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Financing Urban Revitalization: A Pro-Growth Template

In 1950, America's big cities were riding high. The 10 most populous cities in the U.S. enjoyed median household incomes above the national average; all ten had larger proportions of affluent residents and smaller proportions of low-income residents than the nation as a whole.¹ Cities were, in general, the economic engines of their regions—and, indeed, the nation. Writing in 1961, the eminent urbanologist Jane Jacobs neatly summarized cities' uplifting effects:

by Steve H. Hanke, The Johns Hopkins University and Stephen J.K. Walters, Loyola University Maryland*

“[A] metropolitan economy, if it is working well, is constantly transforming many poor people into middle class people. . . . Cities don't lure the middle class. They create it.”²

In the following decades, however, it became clear that many American cities were not working well. Between 1950 and 1980, nine of those 10 most populous U.S. cities lost residents and became less prosperous; only Los Angeles grew, while St. Louis's population shrank 47%, Detroit's 35%, Washington's 20%, and New York's 10%. The causes of this flight were numerous and subject to debate, though most commentators blamed racism, deindustrialization, and Americans' preference for a suburban lifestyle and the affluence that made it attainable—at least for some.

What is indisputable is that this flight put many cities into financial distress and a few close to ruin. As their tax bases shrank, cities often responded by raising tax rates in an attempt to replace lost revenue and maintain service levels. Predictably, this approach did not stem the flight but further fueled it, as out-migrants generally found friendlier tax climates away from core cities. In addition, higher tax rates on physical capital usually reduced investment, since the higher rates damaged both net cash flows and—via tax capitalization—property values.³ Erosion of the capital stock, in turn, diminished job

opportunities and reduced labor productivity and wages. This contributed to a vicious cycle, with economic stress on city residents generating greater demands for government services and transfers, often leading to still-higher tax rates.

Two coastal cities' histories are illustrative: between 1950 and 1975, Baltimore raised its property tax rate 19 times, while San Francisco raised its rate 17 times. In consequence, both cities declined at accelerating rates. Given San Francisco's current status as a “superstar city,” it is somewhat surprising to note that its population actually fell faster than Baltimore's over this period (14% vs. 10%) and by 1975, its total crime rate actually exceeded Baltimore's.⁴

In the late 1970s, however, San Francisco experienced a reversal of fortune. While the national economy struggled with stagflation—the “misery index” reached a modern-era record level of 8.98% during the Carter Administration⁵—the city began to recapitalize and repopulate at a remarkable rate. Though Baltimore's population continued to slide, San Francisco's grew 2.2% by the 1980 census, and surged another 14% by the new millennium. None of the aforementioned conditions commonly thought to explain urban decline had much changed; neither had there been any sudden improvement in city services such as school quality or street safety. And while it is common to assume that the city's late-'70s U-turn

*The authors thank Michell Li, Louis Miserendino, and Emma Paine for very capable research assistance.

1 Stephen J.K. Walters, *Boom Towns: Restoring the Urban American Dream* (Stanford, CA: Stanford University Press, 2014), p. 3.

2 Jane Jacobs, *The Death and Life of Great American Cities* (New York, NY: Modern Library, 1993), p. 377.

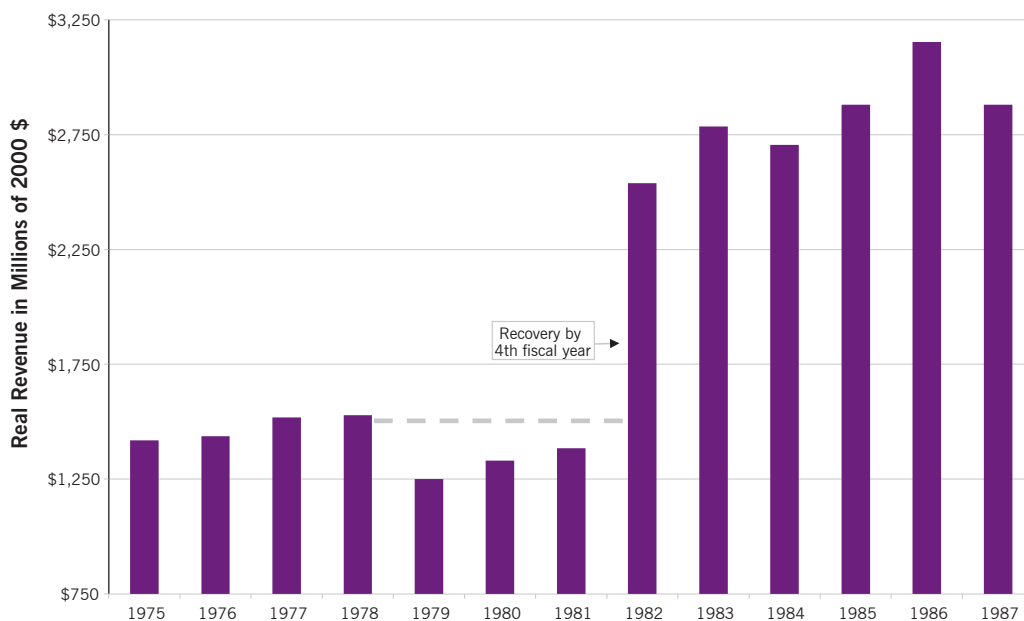
3 Walters (2014), cited earlier, pp. 16-20.

