

December 16, 2010

Bill 18-969, The Adams Morgan Hotel Real Property Tax Abatement Act of 2010

The DC Council is considering legislation that would give a 20-year property tax abatement to a proposed luxury hotel in Adams Morgan. The abatement would result in a \$2.6 million revenue loss in 2015, the first year of the tax break, and \$46 million over the full life of the abatement. Developers of the property say the tax abatement is needed to finance the project, which will generate jobs and contribute significant sales and other tax revenue to the District.

The DC Fiscal Policy Institute believes more scrutiny is needed of tax abatements, which have become an increasingly popular way to finance economic development in the District. Abatements forgive property tax payments for future years, which results in substantial losses of revenue for the city. Currently the District does not have a policy to guide the allocation of tax abatements, and abatements have been granted in an ad-hoc fashion, rather than as part of a comprehensive economic development strategy. DCFPI supports passage of the “Abatements and Exemptions Information Act,” which would require greater financial analysis of these tax expenditures.

Tax abatements result in the loss of future revenues, which means less money down the road for schools, roads, parks and any other program or service provided by the District. Efforts to protect the city’s future revenue base are especially important now, at a time of large budget shortfalls due to falling revenues. Significant cuts have been made in the past three years to a wide array of services affecting all DC residents — with some of the largest cuts made to social services that provide basic support for low-income families.

This memo addresses the four key issues to consider when assessing any tax abatement:

- Is the project an economic development priority for the District?
- Is the abatement needed for the project to move forward?
- What are the costs?
- What are the benefits?

DCFPI concludes, based on these four questions, that the case for the Adams Morgan hotel tax abatement is unproven. In particular, it is not clear whether building a five-star hotel in Adams Morgan – and providing subsidies to speed that development — should be a priority for the city. It also is not clear whether the project has meaningful benefits to outweigh the \$2.6 million in annual lost tax collections. The issues raised in this analysis also suggest that the District needs to reform the process for awarding tax abatements.

Is the project an economic development priority for the District?

Unclear: The “Edition” project has not been featured in the city’s economic development plans, and representatives from the mayor’s office have not publicly expressed support for the project. In July 2010, the Mayor’s office released its Comprehensive Economic Development Strategy report for the city. The report highlighted citywide and neighborhood-focused efforts to promote economic development in the District. The hotel was not included in the report, but the report focused on the need to improve the educational and skills attainment of DC residents. It pointed out that the hospitality and tourism industry is one core sector that has the potential to bridge the gap between available jobs and education levels.

Supporters of the project, including Adams Morgan Main Street, argue that the hotel is a priority for the neighborhood because it will increase daytime economic activity in an area that relies heavily on night life. They argue that hotel will increase pedestrian traffic during the day, and hotel guests may patronize local businesses.

Is a subsidy needed for the project to move forward?

Yes. According to a study commissioned by the District’s Chief Financial Officer (CFO), the developer needs the tax abatement to finance the hotel project.

When DCFPI testified at an Oct. 7, 2010, DC Council hearing on this issue, we raised the concern that no one had demonstrated that a tax break was needed for the project to move forward. This kind of analysis currently is not required for abatements and doesn’t usually occur. We subsequently learned that the CFO had commissioned such a study, because the developer had initially sought tax increment financing, which requires a financial analysis. That study concluded that if the District wanted the hotel built on this location at this time, a subsidy would be needed. The analysis found that the project would not be able to raise sufficient money from private equity investors based on the hotel’s likely room rates, occupancy levels, and restaurant business.

The fact that a project cannot move forward on its own does not justify a subsidy. Instead, that decision should rest on whether the project has enough benefits relative to its costs that it is worth subsidizing it at this time. Also, it is important to note that the analysis is based on this particular project at this particular time. The need for a subsidy may lessen in the future if credit market conditions improve, allowing the developer to borrow more from banks and rely less on equity investors. As well, a different project may require a different subsidy or no subsidy at all.

Most abatement projects do not receive this level of analysis. A bill requiring more detailed analysis is currently being considered by the DC Council. The “Tax Abatement and Exemption Act of 2009” has had a hearing but has not been brought to a vote. DCFPI supports this bill and hopes the DC Council will pass the legislation and Mayor-elect Gray will sign the bill next year.

