# CITY OF PHILADELPHIA
# PENNSYLVANIA

## OFFICE OF THE CONTROLLER

*Promoting honest, efficient, and fully accountable government*

**ECONOMIC IMPACT STATEMENT**

**Proposed Market East Tax Increment Financing District**

**May 2015**

City Controller
**ALAN BUTKOVITZ**

## Executive Summary

Pennsylvania Real Estate Investment Trust (PREIT)/ Macerich propose to invest $325 million in transforming The Gallery into the Philadelphia Fashion Outlets. They seek assistance from the City that includes $55 million in Tax Increment Financing, as well as assistance from the Commonwealth of about $100 million. As required by 17-1100, the City Controller's office has conducted this economic impact statement.

According to PIDC, the benefits of the proposed TIF include:

- $194 million in total new tax revenue during the 20-year period of the TIF
    - $58 million for the City's General Fund,
    - $41 million for the Philadelphia Municipal Retirement System, and
    - $96 million the School District of Philadelphia
- 2,165 construction jobs during renovations
- 3,950 permanent jobs in the renovated mall – 1,400 of which will be new jobs
- A commitment to 25-30% M/WBE inclusion among tenants of the new mall
- First-source hiring to ensure a substantial majority of employees are Philadelphia residents

The Controller has found:

- Under PIDC's <u>'pessimistic'</u> assumptions about The Gallery's future absent the TIF, incremental revenue gains for the City's General Fund will be about <u>$57 million</u>
- Under more <u>'optimistic'</u> assumptions about The Gallery's future absent the TIF, incremental revenue gains for the City's General Fund will be about <u>$23 million</u>
- Although there is an Economic Opportunity Plan (EOP) that sets goals for M/WBE participation and local hiring in the post-renovation mall, there is no data about current levels of M/WBE participation so it is impossible to know whether the EOP's inclusion goals represent an advance over the status quo.
- The TIF proposal is silent about job quality for the 3,950 permanent jobs in the new mall. Section 17-1300 of the City Code requires that recipients of City financial assistance adhere to minimum wage and benefit standards; these requirements extend to entities that lease property from recipients of financial assistance, as long as they employ at least 25 workers, and thus would presumably apply at least to major tenants of the renovated mall.
- **Under virtually any realistic scenario, the TIF will provide substantial economic benefit to the taxpayers of Philadelphia, in the range of $150-194 million in new revenue to the General Fund, Philadelphia Municipal Retirement System, and the School District of Philadelphia.**

The Controller recommends:

- That City Council insist on inclusion of language related to upholding Section 17-1300 of the City Code relating to job quality.
- That City Council requires that PREIT and Philadelphia Industrial Development Corporation provide accurate data about M/WBE inclusion in The Gallery from 2013 and 2014 so that a pre-renovation benchmark can be established.
- Assuming such changes are made, that City Council approve this ordinance.

## Introduction

As required by §17-1100 of the Philadelphia Code, the Office of the Philadelphia Controller has reviewed the analysis performed by the Philadelphia Industrial Development Corporation (PIDC) of the proposed "Market East Tax Increment Financing (TIF) District," as put forth in Bill No. 150380. The goal of the TIF is to enable the renovation of The Gallery Mall at Market East and simplify complex management and control relationships. The TIF District will be approximately 11.7 acres, with more than 1.2 million square feet of improvements and 1.1 million square feet of leasable space for office and retail. The TIF does not include the empty space or "air rights" above the existing roof structure of the Gallery.

Tax Increment Financing is a popular type of local economic development tool because it essentially creates a loan that is repaid by projected future tax increases – the "increment" in "Tax Increment Financing" – derived from the enhanced value of a completed project versus the status quo. In Philadelphia, TIFs are a form of private bond issued by the Philadelphia Authority for Industrial Development (PAID), a subsidiary of PIDC; TIFs must be approved by City Council. At present there are about a dozen TIF districts in Philadelphia, a very small number compared to other cities like Chicago, for example, which has over 130 such districts covering about one-third of the City's land area.[1] TIFs are less prevalent in Philadelphia for at least two reasons: first, Philadelphia has a blanket tax abatement program, which requires no City Council approval; and second, unlike Chicago, Philadelphia's TIF bonds are "non-recourse" loans, that is, they are <u>not</u> backed by the full faith and credit of the City – if revenues from projected tax increments are insufficient to repay the loan, the <u>developer</u> is liable, not the public treasury. Assuming the project is completed and succeeds within range of projections, more taxes will be generated for the public treasury than would otherwise have been generated. In the case of Philadelphia, even though some TIFs have underperformed projections, they have all generated more tax revenue after the TIF than before it.[2]