4 Walters (2014), cited earlier, pp. 32-33, 40-41.

5 The misery index reported here is a refinement of that originally proposed by Arthur Okun, which equaled the sum of the inflation and unemployment rates. For details, see Steve H. Hanke, “Measuring Misery around the World,” <https://www.cato.org/publications/commentary/measuring-misery-around-world>, May 2014.

Figure 1

Effects of Proposition 13 on San Francisco's Budget: Real Total Revenue, Less State Subsidies, 1975-87



was a spillover benefit from the tech firms then starting to blossom in Silicon Valley, the companies associated with that nascent boom were not only relatively small at this time but concentrated in places like Palo Alto, Mountain View, and Santa Clara, 35 to 45 miles away. For a while, at least, they were more likely to pull residents from, than to push them toward, older cities like San Francisco and Oakland, which also reversed a population decline in the late '70s.

What had changed most was these cities' treatment of their stocks of physical capital and their receptiveness to investment. In 1978, a California ballot initiative known as Proposition 13 had capped localities' property tax rates at 1%, forcing San Francisco's rate down by two-thirds. This not only improved cash flows to owners of real property and physical capital but, more importantly, protected their property rights. Prop 13 had won by a 2:1 landslide; repeal of this overwhelmingly popular state-wide tax cap was considered impossible—no matter the local political culture. Henceforth, then, the value of investments in immobile and durable physical capital were protected from the damaging consequences of aggressive taxation; no longer could San Francisco impose capital losses on property owners with 17 tax rate hikes in 25 years. The result was a new gold rush, as investors eagerly bought, built, and improved the city's residential and commercial capital stock, attracting new residents and creating new job opportunities.

In the short run, however, this precipitous tax rate cut—accompanied by a rollback of assessed property values to their 1975 levels—put San Francisco's government finances under great pressure. As Figure 1 shows, real revenue in FY1979 fell 18%; the city needed a \$100 million grant from the state (which was running surpluses in the inflationary '70s) to balance its budget. In the next fiscal year, however, revenue started to recover as the tax base grew and some other rates were increased modestly; only \$1 million more was needed from the state. In the third fiscal year, no state grant was needed at all, and by the fourth fiscal year the city's total real tax receipts had risen so much that they exceeded pre-Prop 13 levels by 66%, enabling significant improvements in the quantity and quality of government services delivered to the city's now-growing population, reinforcing its upward trajectory.

California's "tax revolt" was soon emulated in other states. Massachusetts' Prop 2½ took effect in 1980, and Boston immediately began to reverse decades of population and capital flight. Oregon and Washington capped property taxes in 1990 and 1997, respectively, enhancing growth in Portland and Seattle. In each case, however, the political impetus for tax reform came from outside these states' larger cities, where fears about short-term revenue losses generally led local leaders to vigorously oppose tax caps even as evidence accumulated that the long-term effects of reform on a city's tax base and overall revenue could be very favorable.

But such political resistance should not be surprising. The pain of a three- or four-year revenue trough, like that shown in Figure 1 for San Francisco, could claim the entirety of a term in office for a mayor or city council member. Who in their right minds would want to run for re-election after repeatedly cutting services in order to balance budgets in previous years? Since most politicians are in their right minds, the large cities that eventually benefited from having lower tax rates than their surrounding suburbs or rival metro areas usually did not cut tax rates voluntarily.⁶ Many cities that could have benefited from lower rates did not cut them. But those cities painted themselves into a corner: by failing to do something politically and financially difficult in the short run, they did not become more attractive to investment in the long run. Baltimore, for example, while maintaining a property tax rate more than double that available in the surrounding county, has shed population and jobs continuously since 1950, effectively declining to join more tax-friendly, growing cities like San Francisco, Boston, and others.

