessment process - makes taxes a more certain, predictable cost
- establishes a benchmark for determining incentive cost

Tax Incentive Core Practices

Require Detailed Financial Disclosure

- **Pro forma – project cost, revenue and expenses, and expected returns**
- **Rule of thumb: developer should provide same information as bank or investor**
- **Accurate financials ensures an incentive will only provide the level of assistance *required***

DEVELOPMENT PROGRAM & RENT ASSUMPTIONS

Space Classification		Area (Sq.Ft.)	Rent/Sq.Ft.	Annual Rent
Office Space		33,100	$21.00	$695,100
Retail Space		6,600	$18.00	$118,800
Leasable Total:		*39,700*		*$813,900*
Storage/service:		3,000		
Common space/circulation:		9,500		
Parking:	41 spaces	13,200		
Total Building Area (minus parking)		*52,200*		

COST ASSUMPTIONS

		Cost/Sq.Ft.	Total Cost
Land Cost:	0.6 acres	$0.00	$0
Hard Costs (50.6k Sq.Ft.):		$105.00	$5,481,000
Hard Cost Contingency:		5%	$274,050
Soft Costs:		24%	$1,315,440
Structured Parking Costs:		$17,000 per space:	$697,000
Estimated Street Construction Cost:			$189,000
Total:			$7,956,490

OPERATING PRO FORMA

INCOME		
Gross Office Income (Annual):		$695,100
Vacancy & Collection Loss:		5%
Effective Retail Income:		$660,345
Gross Retail Income (Annual):		$118,800
Vacancy & Collection Loss:		5%
Effective Retail Income:		$112,860
Effective Gross Income:		$773,205
EXPENSES	% of EGI	Expense
Total Expenses:	37.0%	$286,086
NET OPERATING INCOME:	63.0%	$487,119
Indicated Project Value (Based on 7.0 Cap Rate)		$6,958,850

FINANCING ASSUMPTIONS

Total Cost:		$7,956,490
Construction Cost (Minus Land):		$7,956,490
Indicated Value:		$6,958,850
CONSTRUCTION LOAN		
Construction Interest Rate:		7.5%
Term (Months):		18
Collateral (Land - Value estimated):		$600,000
Construction Loan-to-Cost Ratio:		80%
Construction Loan:		**$6,365,192**
Construction Cost:		$7,956,490
Equity Required (Construction):		**$1,591,298**
PERMANENT FINANCING		
Permanent Interest Rate:		*7%*
Term (Years):		*25*
Loan-to-Value Ratio:		*80%*
Project Value:		*$6,958,850*
Loan Amount:		*$5,567,080*
Debt Service (Annual):		*$472,164*
Debt Coverage Ratio:		1.25
NOI:		$487,119
Supportable Debt Service:		$389,695
Supportable Loan Amount:		$4,594,732

STATIC MEASURES OF RETURN

Total Equity Required:	(Total Cost - Loan):	**$3,361,758**
Equity/Cost:		42%
Value/Cost:		87%
RETURN ON COST:	(NOI / Total Cost)	**6.1%**
Leverage:	(ROC - Debt Service Constant)	-2.4%
Internal Rate of Return (IRR):		**10.8%**
Modified IRR (with 8% reinvestment):		10.3%

ESTIMATED VIABILITY GAP

Targeted Return on Cost:	9%
Estimated Return on Cost:	6.1%
CALCULATED VIABILITY GAP:	**$2,544,055**
Gap as % of Overall Cost:	**32.0%**

Tax Incentive Core Practices

Incentives Must Generate Returns for the Community

- Incentive programs should lead to measurable economic outcomes – usually new jobs
- Reporting and auditing provisions are critical enforcement tools
- Clawbacks recoup all or a portion of the incentive if actual performance falls short of promised levels
- Pay for Performance model, where incentive is annually sized based on firm's performance, is even better

Pay for Performance	
Jobs	**Incentive**
1,000	1,000,000
900	900,000
800	800,000
700	700,000
600	600,000
500	500,000
< 500	None

Tax Incentive Core Practices

IAAO 85th Annual Conference & Exposition
September 8-11, 2019
Niagara Falls, Ontario, Canada

Consider Providing Infrastructure Instead

- Infrastructure costs are more known – both in terms of direct costs and debt service requirements
- Infrastructure investments may benefit several development projects or firms
- Providing infrastructure is a more traditional, familiar role for government
- New infrastructure benefits community even if the subsidized business relocates or goes out of business

Tax Incentive Core Practices

Governments should work cooperatively on regional economic issues

- Tax incentives that lure companies across borders erode local tax bases without producing regional economic benefits

- Neighboring communities should work cooperatively to benefit the region
- Coordination between state and local governments on incentives is also important

Fan Pier Case Study

The Fan Pier - prime, waterfront real estate in the heart of Boston's Seaport District

- 15 acres of vacant land and surface parking lots
- Underutilized for decades
- Several developers tried and failed