In short, the Controller supports this proposal and believes it makes economic sense for the taxpayers of Philadelphia. Nevertheless, the Controller believes it is prudent to temper some of the incremental revenue projections for a few reasons: first, this is a complex deal with many proverbial 'moving parts,' dependent on many factors such as the overall trajectory of the local and national retail economy; second, some TIF deals have, in the past, failed to perform up to expectation;[3] and third, PIDC's analysis of the TIF's benefits necessarily starts from a set of assumptions about the trajectory of the Gallery absent any renovation – the worse it is assumed the Gallery will perform absent the TIF, the greater the incremental gains from the TIF, and vice versa. In the Controller's view, PIDC paints a particularly bleak picture of the Gallery's future absent the TIF; if the analysis started from a less bleak prognosis for the Gallery, the TIF would still work quite to the City and School District's favor, but the final benefit would be lower than $194 million in new revenues. Additionally, PIDC's revenue projections hinge on 93%

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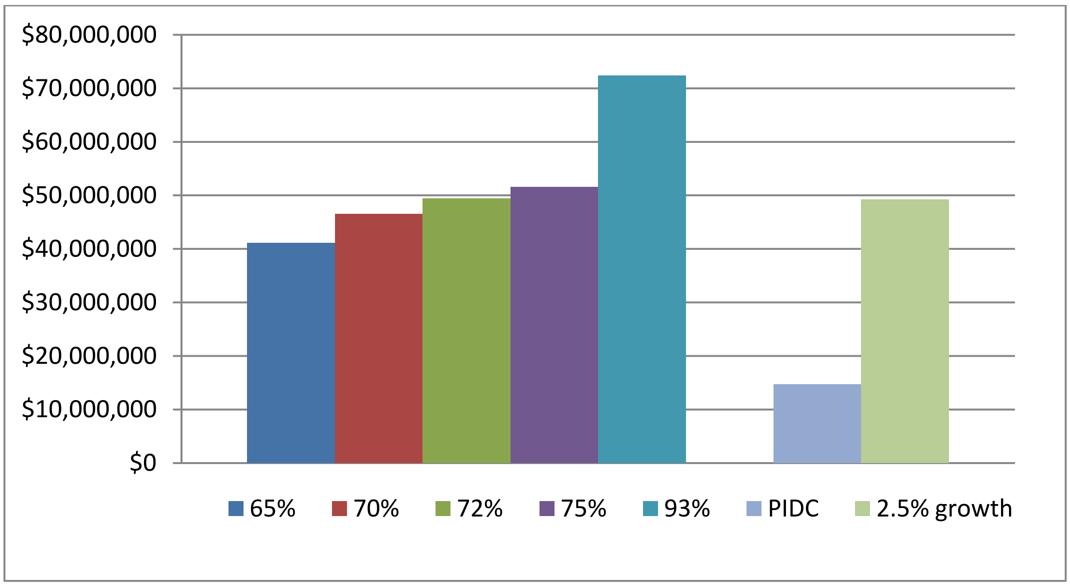
[1] Alex Nitkin, "TIF Districts: A Beginner's Guide to Chicago's 'Shadow Budget'," November 1, 2014 (http://www.chicago-bureau.org/tif-districts-a-beginners-guide-to-chicagos-shadow-budget/.) TIFs have come under increasing scrutiny in Chicago for a number of years; cf. "The Chicago Reader TIF Archive," http://www.chicagoreader.com/chicago/the-chicago-reader-tif-archive/Content?oid=1180567).
[2] Jared Brey, "TIF districts generate less property tax revenue than expected," Plan Philly, November 15, 2013.
[3] Brey, "TIF districts."

occupancy for the post-renovation mall, a figure not out of line with the mall developer's track record, but a massive leap forward for this particular property.

