The Maryland Public Policy Institute

Maryland Policy Report

No 2011-03 July 7, 2011

STATE CENTER, PHASE I: THE $127 MILLION TAXPAYER HANDOUT

MARYLAND PUBLIC POLICY INSTITUTE
MARYLAND TAX EDUCATION FOUNDATION

THIS PAPER EXAMINES the primary taxpayer subsidies for the initial phase of Baltimore City's State Center, a project proposed to replace the current state facilities in mid-town Baltimore bordering Preston Street. Led by a public-private partnership, the project envisions a mixed-use complex containing state and private office space, retail and dining space, mixed-income housing, and a parking garage. The project has attracted significant attention as well as litigation due to its scope and expense. Lost in the debate, however, is a careful accounting of the project's potential cost to the public. In what follows, we estimate and report this cost.

Suggested Citation: "State Center, Phase I: The $127 Million Taxpayer Handout." Maryland Public Policy Institute and Maryland Tax Education Foundation. July 2011.

INTRODUCTION

State Center refers to a state-owned 28-acre parcel of land in mid-town Baltimore bordering Preston Street that currently contains several large office buildings, parking facilities, and the armory. Various state agencies are housed in the buildings, which provide about 1 million square feet of office space for approximately 3,500 state employees.[1]

Due to a combination of the age of the facilities and repeated deferral of necessary maintenance, Maryland's Department of General Services has advocated for a complete redevelopment of the site, involving total replacement of the existing buildings, rather than a more modest renovation. This redevelopment plan has been approved by the state's three-member Board of Public Works, and does not require explicit legislative consent from the General Assembly.

The proposed redevelopment is led by a public-private partnership between the State of Maryland, Baltimore City, and State Center, LLC. State Center, LLC consists of a variety of for-profit private organizations, including: Ekistics, LLC; Linden Associates, Inc.; McCormack Baron Salazar; Neighborhood Development Company; State Center Baltimore Developers, LLC; Midtown Convergence; and TAC Companies.

Unlike traditional public projects, which are financed by low-interest public debt and result in state-owned, rent-free assets upon completion, the State Center redevelop-

THE LAWSUIT

In December 2010, a group of property owners primarily located in Baltimore's Central Business District sued both the state and the private developers of State Center, alleging that the state violated procurement law by failing to award the contract for redevelopment of the site by a competitive process. The suit was later amended to add a group of restaurant owners in Little Italy as plaintiffs, and to expand the complaint to cover the award of $33 million in bonds for a parking garage. The defendants have asked for the suit to be dismissed, arguing that the project is considered a disposition of property, and thus does not require competitive bidding. A hearing was held in April 2011, and the parties are awaiting a ruling by a Baltimore City Circuit Court judge.

ment project will be financed through a variety of mechanisms, including substantial amounts of private loans and equity, as well as public tax increment financing (TIF) bonds and state and federal tax credits. While the state will retain ownership of the land and charge a nominal land rent to the project's private developers, the developers will own the newly constructed buildings, and state agencies will pay rent for the office space they occupy in those buildings.

Project advocates argue that the size and scope of the project, whose total cost approaches $1.5 billion and whose construction will span more than a decade, and thus requires a public-private partnership. In turn, in order for the public-private partnership to secure the large private loans and equity necessary to complete the project, the state has contractually committed itself to a long-term lease of office space in the new buildings. By ensuring that the project has at least one major, guaranteed tenant, the developers hope to inspire confidence in potential investors.

While the State Center project has attracted significant support from the Baltimore City government and many local groups, it has also been a target for criticism. Questions about procedural issues and the lack of transparency surrounding the selection and subsequent replacement of developers abound. The initial development team was

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selected after a non-competitive request for qualifications (RFQ) process, rather than the more competitive request for proposal (RFP) process used in standard procurement situations and designed to ensure the selection of the most cost-effective bid. Several significant changes to the development team were later made without a formal reexamination of qualifications. In part because of these events, the entire is

TABLE 1	
1. PRESENT VALUE OF ADDITIONAL COST OF RENT	$66 MILLION
2. STATE-FINANCED PARKING GARAGE	33 MILLION
3. STATE-OWNED LAND	11 MILLION
4. TIF BONDS	15 MILLION
5. TAX CREDITS	2 MILLION
	$127 MILLION

project is currently on hold pending a lawsuit alleging that the state violated procurement laws in selecting the development team for the project.

Other opponents question the wisdom of locking the state into a long-term lease at rents significantly higher than current market rates, and whether it makes sense to invest in a large, mixed-use complex when significant amounts of office space remain vacant downtown. However, the purpose of this report is not to rehash the debate over whether the State Center project is a good or bad idea, or to take sides in the lawsuit. Rather, we aim to highlight and clarify a largely overlooked matter: the potential public cost of the project.

