RESPONSE TO OBJECTIONS OF GAINES AND PATUSKY

BY GABRIEL MICHAEL, SENIOR FELLOW, MARYLAND PUBLIC POLICY INSTITUTE AND JEFF HOOKE, CHAIRMAN, MARYLAND TAX EDUCATION FOUNDATION

INTRODUCTION

ON JULY 7, 2011, the Maryland Public Policy Institute and the Maryland Tax Education Foundation jointly released the report "State Center, Phase I: The $127 Million Taxpayer Handout," authored by Gabriel Michael and Jeff Hooke. As indicated by the title, the purpose of the report is to estimate the size of the public subsidy for the initial phase of redevelopment of the State Center office complex. As explained in the introduction:

> [T]he 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 day after the report's release, Michael A. Gaines Sr., assistant secretary of real estate in the Maryland Department of General Services, and Christopher Patusky, State Center project director in the Maryland Department of Transportation, issued a letter on behalf of their departments to Maryland Public Policy Institute president Christopher B. Summers, claiming the study "contains serious misstatements of facts about the Project" and requesting that the study be withdrawn.

The Gaines-Patusky letter lists several objections to the study. By and large, the issues they raise were addressed in the study itself, though the letter indicates no familiarity with those discussions.

This response specifies and addresses the objections of Gaines and Patusky.

CRITICISMS AND RESPONSES

The Gaines-Patusky letter makes eight specific objections to the Michael-Hooke report. This response divides the objections into three groups: two General Criticisms, four Specific Criticisms, and two Other Criticisms. We address each of these objections below.

General Criticism 1: The study's authors failed to contact "either the state government or the private development team to verify its information."

We, the authors of the study, contacted both city and state officials while conducting research for the report. We also contacted a prominent Baltimore real estate developer with no ties to the project to discuss rents and land values, and we discussed Baltimore construction and demolition costs with a national consulting firm that publishes relevant data.

In addition, we relied heavily on numerous official documents relating to the project authored by a variety of state agencies, including the Maryland Department of Transportation (MDOT), the Maryland Department of General Services (DGS), the Department of Legislative Services (DLS), the State Treasurer's office, and the Attorney General's office. Many of these documents are explicitly cited in the Michael-Hooke report. Much of the information used in the study is available on the State Center project's official website.

General Criticism 2: The study "overstates the cost of the project to the public while excluding all of the revenues and benefits that would be generated by the project."

Many of the Gaines-Patusky criticisms allege that the Michael-Hooke report overstates costs; those specific criticisms are addressed later in this paper. This particular response addresses the claim that the study fails to consider revenues and benefits.

As explicitly noted in the introduction of this response and in the study itself, the purpose of the Michael-Hooke report is to estimate the size of the public subsidy for the initial phase of the State Center project. This estimate is necessary for any serious discussion of the project's effect on the welfare of the citizens of Maryland. The report is not intended as a comprehensive cost-benefit evaluation of the entire project, and does not claim to be such. As noted in the report's conclusion, such an analysis would require far more information than is currently available.[1]

Numerous statements and reports produced by MDOT and DGS have emphasized the benefits of the project, but, in our opinion, have failed to clearly specify the public costs associated with it. As expressed explicitly in the Michael-Hooke report's conclusion, the State Center project *may* have future benefits, but the size and likelihood of such benefits must be weighed against the $127 million in public costs related to the first phase alone. As already noted in this response, the report explicitly states in the introduction that it takes no position on "whether the State Center project is a good or bad idea."

The Gaines-Patusky letter lists a number of potential revenue streams from the State Center redevelopment project. Though possible revenue streams were not the subject of the Michael-Hooke paper, this response offers the following few comments on them:

> The Gaines-Patusky letter claims that $40 million (present value) in city and state tax revenues will be generated by the project over 20 years. That figure differs from previous estimates produced by MDOT, DGS, and DLS. DLS analyses suggest that this estimate and others represent a combination of property taxes, income taxes, and other indirect taxes (e.g., sales taxes generated from retail establishments). A May 2009 DLS analysis concluded that such estimates appear inflated based on the assumptions used. State tax revenues will be less because existing state employees would not generate new income taxes—they are already taxpayers. Likewise, aggressive estimates of property value appreciation may not be realized, consequently not yielding revenue sufficient either to pay debt service on the Tax Increment Financing (TIF) bond used to partially finance the redevelopment or to pay additional property tax to Baltimore City during the term of the TIF.[2]

Whatever the most recent estimate is, MDOT and DGS reported in December 2010 that about $20 million of any increased tax revenue realized by the city will be used to pay for the Phase I TIF bond.[3] The rest, it is claimed, will be paid into the city's general fund. This assumes that no additional TIF bonds are issued for further phases of the project. Further TIF bond issues would require additional debt service, increase the proportion of city tax revenue dedicated to paying for the TIF, and decrease any amount paid into the city's general fund. Of course, further TIF bond issues will likely accompany increased property tax receipts, but without detailed knowledge of what future phases of development will look like, it is difficult to know how much tax revenue will be devoted to debt service on TIF bonds and how much will accrue to the city's general fund. Given that the current facility produces no property taxes for the city, it is clear that Phase I will offer new tax revenue. What is not clear is whether it will be enough to exceed the debt service requirements for the first and any future TIF bonds.