This brief examines revenue projections based on different scenarios, largely involving different potential post-renovation occupancy levels, comparing these to two different assumptions about the Gallery's trajectory absent the TIF – the 'pessimistic' negative-growth scenario provided by PIDC and a more 'optimistic' scenario that assumes some level of growth absent the renovation and TIF. Chart 1 below summarizes our general findings. **The bottom line: As long as the Gallery or its successor attains at least 72% occupancy, the City's General Fund will see more revenue with the TIF than without it.**

*Chart 1: Projections of General Fund Revenue with TIF and without TIF*




## PIDC's Analysis of the Proposed TIF Deal

In the case of the Market East TIF, PIDC's analysis indicates that it will yield numerous benefits to the City. First, the TIF deal will simplify the complicated management and control relationship between the mall's current part-owner-operator the Pennsylvania Real Estate Investment Trust (PREIT) and partial landlord, the Philadelphia Redevelopment Authority (PRA), eventually leaving the mall in private hands and relieving the City of liability for paying a maintenance and operations fee called a Public Access Easement. Second, after many years of neglect, the developer will invest $325 million into capital improvements, creating 2,165 Full-Time Equivalent (FTE) jobs during the projected two years of construction, July 2015-January 2017. By the time the rebranded "Fashion Outlets of Philadelphia" reaches its projected stabilized occupancy in 2019, there will be 3,950 permanent FTEs, an increase of nearly 1,400 jobs (+55%) over current levels. Third, greater business activity means greater sales tax and Business Income and Receipts Tax revenue; higher property values means more Use & Occupancy and property tax revenue; more jobs means more wage tax revenue; and there will also likely be substantial indirect and induced impact from more money in more employees' pockets.

During the 20-year period of the TIF the City will capture all of growth in wage taxes, the largest contributor to the General Fund: this adds up to just over $5 million annually, a $2 million increase over the status quo. In addition, the Philadelphia Municipal Retirement System will also receive all of the additional revenue generated from the sales tax increment produced by the new mall, a little over $2.5 annually, a $2 million increase.[4] The School District will also receive all of the increased revenue from the U&O, $4 million and liquor tax $1 million annually.[5] This equals an increase of $3.5 million and $0.9 million respectively. The rest of the taxes accrue to the City's General Fund; real estate, City sales, and both parts of the Business Income and Receipts Tax will be capped at 2014 levels and the incremental increases will be directed toward the financing of the renovation, as is the case for the School District's portion of the real estate tax.

Underlying PIDC's analysis is a set of projections about the trajectory of The Gallery over the next 20 years, absent the TIF. Under these assumptions, the renovation project and the new mall that results from it will generate $194 million new tax dollars over the 20-year life of the TIF – $96 million for the School District of Philadelphia via increases in the Use & Occupancy and Liquor Taxes; $41 million for the Philadelphia Municipal Retirement System (PMRS) from Sales Tax revenue; and $57 million for the General Fund from Wage Taxes. To finance the TIF loan, the City and School District will forego $127 million in incremental tax revenue generated because of the renovation. An additional feature of the deal includes shifting the entire property to private ownership after 43 years, thus truncating the City's liability for paying maintenance and operating fee of about $3.5 million a year by 18 years. Finally, once the TIF ends in 2035, the City and School District will capture the full value of the tax ratables on the improved mall. The chart below summarizes the distribution of tax revenues under the TIF.

*Chart 2: Allocation of Tax Revenues During the Life of the TIF, 2016-2034*

| Tax | Tax Entity | Subject to TIF? |
|---|---|---|
| **Real Estate-City Portion** | City | Yes |
| **Business Income and Receipts** | City | Yes |
| **1% Sales Tax-General Fund** | City | Yes |
| **Real Estate-School District Portion** | School District | Yes |
| **Wage Tax** | City | No |
| **1% Sales Tax-Pension Portion** | City/PMRS | No |
| **Use & Occupancy Tax** | School District | No |
| **Liquor-by-the-Drink Tax** | School District | No |

As a result of the investment, PIDC projects that occupancy rates will increase from the current 60% to 93% in the new mall, a figure in line with the performance of other properties in Macerich's portfolio,

[4] Under state law, Philadelphia businesses charge an additional 2% in Sales Tax beyond the Commonwealth's 6%. The first 1% is devoted to the City's General Fund. The second 1% is split between the School District and the Philadelphia Municipal Retirement System (PMRS), with the first $120 million in revenue dedicated to the District. The City has surpassed the $120 million threshold for the past two years and it is assumed that it will do so into the future, so that the entire incremental gain in sales tax revenue from the renovated mall will go to the PMRS.
[5] To make the deal more politically palatable, PIDC has exempted the PMRS portion of the Sales Tax as well as the School District's U&O and Liquor taxes from the TIF.