Fan Pier Case Study

Incentive Tools to Stimulate Development

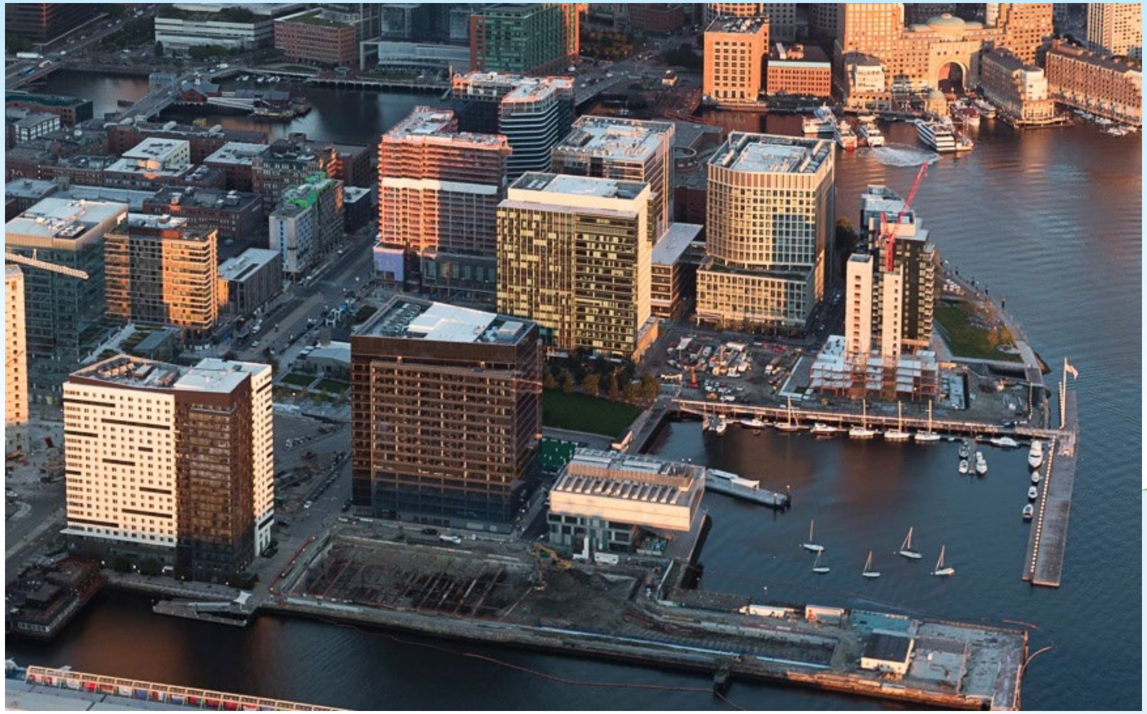
- Boston partnered with Fan Pier's owner and state government to use a new infrastructure program – I Cubed – to provide $37.8M in streets, sidewalks, seawalls, sewers, etc.
- Vertex Pharmaceuticals committed to bring over 1,700 employees to the site in two buildings containing 1.1M sqft.
    - The state offered Vertex $10M tax credits
    - Boston offered a $12M property tax incentive
- Incentives reduced Vertex's occupancy costs to a level more competitive with its alternatives

Fan Pier Case Study

Fan Pier emerged as the signature mixed-use development in the Seaport

- thousands of new jobs, residents, and businesses
- project served as a catalyst that led to the surge of development occurring in the broader Seaport district

- $1.5 B of development under construction
- $850 M is scheduled to break ground soon
- Additional development has occurred without incentives



Fan Pier Case Study

Return on the Vertex Investment

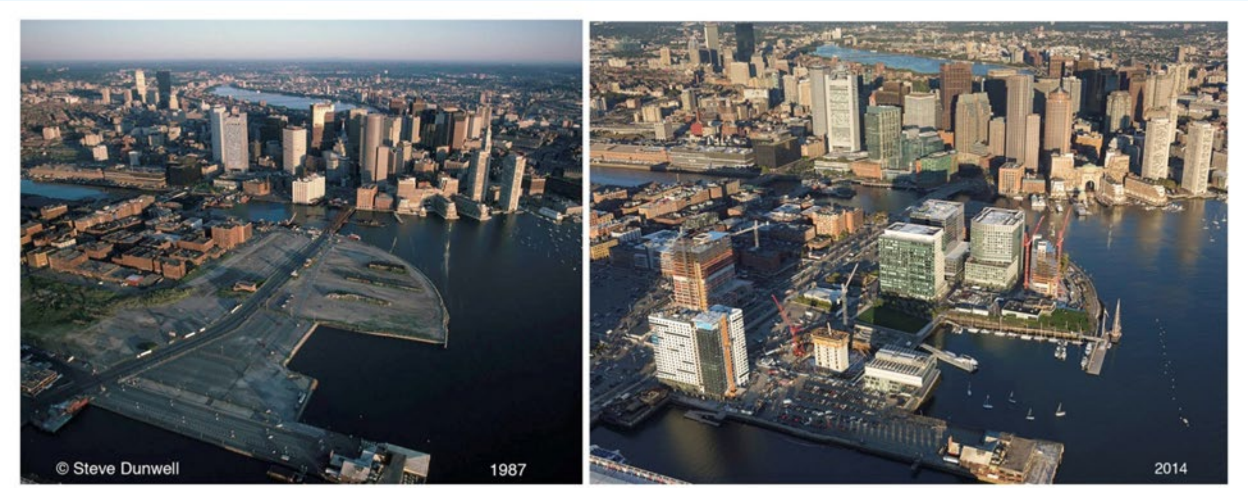
- Over 1,700 hundred employees to the area
- Demonstrated the district's potential as a location for companies in the innovation economy
- Accelerated the pace of development for the area
- The city's TIF investment of $12M yielded $55M in new taxes over the 7 year term of the tax agreement from the Vertex property
- The related development wave resulted in a $96.7 million annual increase in property taxes – and growing – from the Seaport

Fan Pier Case Study

Time to Reflect…

- Would the Seaport have developed without the infrastructure investment and tax incentives?

- Given the potential of the site, would it have been wise to do nothing and risk that this wave of development would be delayed or, even worse, produce an inferior results?



Thank you!

Ron Rakow, Fellow
Lincoln Institute of Land Policy
rrakow@lincolninst.edu