What are the costs?

The District’s Chief Financial Officer has concluded that the hotel tax abatement will cost the District a total of \$46 million over 20 years. The abatement would begin in Fiscal Year 2015, at a cost of \$2.6 million that year.

Supporters of the project claim that the CFO has stated that the project will have no negative fiscal impact for the city. They also claim that because the site currently pays no taxes and will generate sales and income taxes when it is completed, it creates a net gain in revenue for the District.

The DC Fiscal Policy Institute disagrees with both of these claims. First, the CFO has indicated in no uncertain terms that the hotel abatement will reduce future tax collections by \$46 million. And the notion that the project should be supported because it will generate new tax revenues raises many questions and doubts:

➤ **The CFO Has Concluded That the Adams Morgan Hotel Will Result in Lost Tax Revenue**

Some have noted that the CFO's fiscal impact statement concludes that the tax abatement will have no negative fiscal impact, but that is a distortion of the CFO's fiscal impact statement. In DC, fiscal impact statements for legislation assess the financial impact over four years because the District is required to have a balanced four-year financial plan. A piece of legislation can only be passed then if there is evidence that the costs will be covered in the current year and the following three years.

Because the proposed hotel tax abatement does not begin until FY 2015, the year just beyond the District's current four-year window, the CFO concludes that the abatement will have no impact in the current four-year financial plan period. Yet the CFO's analysis also states that "the legislation is projected to result in foregone revenues to the General Fund of \$46 million between FY 2015 and FY 2027." In other words, it is clear that the CFO has concluded that the tax abatement will reduce tax collections by \$46 million. If any of those costs had been reflected in the four-year financial plan period, the CFO would require the Council to find a way to offset the revenue loss before the legislation could be adopted.

Why is this important? The idea that the District does not have to identify funding for the legislation — simply because it occurs outside of a four year window — can lead to budget and policy decisions that are not fiscally responsible. Given the tight fiscal times the District is facing, and the slow revenue growth projected over the financial plan, it is important that residents understand the costs of this abatement (and other proposed abatements) to the District and that it will put pressure on DC's budget to fund other programs and services in the future.

DCFPI has argued that a better solution for accounting for the full costs of tax abatements would be to require the District to pay for the entire cost of the abatement at the time the legislation is passed. Not only would it help residents and policymakers understand the full fiscal impact of legislation that is proposed, it would also ensure the District will be able to afford the costs of the program as actual expenses rise over time.

➤ **The Proposed Hotel Tax Abatement Does Not Necessarily Create a Net Gain in Revenue for the District.**

Supporters of the abatement argue that the site currently pays no taxes and will pay sales and income taxes when complete, creating a net gain in revenue for the District. DCFPI disagrees with this statement for the following reasons.

First, the idea that the tax abatement has no cost assumes that the site will *never* be developed without the abatement. Presumably the property's owners will continue to seek development options if the hotel plan is not viable. Also, if the developer can get better private financing in a year or two, then the project may be able to proceed without an abatement. It is hard to know with certainty how much property tax revenue the site will generate over 20 years in the absence of the proposed tax abatement, but it is very likely not zero. This means that a property tax abatement will result in a loss of future tax revenue.

Second, it is not clear that building a hotel in Adams Morgan would generate a net gain in revenue for the District because it doesn't necessarily mean that the hotel will generate a net increase in hotel space in the city. This is because a subsidy is often used to shift where the development takes place, but it doesn't mean that it will necessarily add more demand or development, in this case for hotel space, than would have been built in the city otherwise. In other words, giving the subsidy to the proposed hotel in Adams Morgan may shift the demand for building a hotel from one area of the city to Adams Morgan, but it doesn't necessarily mean that in the absence of the subsidy, a hotel wouldn't get built somewhere else in the District. Therefore, it cannot be said that the tax abatement for an Adams Morgan hotel will generate a net gain in economic activity or tax collections.