but a major leap forward from current occupancy levels.[6] Under these assumptions, the renovation project and the resulting new mall are expected to generate $250.3 million in total tax revenue over the 20-year life of the TIF, of which $194.1 million will be new revenue. The chart below summarizes PIDC's revenue projections:

*Chart 3: PIDC Tax Revenue Projections, 2016-2034, With and Without TIF*

| | Fund Type | | | |
|---|---|---|---|---|
| | **City** | **PMRS** | **School District** | **Total** |
| **With TIF/Renovation** | $72,326,777 | $52,120,986 | $125,830,658 | $250,278,420 |
| **Without TIF/No Renovation** | $14,715,101 | $11,377,530 | $30,099,900 | $56,192,531 |
| **Difference** | **$57,611,676** | **$40,743,456** | **$95,730,758** | **$194,085,889** |

## Interrogating PIDC's Assumptions

All incentive deals rest explicitly or implicitly on a 'but-for' proposition – that is, if not for the incentive, things would be worse, financially or otherwise. All sensible incentives are investments in a predictably better outcome – the public sector assumes some level of current risk in return for a future reward. TIFs are a popular form of incentive because they are essentially a loan that is repaid by projected future tax increases, derived from the enhanced value of a completed project versus the status quo ante. Thus in the assessment of any economic incentive deal, but particularly a TIF, it is critical to interrogate the determination of the 'future status quo' that serves as the baseline for comparison to the projected future outcome.[7]

In the case of the Gallery, PIDC has calculated "the 20 year value of base amounts without inflation as a middle point between projecting growth, or negative growth if the TIF does not happen." According to PIDC staff, this is a typical method for calculating baselines in this type of project. Today, the Gallery produces roughly $1.7 million a year in tax revenue for the City's General Fund, $569,000 for PMRS, and $1.6 million for the School District. The City pays $1.8 million a year to the Redevelopment Authority for development, maintenance and operations costs associated with the Public Access Easement. The Public Access Easement is a predetermined amount set for the next 61 years, increasing in amount each year. Tax revenues have declined slightly over the last three years because The Gallery has lost $5 million in taxable sales since 2012. PIDC projects that in the absence of the dramatic transformation promised by the TIF and the attendant $325 million private sector investment, The Gallery will soon become a net loss for the City. Specifically, PIDC's model assumes no change in revenue for either improvements in the market or inflation, and projects a declining revenue stream due to incremental increases in the access payments. According to PIDC, not only will revenue from The Gallery not

[6] Between 2010 and 2014, occupancy rates at malls owned and operated by Macerich fluctuated between 92.7% and 95.8%. See Macerich Company 2014 Annual Report/Form 10-K, p.1.

[7] The Controller has done pioneering work in interrogating the 'but-for' proposition in the Keystone Opportunity Zone Program, cf. "An Analysis of the Keystone Opportunity Zone Program, 1999-2012: The Costs and Benefits to Philadelphia," March 2014. In the Controller's view, TIFs are vastly preferable to untargeted tax incentives like KOZs precisely because they are built on verifiable models with recourse if a project fails to live up to projections.

increase without the TIF, but by 2035 the City's General Fund will be a net loser, paying more to maintain the mall than it will generate in tax revenue. The access payment increases each year and by 2019 will be higher than the sum the City garners from the wage tax, $2.26 million.

The Controller questions the validity of the 'but-for' assumption of precipitously declining revenues over the next 20 years absent the TIF. The improving retail environment in Center City is presumably what induced a savvy and successful mall developer and operator like Macerich – a publicly traded Real Estate Investment Trust and S&P 500 Index member with over $13 billion in assets – to consider investing $325 million in this deal in the first place. Century 21 made a substantial investment in its first store outside of NYC on the Gallery's eastern edge. Major investment is already happening in other parts of Market East, such as the Girard Estate site at 11th and Chestnut. Developments on the west side of Broad Street have led major tourism publications to take note, for the first time in decades, of Philadelphia's burgeoning downtown shopping scene. Philadelphia's leisure tourism numbers are impressive and growing, and business at the contiguous Convention Center is on the upswing. Finally, downtown residential density continues to grow, and Philadelphia has now surpassed Chicago as the second most-dense residential downtown in the country.[8] In short, there seems to be plenty of latent demand for retail in Market East.