THE $127 MILLION TAXPAYER SUBSIDY FOR PHASE I

The proposed State Center project, if implemented as envisioned, will eventually provide approximately:

- 2 million square feet of office space;
- 250,000 square feet of retail space;
- 1,100 housing units, including low income housing; and
- 5,800 parking spaces.[2]

The project is scheduled to have five phases. Detailed information is currently only available for the first phase, so our estimate of taxpayer subsidies for this project is necessarily partial. If the later phases of the project proceed, the actual taxpayer subsidy will be significantly larger than we estimate.

Phase I, estimated to be completed in 2014–2015, will provide:

- 515,000 square feet of state office space;
- 15,000 square feet of private office space;
- 65,000 square feet of retail space (primarily a new supermarket);
- up to 100 apartments; and
- a 928-space state parking garage.[3]

Other than the state government, the developers have no committed tenants for the project, either for Phase I or any later phase. However, the developers hope the state's presence will have a catalytic effect, drawing private tenants, residents, and retailers to later phases. There is no guarantee of the catalytic effect occurring, so the subsidies to the project represent a "calculated risk" investment on the part of the state.

TABLE 2	
BASE BUILDING	$138 MILLION
SOFT COSTS AND DEVELOPMENT FEES	29 MILLION
APARTMENTS	30 MILLION
STATE-FINANCED PARKING GARAGE*	28 MILLION
STATE-OWNED LAND	—
CONTINGENCY	22 MILLION
BALTIMORE CITY INFRASTRUCTURE, INCLUDING TIF	26 MILLION
	$273 MILLION

** While the budget specifies $28 million, the Board of Public Works approved bonds totaling $33 million.*

We estimate the total value of the taxpayer subsidy for Phase I to have a present value of $127 million. This figure is derived from the sum of the above-market rent the state will pay during its long-term lease, the value of the state-financed parking garage, the Phase I TIF bond, the value of the state-owned land being rented to the developers at a nominal rate, and tax credits. The estimated subsidies for each of these items are shown in Table 1.

To promote the first phase, the state has, among other items, (1) agreed to pay an above-market rental rate—about $10 per square foot extra—on its new office space, (2) construct a parking garage financed by $33 million in State bonds, and (3) rent the land to the developer for a nominal amount. Additionally, Baltimore City will contribute infrastructure, (4) including about $15 million worth of construction supported by tax increment financing (TIF) bonds. With the project controlled by a private developer (instead of the state), the property will effectively return to the Baltimore City tax rolls. The annual property taxes will be funded by the state and other tenants through rent payments; however, as the state is the primary tenant in Phase I, virtually all of the property tax burden will fall on the state. Since these property taxes will first be used to pay off the TIF bonds before going into city coffers, the TIF bonds represent a direct subsidy from the state, and thus Maryland taxpayers. Finally, (5) Phase I will benefit from approximately $2 million in federal tax credits, primarily due to the construction of low-income housing units.

We anticipate the private developers will invest little of their own money. Apart from the estimated subsidies, most of Phase 1 will be financed through commercial loans backed by the state's long-term office space lease. The Phase 1 office building and commercial space construction cost approximates $232 per square foot, which is substantially higher than the $170 per square foot costs (including $20 per square foot in demolition costs) estimated for Baltimore City office buildings by two national construction cost data services.[4]

We estimate that the total cost for Phase I of the project is $273 million. See Table 2 for a breakdown of these costs.[5]

WHAT IS TAX INCREMENT FINANCING?

Tax increment financing (TIF) is a public financing method widely used to support redevelopment in localities across the United States. A TIF essentially allows a government to borrow in the present against the future increased value of property. Using TIF bonds, a government may undertake public infrastructure improvements to encourage or support redevelopment in a given area. Combined with private investment, such improvements can increased the assessed value of properties, thus leading to increased property tax payments. The "increment" refers to this increase. Future property tax payments are dedicated to paying off TIF bonds; once the bonds are paid off, property taxes will accrue directly to the locality. While TIFs have a lengthy history of use in the United States, they have recently been receiving more scrutiny as localities issue larger TIF bonds. TIFs may sometimes be used even when private development would otherwise occur, and if increased development requires additional public services beyond what is financed by the TIF, areas outside the TIF district may have to make up the difference in increased taxes. If future property taxes prove insufficient to meet the debt service requirements of TIF bonds, the government will default on the bond. TIFs, like revenue bonds, do not guarantee repayment to bondholders based on the taxing power of the government. However, it is possible that a default on a TIF bond could hurt a government's overall credit rating, leading to higher debt service on general obligation (GO) bonds.

Given that public subsidies for Phase I amount to $127 million, they represent more than 46 percent of the budget of this phase.

The assumptions used in the calculation of the subsidies include:

Discount Rate – The State of Maryland is a AAA-rated borrower. The project debt, however, will not be tax-exempt. With 20-year U.S. government bonds at a 3.5 percent yield and AAA corporate bonds at 3.75 percent yield, a state-backed lease can likely be financed in the debt markets at 5.25 percent, which is the discount rate used here for future excess-over-market rent.

We estimate the total value of the taxpayer subsidy for Phase I to have a present value of $127 million.