Finally, the possible increase in tax revenue is not alone a strong argument for subsidizing the hotel. Under that logic, it would be reasonable to give a tax abatement to any commercial project expected to generate new taxes. Instead, the other questions raised in this analysis – is a subsidy needed, is it an economic development priority, and will it provide meaningful benefits – are the key issues to consider.

What are the benefits of the project?

This question — whether the hotel will bring substantial benefits — is critical. If the hotel is able to generate a large number of jobs and other community benefits for DC residents, it may mitigate the costs as well as other factors.

The number of jobs that will be created, as well as other community benefits, are not clearly outlined either in the legislation or in written materials provided by the developer. There are no specific job creation goals in the abatement legislation. A comprehensive prospectus the developer has given to city and community leaders also does not cite how many jobs will be created due to the project. There also is no information on the expected wage levels and benefits of the jobs that will be created.

It is worth noting that the developer has agreed to comply with DC's First Source law, which requires employers to make their best efforts to hire more than half of new employees from the District. While this is notable, especially since it is not required normally for projects getting tax abatements, it is not clear that this will bring great benefits. The bill does not specify whether the

requirement applies to the construction jobs only or to the permanent hotel and restaurant jobs, as well. Moreover, First Source requires making an effort to hire DC residents but not to actually meet the target of hiring DC residents for more than half of the jobs. Many businesses subject to First Source do not meet their targets.

On the issue of jobs, there also is the question of whether the hotel will work to provide training and jobs to DC residents who otherwise might face difficulty getting a job. There is nothing in the proposed legislation to indicate that the developer or Marriott has made such a commitment.

This lack of information on the benefits of the hotel project – and the fact that the abatement may be voted on without this information – highlights a key shortcoming in how the District treats tax abatements. The Abatements and Exemptions Information Act, described above, would address this by requiring clear information on community benefits before an abatement is considered.

It is worth noting that there is some precedent for attaching job creation goals to tax abatement legislation in the District. Earlier this year, the CoStar Group moved into the District and qualified for roughly \$2 million a year in abatements. The company agreed that it would not start claiming all of the approved tax benefits until it hires 100 DC residents. And it will lose the abatement in any year in which it falls below this target.

Any community benefits tied to a tax abatement should be spelled out clearly and in detail in the legislation. Given that the Adams Morgan hotel legislation does not include key information – such as the number of construction and permanent jobs that will be created and whether the abatement is condition on actually hiring a specified number of DC residents – the community benefits flowing from the project appear to be minimal.

Conclusion

Based on these four key questions, DCFPI believes the case for the Adams Morgan hotel tax abatement is unproven. In particular, it is not clear whether building a five-star hotel in Adams Morgan – and providing subsidies to speed that development -- should be a priority for the city. It also is not clear whether the project has meaningful benefits to outweigh the \$2.6 million in annual lost tax collections.

The issues raised in this analysis suggest that the District needs to reform the process for awarding tax abatements. This would include setting priorities, creating mechanisms to determine when a subsidy is needed, and developing tools to weigh the costs and benefits of abatements.

DCFPI suggests:

- The DC Council should pass the “Abatements and Exemptions Information Act.” This act, introduced in 2009, would require the CFO to conduct a financial analysis of every proposed abatement. The act also would require a thorough listing of a project’s community benefits, so that the costs can be weighed in light of the benefits. Ward 1 Council member Jim Graham, who supports the Adams Morgan hotel abatement, has co-sponsored the abatements accountability act, but the bill has not moved forward.

- The District should create a budgeted amount for tax abatements and then treat that as a limit, just as we set budgets for libraries and other DC agencies. That way, the Mayor and Council members will prioritize abatements based on the criteria above.
- The District should establish a plan for the kinds of commercial development it wants to support, and also set geographic targets, and then pursue tax abatements consistent with that plan.
- The District should tie the abatement to meeting the stated community benefit targets the developer agrees to meet. Just as was done for the tax abatement for the CoStar group, the District should consider making abatements conditional on meeting community benefit targets the developer says they will meet. CoStar cannot claim its abatement until it hires 100 DC residents, and the company will lose the abatement if they ever fall below that number of DC hires in a given year. Similar provisions could be added for future abatements.