With all of this relatively organic development happening, it is plausible to assume that absent the TIF, such a well-located shopping center would continue to plod along at the status quo at the very worst, perhaps even see more one-off developments like Century 21 within the existing mall infrastructure. It does not seem far-fetched under current market conditions to predict non-transformative but slow and steady, piecemeal, incremental improvement at the Gallery. Thus the Controller's assessment of the TIF's potential benefits juxtaposes PIDC's 'pessimistic' declining-revenue scenario with an 'optimistic' scenario that predicts 2.5% annual growth over this period. Again, to be clear: **Under either scenario, as long as the Gallery/Outlets surpasses 72% occupancy by 2020, the TIF's financial math pencils out and the TIF will be a major gain for both City and School District.**

In PIDC's analysis, the new mall will achieve its stabilized revenue base four years after construction is complete. At that point PIDC projects 93% occupancy, $566 of sales per square foot, and 3,950 FTEs.[9] Extrapolating from these projections, as long as the renovated mall achieves 72% occupancy, 3,084 FTEs and $372 in sales per square foot, the City's General Fund will break even compared to the status quo; occupancy levels and sales per square foot in Macerich-owned and operated shopping centers in the last 5 years have greatly outperformed these break-even thresholds. Further, even at very modest assumption of 72% occupancy, the PMRS and School District would see substantial increases in revenue: the pension fund would gain $20 million and the School District would gain $57 million during the 20

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[8] Jared Shelley, "Philadelphia named No. 2 shopping city in the world," Philadelphia Business Journal, January 14, 2015; on tourism numbers, see Philadelphia Controller, "An Analysis of Philadelphia's Destination Marketing Infrastructure and its Role in the Hospitality Sector," September 2014; on Convention Center's recent turnaround, see Fran Hilario, "Pennsylvania Convention Center bookings hit record high in 2014," Philadelphia Business Journal, February 3, 2015; on downtown density, see Center City District, State of Center City 2015.

[9] Per Macerich's 2014 Annual Report, sales per square foot in Macerich-owned and operated shopping centers in the last 5 years have averaged between $433 and $587.

years of the TIF compared to the status quo. The Controller believes that 72% occupancy, 12% greater than today's historically low 60% occupancy rate, is a very conservative lower bound. This benchmark is likely to be surpassed significantly, and if so, the TIF district will generate substantial additional tax revenue for the City's General Fund and the School District. The charts below illustrate the revenue gains for just the City's General Fund from the TIF, starting from each of the different baselines.