A key policy question is whether there is a feasible way out of this corner—i.e., a program that does not involve the kind of near-term budgetary pain that is such a barrier to pro-growth tax policy. In what follows, we present a politically and economically feasible template to achieve tax reform in fiscally challenged cities without doing violence to programmatic spending and services. In a nutshell, we propose announcing at time t a competitive tax rate to take effect at time $t + n$, with an escrow fund accumulating over the intervening n years (during which the city's tax base can be expected to grow more rapidly than it would at its higher, non-competitive rate). That fund would then be used to “pay for” the lower tax rate once it is delivered. In addition, we identify financial instruments that can be used to supplement the fund and assure a margin of financial safety at time $t + n$. Before we turn to the details of this program, however, it will be useful to discuss the responsiveness of various tax bases to changes in tax rates.

Tax Rates, the Tax Base, and Investment/Location Decisions

When discussing proposals for tax cuts of any size, the politically risk-averse often employ static rather than dynamic analysis. With respect to property taxes, for example, it is

6 One interesting exception is Prince George's County, Maryland. Bordering the District of Columbia, “PG County” was losing population during the '70s despite rapid growth of employment in the nation's capital and other neighboring suburbs. Since out-migrants often blamed the county's property tax rate—second highest in Maryland, behind only Baltimore City—some entrepreneurial local politicians put a tax cap referendum on the ballot in 1978, and it won 70% of the vote. The county's population losses immediately were reversed; it is today the wealthiest majority-minority county in the U.S. Steve H. Hanke and Stephen J.K. Walters, “Another Tax Increase Legacy from Martin O'Malley,” *The Wall Street Journal*, March 21, 2015, p. A9.

common to say that “every penny we cut off the tax rate costs us X millions of revenue dollars” (with X varying by jurisdiction). The implication is usually that such cuts are “unaffordable” over any reasonable time frame, inevitably doing great violence to cherished spending programs. In truth, tax bases expand when tax rates are cut, and vice versa. But the first problem, as we have already pointed out, is that it takes time for the expansion to replace lost revenue from rate cuts, making them politically unattractive (unless, as at the federal level, resulting deficits can be financed by borrowing). The second is that even far-sighted local leaders may worry that this expansion of the tax base might not be adequate to support the level of government services that their constituents demand.

The empirical literature on these issues is not as abundant as one would hope,⁷ but it tends to point in the same direction: the health of the tax base is inversely related to the tax rate, the effects of rate changes are often large, and individuals are quite sensitive to rate changes in making investment and location decisions.

In a study of the effects of variation in property tax rates using pooled cross-sectional and time-series data for 62 large cities over the period 1966-81, Sacramento State Professor Robert Wassmer concluded that, all else the same, “a greater than average reliance on property taxes reduces property value and drives out property.”⁸ Berkeley real estate Professor Kenneth Rosen studied the effects of Prop 13 in California and found that “[e]ach dollar decrease in relative property taxes appeared to increase property values by about seven dollars,”⁹ though he did not study the long-term effects of tax cuts on new construction.

Federal Reserve economist Andrew Haughwout studied the effects of local property, income, wage, and sales taxes on tax bases and government revenue in four large cities—Houston, Minneapolis, New York, and Philadelphia—and found that all four increases in the property tax rate had “a statistically significant and quantitatively important negative effect on the rate of change of the city's property tax base.”¹⁰ Further, in three

7 There is, on the other hand, copious literature on the extent to which local public service levels and tax rates are capitalized into market values of real property. For a useful survey, see G. Stacy Sirmans, Dean H. Gatzlaff, and David A. Macpherson, “The History of Property Tax Capitalization in Real Estate,” *Journal of Real Estate Literature*, 2008, v. 16, iss. 3, pp. 327-43.

8 Robert W. Wassmer, “Property Taxation, Property Base, and Property Value: An Empirical Test of the New View,” *National Tax Journal*, June 1993, v. 46, iss. 2, pp. 135-59, at p. 154. Wassmer calculated the effects of deviations of a city's property tax rate from the national average (rather than from rival, neighboring jurisdictions), so his estimates of the relevant elasticities tend to be smaller than those found in other studies.

9 Kenneth T. Rosen, “The Impact of Proposition 13 on House Prices in Northern California: A Test of the Interjurisdictional Capitalization Hypothesis,” *Journal of Political Economy*, 1982, vol. 90, no. 1, pp. 191-200, at p. 200.

10 Andrew Haughwout, “Local Revenue Hills: Evidence from Four U.S. Cities,” *Re-*

of the cities studied, the elasticity of the property tax base with respect to changes in tax rates over just a three-year period was “statistically indistinguishable from -1 ”¹¹—meaning that, say, a 10% rate cut could increase the tax base by 10%, yielding a neutral revenue effect in a reasonably brief time.