The Gaines-Patusky letter also claims that the State Center project will generate $25 million (present value) in ground rent over 50 years. The letter does not specify how that figure was derived. The Master Development Agreement specifies ground rent revenue as deriving from three sources: 1) a base rent of $2,000 per acre per year (to be increased annually); 2) reimbursement for already-incurred state expenses; and 3) the proceeds of a profit-sharing arrangement. With regard to the base rent, a February 2009 DLS analysis estimated that "over 90 years, assuming the full term of the ground lease, the State will have received about $5 million."[4] The second source of ground rent is reimbursement for already-incurred state expenses and thus does not represent any new revenue. Finally, with regard to the profit-sharing arrangement, while the DLS's non-discounted figure of $5 million over 90 years does not appear to include any revenue derived from the agreement, its analysis concludes that because of the structure of equity participation, "net operating income is likely to be minimal," since any profit-sharing revenues will only be paid after numerous other obligations.[5]

The Gaines-Patusky letter claims the State Center project will generate $16 million (present value) in garage revenues over 20 years. The Michael-Hooke report does assume that state employees will not pay for parking, since employees typically receive parking for free. If the envisioned State Center supermarket is brought online, it is unlikely that its customers will pay for parking, following common practice for mixed-use development supermarkets. It is, of course, possible that a small number of non-employee visitors to the garage will pay for parking, but our calculations suggest that the present value of this revenue, net of expenses, is negative.

Finally, the Gaines-Patusky letter criticizes the Michael-Hooke report for not "consider[ing] the thousands of jobs that will be created and its positive impact on the area." In fact, the report specifically notes in its conclusion that there are potential benefits related to construction, retail, and facilities-related jobs, but warns that it is usually impossible to know how many jobs will be "created" by a given project, as opposed to jobs that will simply be shifted to State Center from other Maryland locations.

Specific Criticism 1: The report "double-counts the $15 million tax increment financing amount."

Tax-increment financing (TIF) essentially allows a government to borrow against a future increase in property taxes. A TIF bond is issued in the present, often to finance infrastructure related to a private development project or to encourage such development.[6] The bond is serviced by the increased property taxes that are collected in the future. In the case of State Center, there is a guarantee of increased property taxes, since the state currently pays no property taxes on the existing site but the private developer will pay property tax on the developed site.[7]

As noted in the report, and implicitly confirmed in the Gaines-Patusky letter, the cost of the property taxes will be passed on to tenants in the form of higher rents. Since in Phase I the state government is the primary tenant, state government will bear the vast majority of the cost of the property taxes. This represents a transfer of state (i.e., taxpayer) money to Baltimore City. This transfer happens irrespective of whether a TIF is issued or not, and represents a public subsidy: state taxpayers are essentially footing the bill for the private owners' property taxes—something that would not happen if the state were to continue sole ownership of State Center.

However, when a TIF is issued, the amount of the subsidy effectively doubles. By designating property tax revenues for debt service, TIFs shortchange the traditional destination of such revenues, such as local schools, libraries, and other government services.[8] Thus, not only will state taxpayers fund the private owners' property taxes, but those taxes go to service the TIF bond rather than pay for school and other local government services, and thus primarily benefit a private party. This is the second half of the subsidy.

To re-emphasize why this is not "double counting," consider future phases of State Center development in which tenants would primarily be non-governmental. If that development does occur, future TIFs would be serviced by property taxes that would ultimately fall on non-governmental tenants in the form of higher rents. Obviously those rents, being paid by private parties, would not constitute a public subsidy in the same way that such rents being paid by the state government would. However, the TIF would still represent a public subsidy, as property taxes would still be redirected from traditional destinations for the primary benefit of a private party. In that case, an analysis of the later phases of State Center would still include the TIF as a public subsidy, but would not include the rent paid by private parties.

Specific Criticism 2: The report "inflates the land value" of the State Center property.

The report estimates that the land value of State Center is $0.5 million per acre. This estimate was determined using data of recent sales of raw and nearly raw land in the downtown area. It was further informed by discussion with a Baltimore real estate developer with no ties to the project. Additionally, a report by DLS offers a wide range of potential appraised values for both the State Center land and buildings, anywhere from $18 million to $73 million.[9]

The Gaines-Patusky letter asserts a land value of $1.8 million for the entire parcel, which averages out to a mere $82,000 per acre. That figure does not seem credible when somewhat similar land sells for $0.5 –$1.0 million per acre.