*Chart 2a: City Revenue Possibilities, 'Pessimistic' (PIDC) Baseline*

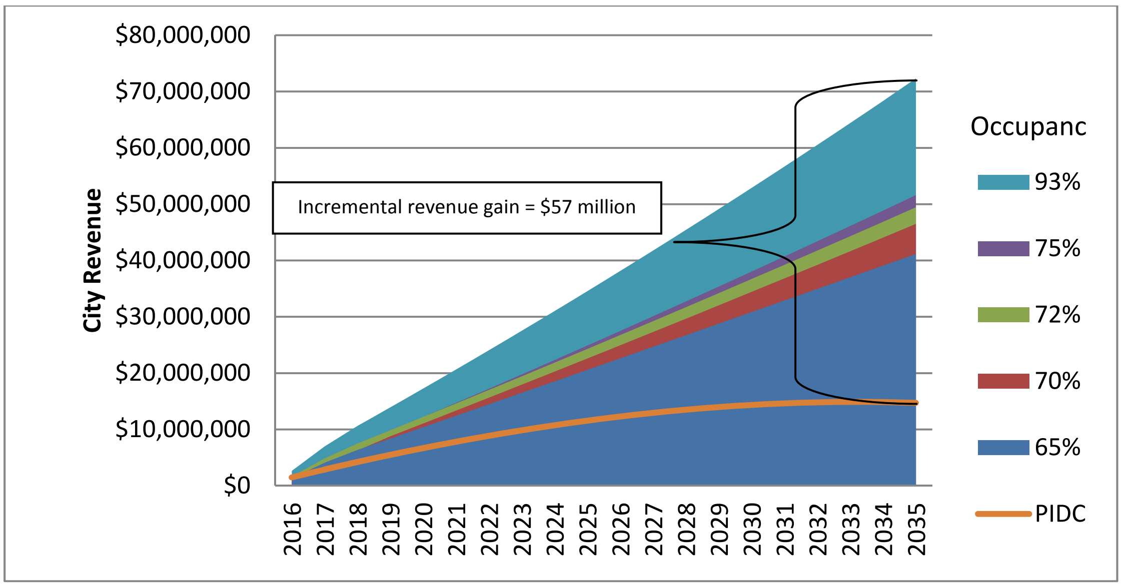


*Chart 2b: City Revenue Possibilities, 'Optimistic' (Controller) Baseline*

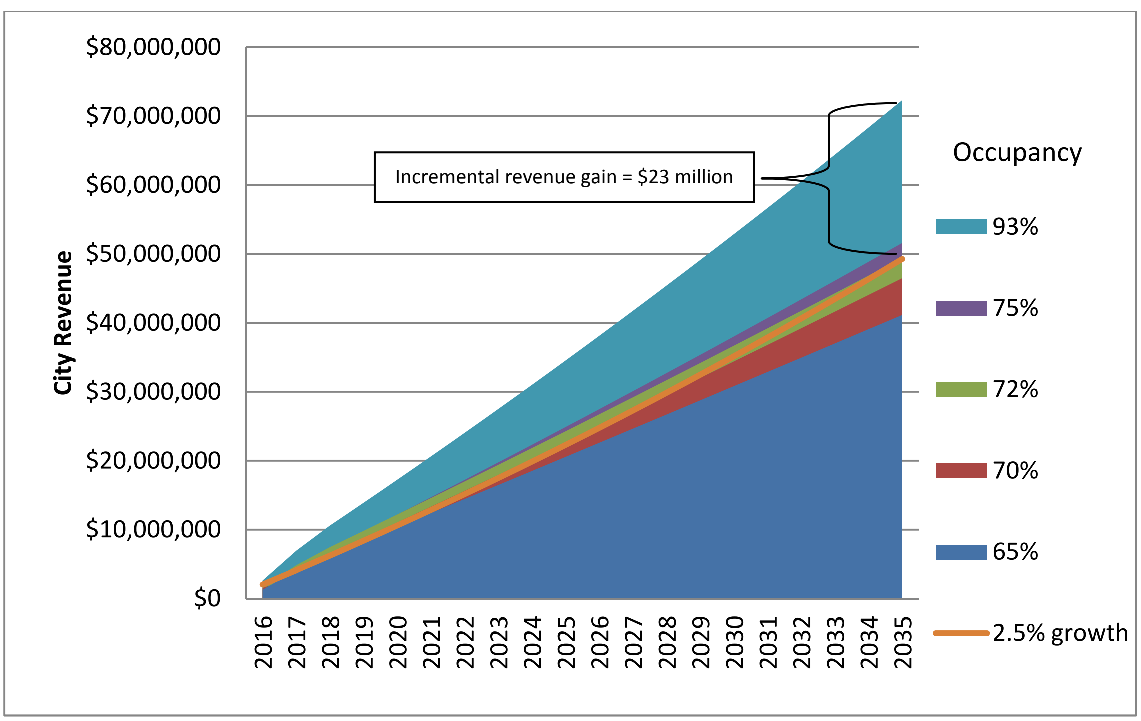

Chart 2a starts from PIDC's 'pessimistic' status quo projections and estimates revenues over the period based on the occupancy of the renovated Gallery. PIDC's projection is represented by the orange line in the chart. As the years go by, the Public Access Easement payments made by the city grows – increasing by nearly $2 million from $2.1 million in 2016 to $3.7 million in 2035. By assuming no growth from a TIF-less Gallery, revenues cannot keep up with access payments. By using this 'pessimistic' baseline and assuming 93% occupancy by 2019, PIDC projects incremental gains of about $57.6 million.

Chart 2b assumes an 'optimistic' baseline of 2.5% annual growth for the Gallery absent the TIF. At 72% occupancy the City's General Fund would gain about $50 million during the 20-year period of the TIF, which is equal to the revenue the City would receive without the TIF; at the 93% occupancy level projected by PIDC, the renovated mall would generate over $70 million – an incremental gain of about $23 million.

While data provided by PIDC indicate declining sales tax revenue in the period from 2011-2014, we do not know if this has led to a commensurate decrease in employment and therefore in wage tax revenue, the largest portion of the City's tax revenue from The Gallery. In short, we cannot verify the validity of PIDC's assumed 'pessimistic' revenue scenario. Thus the Controller believes it is more prudent to project incremental revenue gains for the City's General Fund of somewhere between $23 million and $57 million. Again, either way, as long as the mall achieves at least 72% occupancy, the TIF will result in higher revenues for the City and the School District than without the TIF.

