

# ***Economic Development Incentives - Impact on Taxing Jurisdictions Conflict, Issues and Remedies January 2010***

## ***Introductory***

---

There has been an increasing appetite among developers, development attorneys, and businesses for economic development incentives to support many of the construction activities undertaken in the Kansas City metropolitan area. This is creating significant financial pressures on the schools, counties, libraries, mental health organizations, and others because taxes are being directed away from the taxpayer's intent and being used or abated in the name of economic development. The increasing frequency and use of incentives that divert both property tax and economic activity taxes (sales tax, utility tax, and earnings tax) from the taxing jurisdictions reduce the capacity of these jurisdictions to provide basic services upon which all citizens depend. Ironically, research indicates it is these “quality of life” services provided by our schools, libraries and health services which are necessary to foster economic development in a vibrant city. These conflicting goals and counterproductive decisions are apparent to very few, but of the utmost concern to the taxing jurisdictions.

There has been conflict between the taxing jurisdictions, Economic Development Corporation (EDC), Tax Increment Financing (TIF) Commission staff and legal counsel, City Council and the development community regarding the proper use and level of incentives for economic development within Kansas City, Missouri. There has also been major conflict between the parties regarding the proper structure, process and procedures used to approve incentives. This document will outline some of the issues as the taxing jurisdictions see them and propose suggested remedies.

While there has been progress and some reform of the process as a result of the Economic Development Incentive Policy (EDIP) adopted by the Kansas City Council on September 20, 2007, the EDIP has yet to be fully implemented after more than two years since its adoption. The public believes that the reforms are in effect, when they are not.

As stated many times, the taxing jurisdictions are not “anti-development”, they are for “smart and sustainable development”. The taxing jurisdictions are in favor of bringing new jobs and creating new investment into Kansas City. But just like a business, the taxing jurisdictions depend upon the increase of revenue to offset increasing costs. There should be a balance to promoting development and redevelopment within Kansas City and ensuring that the taxing jurisdictions are not harmed in the process. As quoted from the EDIP Rating Factors as the policy objective of “Stewardship of City Resources” the taxing jurisdictions want to ensure that all incentives are designed to “mitigate potential financial impact on other taxing jurisdictions / provide an immediate share of increment to schools and others.

Over the years, there has been a migration in thinking that has become pervasive. The tools that are discussed in this document are ones which were created for the purpose of fostering economic development. They have now become just another layer of financing that a developer uses in putting together a project. So there is a presumption of

entitlement that has emerged among developers, and this plays out in the city political process, where anyone who questions the granting of incentives receives the mantle of being anti-development. This card is played with the public and the press as soon as anyone questions the application of the economic development incentive process.

The conflicts need to be resolved between the parties. It is clear that the uncertainty of this process is not good public policy and does not promote the development we all wish for in our City. This report shall attempt to list out the concerns of the taxing jurisdictions, provide potential solutions, and but more importantly start the discussion to resolve the issues

## **Issue - Conflict of Interest**

### **EDC Revenue Structure**

A significant percentage of the revenue of the Economic Development Corporation (EDC) comes from receiving a percentage of the diverted property and sales taxes and/or a percentage of the redevelopment costs. The EDC staffs the redevelopment agencies and has influence over policy and commissions. Some EDC staff bonuses are tied to revenue produced from these fees. This form of revenue structure creates an inherent conflict of interest for the EDC.

#### *Potential solutions*

*Prior to 2000, the vast majority of the revenue to fund the EDC was provided by the City of Kansas City Missouri. Over the years this revenue has been reduced, which may have led to the EDC seeking to increase fees elsewhere. The taxing jurisdictions would propose that this revenue structure be changed to ensure that there is no real or perceived conflict of interest and the staff remains impartial to development projects. This would ensure that the EDC negotiates with developers for the term and percentage of incentives required for a project without consideration of how it might impact the revenue for EDC operations..*

### **Roles of EDC and TIF Staff and Legal Counsel**

For a board or commission to function professionally and properly the role of the board staff and legal counsel must be defined, trusted and reliable. It has been the experience of several commissioners representing the taxing jurisdictions that the staff and legal counsel for the TIF Commission have conflicting roles in that they provide counsel not only to the TIF Commission to formulate a recommendation to City Council, but also advise the City Council (sometimes with an opposing position) on the same projects which they have staffed and advised the TIF Commission. This was very evident on the 8th Amendment to the 43rd & Main TIF plan when the TIF staff opined its own recommendation to the City Council based upon the opinion of counsel to the Commission. That recommendation was contrary to the vote and recommendation of the Commission. (The 1998 City Auditor's Office in the 1998 TIF Commission Audit also made note of the conflicting responsibilities of the EDC staff as it relates to the TIF Commission. The report notes that EDC staff is responsible for assisting developers with proposals and determining feasibility of those proposals. The report goes on to say that

these responsibilities decrease the staff's ability to evaluate the developer's work objectively. This has not been resolved.)