Studies of state-level property tax caps in Oregon, Idaho, and Indiana have found that such limitations tend to yield long-run increases in key measures of economic activity such as output, employment, and household income.¹² In 2015, Federal Reserve economist Byron Lutz examined the effects of reforms in New Hampshire, and found that investment rates are quite sensitive to property tax cuts: “the elasticity of residential construction with respect to the property tax burden is very roughly equal to (negative) one.”¹³ And in 2012, the University of Illinois’ Yonghong Wu looked at tax policy differences across the six-county Chicago metro area and found that the elasticity of employment with respect to the property tax rate equaled -2.21 , so that a 10% rate cut increased employment by 22.1%.¹⁴

Finally, public finance specialists Jan Brueckner, Hyun-A Kim, and Robert Wassmer found that the property tax not only depresses investment in property improvements in cities, but contributes to suburban sprawl by diverting this investment to lower-density, lower-tax jurisdictions.¹⁵ And in a detailed 2009 study of Michiganders’ response to a mid-1990s change in state tax policy, economists Erik B. Johnson and Randall Walsh found clear evidence that “net housing counts are sensitive to differences in property tax rates” and that “tax changes will lead to population changes.”¹⁶

In sum, the literature provides no support whatsoever for officials’ tendency to rely on static models when evaluating their tax policies. The nature and size of the dynamic effects of

tax changes will certainly depend on a host of factors specific to a particular jurisdiction, but it is undeniable that there will be favorable long-run effects. The challenge is to make the policies that can yield these effects politically palatable to decision-makers in the short run.

A Template for Affordable Reform

While there is no such thing as a free lunch, there is a way for a city to cut its property tax rate to a competitive level without accompanying short-term cuts in revenue and cherished spending programs. This does not mean that such a city can abandon fiscal discipline, by any means, but given a modest commitment to restrain spending growth, a high-tax city can escape the financial corner into which it has painted itself while first maintaining—and then expanding—the quality of services it delivers to residents.

The key is to build a financial bridge before one must cross the river. This can be done by implementing the following four-step program:

1. Announce a property tax rate cap that is binding on decision-makers (i.e., one embedded in a city’s charter that would require a super-majority of the popular vote to repeal) at time t , but to take effect at time $t + n$. Given the durable nature of residential and commercial capital, rational investors would not wait until the more competitive tax rate arrives in $t + n$ to acquire, improve, or construct such assets. In an effort to “get in on the ground floor,” they would immediately begin to invest and, thus, enhance growth in the city’s tax base.

2. During the n -year transition period, the city should limit its spending growth to a “maintenance of service” level, while allocating any added revenue (above the level necessary to maintain services) from its expanding tax base to an escrow fund.

3. In addition and simultaneously, the city should supplement this reserve with the proceeds of sales of assets on its balance sheet via sale-and-leaseback contracts (SLBs)—described in more detail later—or privatizations. Most cities have vast holdings of real property that, by virtue of its potential depreciability for tax purposes, would find a ready market if held in the private, for-profit sector; SLBs (which return ownership of the assets in question on expiration of the lease) provide a means for cities to monetize these assets’ considerable value without loss of short- or long-term control.

4. When the tax cut is delivered in year $t + n$ and revenue falls in the short run, cash would be withdrawn from the escrow fund in order to continue to maintain levels of government services at accustomed levels.

Of course, the size of the tax cut necessary to make a city competitive with rivals for investment, and the optimal timing

view of *Economics and Statistics*, May 2004, v. 86, iss. 2, pp. 570-85, at p. 573.

11 Haughwout, cited earlier, p. 575.

12 Edward C. Waters, David W. Holland, and Bruce A. Weber, “Economic Impacts of a Property Tax Limitation: A Computable General Equilibrium Analysis of Oregon’s Measure 5,” *Land Economics*, February 1997, v. 73, no. 1, pp. 72-89; Roxana Julia-Wise, Stephen C. Cooke, and R. David Holland, “A Computable General Equilibrium Analysis of Property Tax Limitation Initiative in Idaho,” *Land Economics*, May 2002, v. 78, iss. 2, pp. 207-27; Nalitra Thaiprasert, Dagny Faulk, and Michael J. Hicks, “A Regional Computable General Equilibrium Analysis of Property Tax Rate Caps and a Sales Tax Rate Increase in Indiana,” *Public Finance Review*, July 2013, v. 41, iss. 4, pp. 446-72.