Extra Rent – The $10 extra rent per square foot has been documented in Department of Legislative Services reports, the litigation by downtown real estate owners, and our discussions with real estate business people in the area.[6] It amounts to $5.15 million per year (515,000 square feet × $10 per square foot).

Rent Escalation – We assume the state's 3 percent rent escalation is the same percent as inflation in competing office building rents.

Land Values – A contiguous 22 acre[7] parcel near downtown Baltimore is unusual. There are no comparable sales in recent years. We assume $0.5 million per acre, based on recent real estate offerings in Baltimore ($11 million = $0.5 million per acre × 22 acres).

Parking Lot – To fund fully the debt service and operating costs of the parking lot, the state would have to charge its outside users/employees over $250 per month per space. The suggested employee fee is $56 per month, but state employees traditionally do not pay for parking. Some 550 of the 928 spaces are reserved for the state's use.

Spillover/Multiplier Effects – The first phase of the project replaces older state office space with newer space. It does not bring new employees to the area or provide much added commerce. For this reason we assume no spillover/multiplier effects. Successful later phases may produce such spillover effects that are beneficial to the local economy, but predicting such effects is speculative at this point.

Delays/Overruns – Because the private developers are so thinly capitalized, the state must pay rent even if Phase I's completion is delayed. Otherwise, commercial debt financing is unavailable according to project-related documents. This analysis assumes no cost overruns, although cost overruns are not unusual in a project of this size.

CONCLUSION

Based on the publicly available information regarding the State Center project, we estimate the total cost of taxpayer subsidies for Phase I amounts to $127 million. This represents a significant commitment of public resources for the primary benefit of private developers.

Proponents of the project argue that in addition to whatever costs may be incurred, the project will also bring significant benefits to both Baltimore City and to Maryland. These include some soft, hard-to-quantify benefits such as revitalization of the area surrounding State Center and construction, retail, and facilities-related jobs. We consider these benefits to be "soft" because they rely on completion of multiple phases of the project, and it is often impossible to determine how many jobs are "created" versus shifted or relocated. Such benefits are certainly possible, but at this point their value remains impossible to estimate or rely upon.

There are other, more easily quantifiable potential benefits associated with the project. Foremost among these are increased tax revenues. As discussed in our analysis, the current state facilities lie on state-owned property, and produce no property taxes for Baltimore City. Under the proposed project, the developer would pay property taxes to the city. Naturally, the cost of these property taxes will be passed on to tenants. While the state is the primary tenant in Phase I, if additional phases are completed, the property tax burden will presumably fall on other, non-government tenants.

Before any property taxes accrue to Baltimore City, they will first be used to pay off any TIF bonds.

However, before any property taxes accrue to Baltimore City, they will first be used to pay off any TIF bonds issued in support of city infrastructure for the project. While Phase I only calls for $15 million in TIF bonds, future phases will require additional TIF bonds. Furthermore, the nonpartisan Department of Legislative Services states that "the projected property assessments for State Center appear unrealistically high," and also questions the assumptions of low vacancy rates in the competed facilities, given vacancy rates in other areas of the city.[8] These factors may result in significantly less property tax revenue than anticipated, and in the worst case, inability to meet debt service on the TIF bonds.

Redevelopment of the state office complex is not an inherently unworthy goal, but advocates of the State Center project have touted far-off and highly uncertain benefits in order to make their case. Our estimates reveal the true cost of the project to taxpayers, a cost that will only increase with additional phases of the project.

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ABOUT THE ORGANIZATIONS

The Maryland Tax Education Foundation is a nonprofit, nonpartisan organization that studies budget and tax issues in Maryland. Previous topics have included a $1.5 billion slots license giveaway proposed by the State of Maryland, the $4 billion Washington Sanitary Suburban Commission, and Montgomery County school spending and student performance.

The Maryland Public Policy Institute is a nonpartisan public policy research and education organization that focuses on state policy issues. Our goal is to provide accurate and timely research analysis of Maryland policy issues and market these findings to key primary audiences. The mission of the Maryland Public Policy Institute is to formulate and promote public policies at all levels of government based on principles of free enterprise, limited government, and civil society.

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1 Department of Legislative Services, "State Center – Transit-oriented Development Briefing." February, 2009.
2 State Center, "State Center 101 Fact Sheet." Available at www.statecenter.org; Department of Legislative Services, "State Center Transit Oriented Development Briefing." May, 2009 (on file with author).
3 Maryland Department of General Services and Maryland Department of Transportation, "State Center Summary." February 15, 2011.
4 $138 million ÷ 595,000 square feet = $232 per square foot.
5 Maryland Department of General Services and Maryland Department of Transportation, "The State's Participation in the Redevelopment of State Center in Baltimore City." October 2008.
6 Department of Legislative Services, February 2009; Department of Legislative Services, May 2009; Circuit Court for Baltimore City Case No. 24-c-10-009242 OG (on file with author).
7 While the entire parcel is 28 acres, publicly available documents indicate that the development agreement only concerns 22 acres.
8 Department of Legislative Services, May 2009.

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