*Potential solutions*

*Ensure that the staff and legal counsel provide professional support adhering to and following and supporting the decisions of the Commissions. Consider implementing the recommendations of the City Auditor from the 1998 – attached.*

**Roles of EDC and the city**

The EDC is dependent on the pleasure of the City Council and the Mayor for its operation. Because of that, directives that the staff receives from the City's elected officials sometimes takes precedent over the input from the other elected officials that are impacted by the decisions of the TIF Commission. This has been extended to the degree that the city has been named the developer on projects that are approved by the TIF Commission and is held to a different performance standard in that a plan for the use of the resources was not required and there was not demonstrated ability to meet a but-for test.

*Potential solution*

*The City should not be named as the developer for a project unless there is unanimous approval by the other taxing jurisdictions.*

**Issue – Equity and Accountability in the Process**

**Voting Rights / Representation**

There has been much discussion over this issue. The Tax Increment Financing (TIF) Commission staff and legal counsel ensures that the taxing jurisdictions have limited representation on the commission. It is the opinion of TIF legal counsel that these rights are time limited rights in that the taxing jurisdictions are not afforded any voting rights on matters outside the creation of a TIF Plan, project activation and budget and any amendment thereto. We believe the State statute does allow for full voting rights for all Commissioners. Many important aspects related to a TIF project are decided only by mayoral appointees. In addition the taxing jurisdictions have no representation on the Land Clearance for Redevelopment Authority (LCRA) or the Planned Industrial Expansion Authority (PIEA) or in the consideration of Chapter 100 financing, Enhanced Enterprise Zones (EEZ) approvals, or Chapter 353 approvals.

*Potential solutions*

*Taxing Jurisdiction should be afforded full voting rights on the TIF commission. These reforms should also be made on the LCRA as well as the PIEA boards. The taxing jurisdictions should be solicited for comments on Chapter 100 or 353 projects.*

**Accountability and Reporting of Funds**

It has been the experience of the taxing jurisdictions that information on the funds held by the EDC for TIF projects is difficult to obtain from the TIF staff, and typically inadequate in detail if obtained. The taxing jurisdictions have actually been asked to submit a request under the Sunshine Statue, and pay in advance for the time and effort

required, to obtain a detailed accounting of a special allocation fund. In fact transparency has been reduced through the most recent revisions to the TIF Commission annual report, thus withholding information from the public as well as the other taxing jurisdictions.

*Potential solutions*

*As noted in the 1998 City Auditor's Report ".....the TIF Commission had clearly identified the inadequacy of staff as an issue and has attempted to address the problem. We recommend that the TIF Commission be responsible for selecting an executive director who would serve at the pleasure of the commission and would select and be responsible for staff. Funding to staff the TIF Commission should be provided through the city's normal budget process"*

*Additionally, there are normally representations made by the developer which involve an estimation of the number of jobs to be created or the revenue that will be generated. There is little effort to determine if the projections are met, and there is no adverse outcome to a developer if the projections are wildly overstated.*

## **Issue - Review Process**

### **Taxing Jurisdictions Are Brought Into the Review Process Too Late**

As noted in the EDIP and played out in practice the EDC, Statutory Agency and City staffs work jointly on the initial incentive project review and analysis to ultimately come up with a joint recommendation on the incentive. This is certainly done with much interaction with the developer. It is only after this process that the non-city taxing jurisdictions are brought into the process – after the “deal” is essentially done. This in essence puts the non-city taxing jurisdictions in an adverse position of changing or renegotiating something that has for all purposes been vetted and agreed upon.

*Potential solutions*

*All Taxing Jurisdictions should be brought into the initial review process with the EDC, Statutory Agency and City staffs so their input can be part of the recommendation.*

## **Some of the Other Issues - Level and Use of Incentives**

### **Subsidies for Economic Development**

There is a philosophy in the development community that if a development project does not bring in adequate return, then incentives should be used to increase the return and make the project feasible. There are many social reasons to justifiably assist projects, but why do taxing jurisdictions need to provide market return to developers? This is a backwards mentality, if a project cannot work, maybe another development plan should be sought. This has been extended so far that any developer considering a major project is encouraged to seek development incentives as a matter of course in putting the project together. This is further extended by existing practice that "proves up" the but-for test on

the initial phase of a project, but tags on many more project phases whose requirement to meet the but-for test is waived.