13 Byron Lutz, “Quasi-Experimental Evidence on the Connection Between Property Taxes and Residential Capital Investment,” *American Economic Journal: Economic Policy*, February 2015, v. 7, iss. 1, pp. 300-330, at p. 313.

14 Yonghong Wu, “How Major Local Taxes Affect Private Employment: An Empirical Analysis of Northeastern Illinois Municipalities,” *Economic Development Quarterly*, 2012, vol 26, no. 4, pp. 351-60.

15 Jan K. Brueckner and Hyun-A Kim, “Urban Sprawl and the Property Tax,” *International Tax and Public Finance*, January 2003, v. 10, iss. 1, pp. 5-23; Robert W. Wassmer, “Further Empirical Evidence on Residential Property Taxation and the Occurrence of Urban Sprawl,” *Regional Science and Urban Economics*, November 2016, v. 61, pp. 73-85.

16 Erik B. Johnson and Randall Walsh, “The Effect of Property Taxes on Location Decisions: Evidence from the Market for Vacation Homes,” *NBER Working Paper 14793*, March 2009, 24 pp., at pp. 20, 21.

of this “cash on delivery” program, must vary according to a city’s particular circumstances. It will be useful, therefore, to illustrate how such a program might work in a specific context.

A Case Study

Consider Baltimore, which, as we have mentioned, has long endured chronic financial stress and other adverse consequences of a property tax rate that is more than twice that in its surrounding county (2.248% vs. 1.1%).¹⁷ The city’s leaders clearly understand that this puts them at a competitive disadvantage in retaining or recruiting investors and residents. They have coped by granting large-scale developers up-front subsidies that reduce the effective tax rate on certain projects toward a competitive level.¹⁸ But this “targeted incentive” strategy is neither efficient nor equitable: It leaves vast areas of the city’s 81 square miles (much of which contains aged, decaying capital that is starved for investment) untreated, and discriminates against the many thousands of property owners and potential investors who lack the connections or wherewithal to bargain for similar tax breaks.

To make its investment climate truly competitive and equitable for all its residents, then, Baltimore must roughly halve its property tax rate. But since the city generally receives over a third of its operating revenue from the property tax—in Fiscal Year 2017, for example, this amounted to \$408.5 million—to suggest such a thing causes panic among city officials, who commonly enumerate all the valuable city services which would disappear if that sum was no longer forthcoming.

As we have noted, however, a lower property tax rate immediately improves city property values and stimulates new investment. Even in the midst of the stagflationary late-’70s, San Francisco attracted substantial new investment after becoming tax-competitive with surrounding counties. That augmented the property tax base further over time. What is more, Maryland’s state income tax system—which shares receipts with localities via what is called the “piggyback” tax—carries great revenue potential for the city. Since this tax is based on place of residence rather than place of employment, reversing the city’s chronic out-migration of population would expand its income tax base as well as its property tax base.

Suppose, then, that Baltimore announced in Fiscal Year 2019 (again, via a binding change in its charter) that it would cap its property tax rate at half its current level (1.124% vs.

2.248%) six years later, in Fiscal Year 2025. Since real property is reassessed every three years in Baltimore and elsewhere in Maryland, this would allow two full reassessment cycles during which property values would rise more rapidly than in the previous high-tax regime, while new development, investment in existing properties, and population growth would occur in anticipation of the soon-to-arrive favorable tax environment.

Suppose further that the city committed to a binding budget constraint or fiscal rule, capping expenditure growth at 1.5% annually¹⁹ during this phase-in period. All growth in tax revenue above that level—chiefly from enhanced property, income, and transfer tax receipts—would then go into an escrow fund that would be available to pay for the tax cut when effective in FY2025, after which expenditures could grow at 2% annually.

Figure 2, which is based on recent budget data for Baltimore,²⁰ illustrates the implications for the city’s operating revenue and expenditures over a 20-year span. Between

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A lower property tax rate immediately improves city property values and stimulates new investment. Even in the midst of the stagflationary late-’70s, San Francisco attracted substantial new investment after becoming tax-competitive with surrounding counties.

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year t (FY2019) and year $t + n$ (FY2025), the escrow fund is built up; after the tax cap takes effect, this fund is drawn down and forestalls the kinds of short-run expenditure cuts which cities like San Francisco had to endure (see, again, Figure 1) when unexpected and unplanned-for tax caps were imposed on them by state referenda. During the n years between the tax cap’s approval and its delivery, we assume that Baltimore’s annual growth of property tax revenue would be 6%, and 4% after year $t + n$, while annual growth in income and transfer tax receipts would rise to 4% in year t and thereafter. We assume all other sources of revenue grow at 2% annually (and which we conservatively assume is uncorrelated with property tax rates, population, or income growth).