## Diversity and Inclusion, Job Quality Considerations

As required of every project that receives substantial City economic assistance, the mall developers have produced an Economic Opportunity Plan, designed to ensure job growth among local businesses in retail and minority entrepreneurs in food and beverage. PREIT's retail initiative is entitled "Home Grown Retail Development Pilot" (HGRDP) while the other is entitled "Food and Beverage Minority Entrepreneur Initiative." PREIT also states it will promote local and youth hiring to its tenants, to try and reach local employment levels identical to the 65% it had purportedly achieved prior to the renovation. The stated goal of the HGRDP is 25-30% M/W/D/SBE participation. However, since the Controller has been unable to obtain data from PREIT regarding pre-renovation participation levels, it is impossible to know whether these programs will improve upon or simply revert to the status quo; additionally, there are few specifics outlined as to what kind of businesses will be eligible for the program.[10] Among the early objectors to the renovation plans and the TIF proposal have been a group of M/WBE kiosk owners who have already been displaced by the renovation; according to press accounts, City officials have assured them assistance in relocating to the renovated mall.[11]

The Controller is concerned that the mall renovation will import growth into Philadelphia rather than develop local wealth. While PREIT has made commitments to hire local youth for entry-level retail jobs,

[10] According to PREIT officials, The Gallery collected no demographic data about tenants.
[11] Jane von Bergen, "Gallery kiosk owners, evicted for renovation, hope for reprieve," Philadelphia Inquirer, February 17, 2015 (http://articles.philly.com/2015-02-19/business/59273571_1_kiosk-owners-tigest-tessema-the-gallery).

promotional materials suggest that the bulk of the mall's tenants will be outposts of major national and multinational retailers with little or no ownership stake in Philadelphia. Thus the Controller would like to see a specific commitment on the part of PREIT/Macerich to encourage local entrepreneurs to become tenants of the new mall. He would also like to see certified data on diversity and inclusion in the current mall incorporated into the agreement as a benchmark.

Additionally, it is the policy of the City of Philadelphia, as expressed in Chapter 17-1300 of the City Code, that jobs created as a result of City financial assistance should pay an hourly wage that enables employees "to live with more dignity and increased economic self-sufficiency." Nearly all construction in Philadelphia is performed under Project Labor Agreements that require the payment of area standard wages and benefits to construction workers; however, the TIF proposal appears to be silent on the quality of the projected 3,950 permanent jobs to be created at the new Outlets. While some of the current service employees at The Gallery such as the janitors work under collective bargaining agreements, and presumably the union will attempt to maintain these agreements in the new mall, the bulk of current retail employees have no such protection.[12] But according to 17-1300 of the code, direct recipients of City financial assistance as well as any entity that "leases property… from a City financial aid recipient" and employs 25 people or more are required to pay at least 150% of the federal or state minimum wage or $12 an hour, whichever is higher, for at least 5 years. Presumably this requirement will apply to at least the major tenants in the new mall. The Controller calls on City Council to insist that PIDC and the mall developers incorporate these considerations into the final agreement.

## Conclusion: A Deal Worth Supporting

Creating the Market East Tax Increment Financing District promises to complete the transformation of a heretofore underutilized portion of the Market East corridor, create many jobs in construction and retail, and enhance tax revenues for the City and School District. The Controller questions some of PIDC's assumptions about the 'but-for' trajectory of The Gallery along with the projected level of revenue based on an assumed 93% occupancy level. Despite these minor disagreements, the Controller's review agrees with PIDC that the promise of this deal is real and realizable. With only modest and realistic projected increases in occupancy level, the City and School District will accrue significant revenue benefits, and due to the non-recourse nature of the TIF, there is little or no downside risk. Importantly, the TIF has been structured in such a way that the School District and the Philadelphia Municipal Retirement System both benefit immediately from the renovation.

As in the case of every economic development deal, the Controller aims to ensure that City-assisted projects benefit all Philadelphians and not just a few; while the initiatives outlined in the Economic Opportunity Plan offer promise, there are precious few details. In sum, while the Controller encourages City Council to request more details about the PREIT/Macerich plan for inclusion in the new mall for local and diverse businesses as well as quality jobs for Philadelphia workers, he believes that this is generally a deal worthy of support.

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[12] According to officials of SEIU Local 32BJ, the janitors who currently clean The Gallery work for the contractor TMM under a union contract, but there is no successorship agreement.