*Potential solutions*

*Most projects are analyzed by a third party to evaluate the rate of return with and without incentives. This information, or but-for report usually is the argument for receiving incentives. The EDIP clearly calls out for each project to be weighed by the other 22 Policy factors, including social and fiscal impacts. The merits of the project should be awarded based upon the 22 policy factors and not whether or not the rate of return is too low for the developer to undertake the project without incentives. These factors are not being analyzed or evaluated for current projects.*

## **Benefit Districts**

TIF districts are often created not to promote real estate development and the creation of new jobs or investment, but to fund neighborhood improvements or other capital costs normally funded through the City's PIAC process. These plans are very attractive to the City and to politicians since they can provide free funds for home improvement, sidewalk replacements or other infrastructure improvement at the expense of the other taxing jurisdictions. These districts capture increment from existing development or new development that does not need public subsidies to be completed. Some Council members are able to enrich their districts and others are not.

*Potential solutions*

*TIF should not fund services that are the responsibility of the city or the citizens, while taxing jurisdictions may want to contribute their portion of the tax base, it should be voluntary and not mandatory.*

## **Displacement and Substitution Effects**

The use of Tax Increment Financing often removes base taxes. If an existing business relocates into a TIF area, economic activity taxes that the business was paying at the previous facility cannot be captured. This is a displacement of taxes, which can occur in TIF plans. The substitution effect of TIF applies to retail projects in which the retail sales move from a retailer that is not subsidized to a retailer that is subsidized through TIF. Additionally, State statute mandates that a "base" is established when a retailer relocates within a County and the City has failed to do so on a couple occasions. The demand for basic services does not increase with a new retailer; hence the sales at the new subsidized retailer will come from existing retail which pays full taxes.

*Potential solutions*

*Many Missouri cities have policies to ensure that displacement or substitution effects are added to the base level of taxes the project pays. This policy should be enacted by the TIF commission to ensure that unwilling taxing jurisdictions do not have existing taxes removed. Further, rigor in the development of the cost-*

*benefit analysis should be required and should fully quantify this substitution effect.*

### **Manipulation of Base Taxes**

Most economic incentives tools freeze the existing taxes for a period of years. A strategy employed by developers to increase tax abatement has been to manipulate base taxes by allowing or creating blighting factors or demolishing improvements prior to locking in the base. Another way developers have manipulated the base taxes is by deeding the property over to a public agency, such as LCRA or PIEA. This method removes all base taxes.

#### *Potential solutions*

*The boards and commissions should create a PILOT above the base taxes if it is believed that the base taxes are artificially low because of actions of the applicant. The taxing jurisdictions permission should be received prior to a public agency taking ownership of a property to remove base taxes.*

### **Repetitive use of Incentives**

The repeated use of incentives on the same parcel has been an ongoing problem; this process either prolongs the incentive or supplements it further, both of which can be detrimental to the taxing jurisdictions. When incentives are granted, the taxing jurisdictions are supposed to receive a benefit of full taxes after the term of the incentive expires. Often, as soon as the term or the percentage of abatement is reduced or expires, a developer petitions to use another incentive tool to extend the abatement.

#### *Potential solutions*

*The double dipping of incentives should not be allowed by the boards or commissions, and the EDIP should be amended to support this change.*

### **Premature Activation**

TIF projects must be activated within 10 years of the plan being approved. TIF staff have often bypassed the commission to activate TIF projects that are not ready to be developed. After activation, any and all new increments of taxes from the project are redirected from the taxing jurisdictions to the TIF special allocation fund.

#### *Potential solutions*

*If a project cannot be developed within 10 years it is not a viable project. If a viable project does emerge after the 10 year period, and it requires economic incentives then the project should start at the beginning of the incentive approval process stated in the EDIP.*

### **Subsiding speculators**

All too often, land or building speculators squat on blighted property within incentive areas and ask for an above market sales price. They are able to achieve these above market sales prices, because the buyer expects to receive incentives. Hence the

incentives are being used to subsidize the land or building cost instead of the renovations or new construction.

*Potential solutions*

*These above market rates are often two to three times higher than the current property tax assessment.*

**Misleading But-For analysis**

Often the members of the commission or boards are presented but-for reports, that provide misleading results to the benefit of the developer. Often additional incentives secured or applied for by the developer from the City, State or Federal level are not included in the revenue projections, thus lowering the return and justifying the incentive. In addition to hiding potential revenue, the developer often inflates the actual equity they are bringing to the project. This is done by a contribution of a developer's fee, or including other incentives as their equity. Lastly, when the developer is also the user of the property or there are interrelated parties, the data can be very misleading.

*Potential solutions*

*To prevent the presentation of analysis by multiple parties at the commission, the same analyst would prepare the taxing jurisdictions assumptions and present both viewpoints. Also, the developer should present the analysis given to debt holders.*