17 Clearly, a jurisdiction’s tax rate is just part of the cost-benefit calculation a resident or entrepreneur will make before choosing to invest; the quality of its services as well as other factors will play significant roles. Suffice it to say that Baltimore’s services are not generally perceived to be superior to those in its nearby jurisdictions.

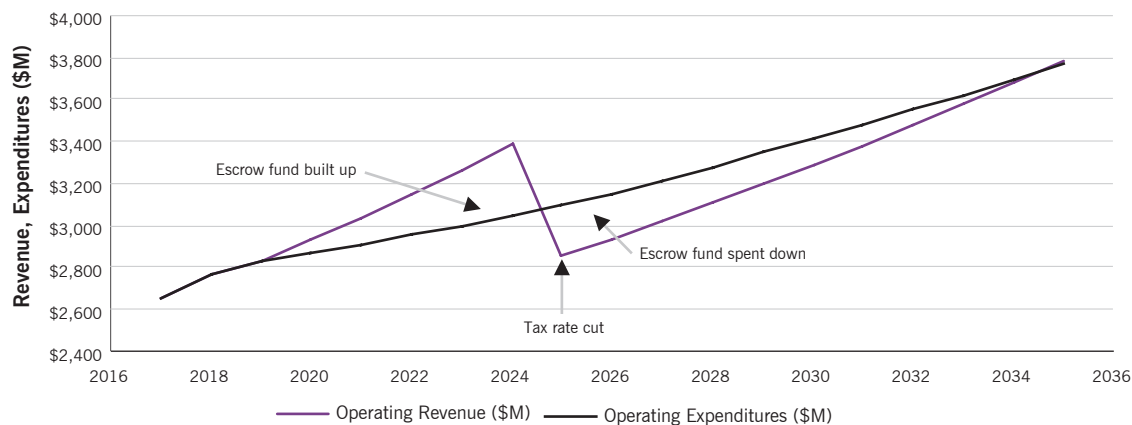
18 As one example, see Adam Marton, Natalie Sherman, and Caroline Pate, “The Port Covington Redevelopment Examined,” *The Baltimore Sun*, <http://data.baltimore-sun.com/news/port-covington/>.

19 This would be slightly below the 2% inflation rate predicted for the national economy over the next decade. See Federal Reserve Bank of Cleveland, *Inflation Expectations*, <https://www.clevelandfed.org/en/our-research/indicators-and-data/inflation-expectations.aspx>.

20 Baltimore City Department of Finance, *Preliminary Budget Plan, Fiscal Year 2019*, https://bbmr.baltimorecity.gov/sites/default/files/FY2019%20Preliminary%20Budget_FINAL_II.pdf.

Figure 2

Cash on Delivery: Revenue and Expenditures in Baltimore With a Property Tax Cut Announced in 2019 and Delivered in 2025



If the various elasticities of tax receipts with respect to tax rates found in the previously discussed studies still hold, the city’s escrow fund would increase by \$988 million by the time the tax cut was delivered. And if these deposits were invested as received at a 7% annual yield (a common assumption of public pension funds), the escrow fund would have a balance of \$1.16 billion to cover the estimated \$239 million shortfall²¹ in the FY2025 budget, with enough left over to balance budgets in the following fiscal years until growth in the city’s tax base “catches up” with the 50% lower property tax rate (in FY2034), after which expenditures could grow more rapidly than the assumed 2% in order to improve the quantity and quality of municipal services.

But dynamic growth in the city’s tax base is not the only means by which the necessary reserve fund would be built between years t and $t + n$. As we will discuss in the next section, the city’s considerable holdings of real property provide it with ample capacity to build its reserves and create a very comfortable margin of safety that will enable it to maintain—and, indeed, ultimately enhance—services from year t onward.

A Margin of Safety

Skeptics will worry that anticipated growth in a city’s property, income, and/or transfer tax receipts resulting from a more competitive tax environment might be less robust than projected. Macroeconomic trends may adversely affect invest-

ment decisions and/or income growth; yields on escrow fund investments may be disappointing; investors may be slow to “buy in,” dubious that a city will flourish in the way other tax-friendly jurisdictions typically have.

Sale-and-leaseback contracts (SLBs) can also help build the escrow fund substantially and quickly. SLBs enable government entities and nonprofits (not just businesses) to sell their property and receive an immediate cash infusion in exchange for an annual rental payment.²² There are many variations, but generally ownership of the property reverts to its original owners at the end of the lease period, while during it, control and management of the property remains with the lessee (though in some cases the buyer/lessor offers to take on maintenance responsibilities if this saves the lessee money).