Specific Criticism 3: The report "greatly understates the cost of construction to the private development team."

Publicly available documents indicate that the developer's equity contribution for the entire State Center project (i.e., Phase I and all future phases) will be an estimated $30 million.[10] The vast majority of the project will be financed by loans. Developer equity thus represents a fraction of the project's estimated $1.5 billion cost.

It should be noted that developer equity estimates do not affect the public subsidy estimation, which is the purpose of the Michael-Hooke report.

Specific Criticism 4: The report "fails to note that the State's office rent rates are at the low end of what is required to finance new construction."

As noted in the Michael-Hooke report, "[t]he $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."[11]

The Gaines-Patusky letter does note that the Social Security Administration recently agreed to lease office space for $39 per square foot in a to-be-constructed building at the Reisterstown Plaza Metro Station. The SSA lease does provide one reference point for comparison, however there are reasons to not use that project as the sole reference point for the

State Center project. For instance, the federal government has unique reasons, such as heightened security concerns and geographical proximity to its headquarters, for its willingness to pay an above-market-rate for its expansion.

Other Criticism 1: The report "fails to note or analyze the flaws inherent in its recommended alternative."
Contrary to this criticism's assertion, the Michael-Hooke report does not recommend any specific alternative. Such a recommendation would be beyond the paper's purpose.

Other Criticism 2: The report mischaracterizes the Request for Qualifications (RFQ) process and the replacement of development team members.
The Michael-Hooke report makes no claims as to whether the RFQ or replacement of development team members was carried out appropriately. Instead the report simply notes that "[q]uestions about procedural issues and the lack of transparency surrounding the selection and subsequent replacement of developers abound"—a statement that is surely accurate. Further, the report explicitly refuses to "take sides" in the ongoing litigation over those questions.

As noted in the Michael-Hooke report, standard procurement procedures require a process of competitive bidding designed to ensure the selection of the most cost-effective bid from the perspective of the state and taxpayers. Given that there have been significant changes in the initial development team, including one withdrawal related to financial instability of the partner and another related to alleged bribery, it is hardly surprising that the less stringent RFQ process has attracted scrutiny from many parties.[12] A May 2009 report by the non-partisan DLS warned that "it is not known if the new PS Partners LLC team has the financial resources or any experience in undertaking the construction or management of a project of this magnitude."[13]

CONCLUSION

After careful consideration, there appears to be no objection raised in the Gaines-Patusky letter that poses a significant challenge to the Michael-Hooke report estimating the public subsidy in Phase I of the State Center project. Indeed, many of the issues raised in the letter were explicitly addressed in the report.

A careful estimate of the public subsidy for a proposed public project is a requirement for any cost-benefit analysis of that project, and obviously no public project should go forward without a careful weighing of the costs and benefits. The attention given to the Michael-Hooke report and the contents of the Gaines-Patusky letter underscore the need for this report.

---

1 Both MDOT and DGS appear to agree with this point, noting that currently "there is no set development plan for future phases and there has been no study done of the City infrastructure needs beyond the Phase One plan." Department of General Services and Maryland Department of Transportation, "State Center Project Review," December 9, 2010: p. 3.
2 Department of Legislative Services, "State Center—Transit Oriented Development Briefing," May 28, 2009: p. 2 (on file with authors).
3 Department of General Services and Maryland Department of Transportation, "State Center Project Review": p. 4.
4 Department of Legislative Services, May 2009: p. 22.
5 Ibid., p. 13.
6 John S. Klemanski, "Using Tax Increment Financing for Urban Redevelopment Projects," *Economic Development Quarterly*, Vol. 4, No. 1 (February 1, 1990): p. 24.
7 Department of General Services and Maryland Department of Transportation, "State Center Project Review": p. 3.
8 Catherine A Chikow, "Tax Increment Financing," *Journal of State Taxation* 17 (1999 1998): 49.
9 Department of Legislative Services, May 2009: p. 10.
10 Department of General Services and State Center LLC, "Master Development Agreement," June 15, 2009, p. 160; Department of Legislative Services, "State Center—Transit-oriented Development Briefing," February 2009: p. 10.
11 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).
12 Lorraine Mirabella, "State Center renewal planned as model of 21st-century design," *The Baltimore Sun*, October 11, 2010; "Struever Bros. Eccles & Rouse stops work on Baltimore projects," *Baltimore Business Journal*, June 9, 2009.
13 Department of Legislative Services, "State Center Transit Oriented Development Briefing": p. 7.