One high-profile use of SLBs involved the state government of Arizona, which employed such contracts to cope with a 34% plunge in revenue and heightened demand for services arising from the Great Recession of 2007-09. In January 2010, the state raised \$735.4 million by selling 14 state buildings via “certificates of participation” that promised institutional and individual buyers annual returns of 4.57% over 20 years, during which the state would continue to manage and maintain the buildings at its expense, with the properties returning to state ownership if all lease payments were made. The sale was so successful that the state raised another \$300 million with a similar offering six months later.²³ Thus,

21 As noted earlier, at current levels for the city’s tax rate and base, halving the tax rate would “cost” over \$400 million in foregone revenue using static analysis. By year $t + n$, however, the combination of limited expenditure growth and expansion of the city’s property and income tax bases reduces the magnitude of the budget deficit that results from delivery of the tax cut.

22 For a brief primer on SLBs, see Ronald Pollina, *Raising Local Capital through Sale-Leasebacks*, Aug. 1, 2009, <https://icma.org/documents/raising-local-capital-through-sale-leasebacks>.

23 Richard Williamson, “Arizona Back to Selling Buildings,” *The Bond Buyer*, June

SLBs helped the state close a \$2.6 billion budget deficit in 2010 with an immediate \$1 billion cash infusion, though it took on about \$76 million in annual lease payments over the following 20 years.

But this instrument should not be seen merely as a means for firms or governments to respond to fiscal stress. In 2017, sales volume exceeded \$12 billion,²⁴ in part because SLBs can yield tax advantages that enhance their appeal for both buyer and seller. In a 2012 study, economists Kyle Wells and Ryan Whitby found that SLBs “offer the opportunity to transfer or ‘sell’ non-debt tax shields. ...The lessor ‘buys’ these tax shields by reducing the lease payment, thus lowering the financing costs of the asset.”²⁵ Because governments are tax-exempt property owners themselves, they cannot directly benefit from tax depreciation allowances. But, by doing SLBs with taxable enterprises, governments can capture much of those benefits.²⁶

According to its most recent accounting statements, the government of Baltimore City owns approximately \$4.4 billion worth of property that is potentially available for SLB contracts. Most cities, towns, and nonprofits of any size similarly maintain holdings of physical capital that would carry depreciation allowance-related tax benefits if held in the for-profit sector. In a growing national economy, the demand for such contracts is potentially great. And, as the Arizona experience shows clearly, making a portion of these capital assets available for SLBs has enormous capacity to address budget shortfalls that might arise if the city’s tax base grows at less-than-predicted rates. Of course, the rental payments attached to SLBs reduce the net cash infusion available. For example, at a 5% yield rate for the buyer/lessor, each \$100 million received by a seller/lessee would raise its expenditures by about \$7.9 million in annual rent payments over a 20-year SLB contract. Clearly, however, the net effect of SLBs would be to increase substantially the amount of cash available for delivery when, as in our Baltimore case study, the proposed competitive tax rate arrives in year $t + n$.

In addition to SLBs, a tax-cutting city’s escrow fund could be augmented with the proceeds of privatizations. Over the decades, many cities have taken control of a wide variety of assets and enterprises, including water utilities, parking

garages, convention centers, stadia and arenas, and even hotels and golf courses. It is certainly possible that at one time, public ownership of these facilities made some sense as, e.g., an alternative to regulation of privately operated natural monopolies. Over time, however, as public employee unions have gained strength and raised wages and benefits significantly, these enterprises have become increasingly costly relative to privately run alternatives. If the requisite auctions are competitive and sale contracts are properly designed and executed²⁷—which conditions have not always been met in practice—then privatization can be a twofer, trimming local governments’ operating costs²⁸ as it funds more competitive tax rates.

It is true that privatization is politically unpopular precisely because it carries the potential for significant operational efficiencies and cost savings; this goes the public employee unions’ ox.²⁹ Once again, however, the tax benefits of private ownership of these facilities provide a unique opportunity to blunt some of these unions’ opposition to privatization efforts. Again assuming the bidding process is competitive, a (nontaxable) seller can capture some of the depreciation allowance-related benefits that would flow to (taxable) buyers. Some of these proceeds could then be allocated to buyouts or employment guarantees for those union members adversely affected by the privatizations.

Finally, cities might (unless this is expressly prohibited by their charters) employ revenue anticipation bonds to supplement the reserve fund and assure adequate revenues are available on delivery of tax cuts in year $t + n$. Indeed, as we have already mentioned, many cities already use such instruments, called tax increment financing (TIF), to subsidize and encourage investment that otherwise might be uneconomic by virtue of high taxes or other factors. They justify these targeted incentives by noting that they spur growth in the tax base, which allows TIF bonds to be retired. The same logic certainly applies to a program of tax cuts that promises to generate more broad-based growth in the tax base.

8, 2010, p. 1.

24 Beth Mattson-Teig, “Investors Welcome Surge of Corporate Sale-Leasebacks,” *National Real Estate Investor*, April 4, 2018, <https://www.nreionline.com/finance-investment/investors-welcome-surge-corporate-sale-leasebacks>.

25 Kyle Wells and Ryan Whitby, “Evidence of Motives and Market Reactions to Sale and Leasebacks,” *Journal of Applied Finance*, 2012, no. 1, pp. 57-69, at p. 58.

26 Historically, the IRS has viewed some SLBs as sham transactions solely aimed at tax avoidance. Accordingly, SLB contracts must be written with care. See: Eileen O’Neill, *Federal Tax Implications of Sale-Leaseback Transactions*, 2009, https://readingroom.lib.gsu.edu/lib_student/68.

27 For guidance on this issue, see: Steve H. Hanke and Stephen J.K. Walters, “Privatizing Waterworks: Learning from the French Experience,” *Journal of Applied Corporate Finance*, Summer 2011, v. 23, no. 3, pp. 30-35; Steve H. Hanke and Stephen J.K. Walters, “Reflections on Private Water Supply: Agency and Equity Issues,” *Journal of Applied Corporate Finance*, Summer 2011, v. 23, no. 3, pp. 36-40.

28 For an entertaining example of cost inflation at Baltimore’s water utility, see: Jason L. Riley, “My Lazy Summer as a Public Employee,” *The Wall Street Journal*, June 20, 2018, p. A17.

29 In Baltimore, interest groups opposed to privatization recently persuaded the city council to fast-track legislation aimed at amending the city charter to prevent privatization of the city’s water utility. As this is written, the outcome is uncertain, pending a referendum in November, 2018. See: Joe Setyon, “Baltimore City Council Approves Water Privatization Ban,” *Reason*, Aug. 7, 2018, <https://reason.com/blog/2018/08/07/baltimore-city-council-approves-water-pr>.

Conclusions

In the years after WWII, many large American cities responded to the budget problems associated with flight to the suburbs by raising tax rates to those who remained. This, in turn, fueled additional flight of population and investment, often putting these cities under financial stress and damaging the economic and social welfare of many of their residents. As a result of several statewide tax revolts starting in the mid-1970s, however, some cities were forced to reset their property tax rates at competitive levels. This set them on a healthier growth path, but also caused some immediate budgetary pain. For that reason, tax caps or rate cuts aimed at enhancing other struggling cities' attractiveness for investment face substantial political obstacles, as rational political actors are reluctant to prescribe short-run pain even if the result is long-term gain.

These obstacles need not be insurmountable, however. Tax reforms which make a city's investment environment competitive with rival jurisdictions can be timed so that painful budget cuts can be avoided, incumbent decision-makers' political viability is not endangered, and the city's residents can enjoy greater economic opportunity and prosperity. The key is to (i) announce a binding tax cap at time t for delivery at time $t + n$, (ii) limit spending growth to a maintenance-of-service level during the n intervening years, while banking the enhanced tax receipts resulting from more-rapid tax base growth associated with investors' desire to "get in on the ground floor," and (iii) use the accumulated funds to close the budget gaps that will arise at time $t + n$.

A city may also assure an additional margin of safety for its reserve fund by sales of publicly owned real property, either

as outright privatizations or via sale-and-leaseback contracts. The latter, depending on the nature of the sale contract and the resulting IRS treatment of depreciation allowances, should have enormous appeal for both tax-paying buyers/lessors seeking tax deductions and for governmental sellers/lessees that cannot use those deductions. In consequence, SLBs can have a transformative role to play in enabling fiscally struggling cities to thrive economically.

High-growth cities like San Francisco and Boston have shown that decades of population loss and urban decline can be reversed quickly once tax barriers to investment are removed; the scholarly literature makes clear that cities' tax bases and a host of key economic and social variables are sensitive to tax rates, especially on physical capital. But many cities burdened by tax policies that are locally or regionally noncompetitive feel hemmed-in by these policies, unable to pursue needed reforms because of fears of adverse near-term budgetary problems. The strategy outlined here can get cities past such concerns, and financial firms can partner with policy makers to achieve a brighter future for these cities' residents.

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