

PAYMENTS IN LIEU OF TROUBLE: NONPROFIT PILOTS AS EXTORTION OR EFFICIENT PUBLIC FINANCE?

JULIA A. QUIGLEY*

INTRODUCTION	272
I. BACKGROUND ON STATE CHARITABLE PROPERTY TAX	
EXEMPTIONS.....	275
A. <i>Legal and Historical Context</i>	275
B. <i>Backlash</i>	277
1. <i>Budgetary Pressures</i>	277
2. <i>Increased Scrutiny</i>	279
II. PAYMENTS IN LIEU OF TAXES (PILOTS)	281
A. <i>Prevalence and Practice of PILOTS</i>	281
B. <i>Criticisms</i>	282
1. <i>Extortion</i>	282
2. <i>Inconsistent</i>	286
3. <i>Inefficient</i>	287
III. AN ECONOMIC ANALYSIS OF PILOTS.....	288
A. <i>An Answer to the Critics</i>	288
1. <i>Extortion</i>	288
2. <i>Inconsistent</i>	292
3. <i>Inefficient</i>	293
B. <i>Policy Implications</i>	294
CONCLUSION	295

INTRODUCTION

Under state law, nonprofit institutions are wholly exempt from paying state and local property taxes.¹ This is a coveted legal entitlement: many for-profit institutions bargain with state and

* New York University School of Law, J.D. 2017. The author would like to thank Professor Mitchell Kane, the faculty and student members of the 2017 Lederman Fellows seminar, and the staff of NYU ELJ for their discerning comments.

¹ See DAPHNE A. KENYON & ADAM H. LANGLEY, PAYMENTS IN LIEU OF TAXES: BALANCING MUNICIPAL AND NONPROFIT INTERESTS 2 (Ann LeRoy ed., 2010).

local governments to reduce their property tax burdens by a fraction.² Yet large nonprofits increasingly make “Payments in Lieu of Taxes,” or PILOTs, to the locality in which they reside.³ Municipalities largely ask “eds and meds”—institutions of higher education and hospitals—for payment because of their large landholdings and financial stability.⁴ The payments (and their moniker) are counterintuitive because these organizations have no independent legal responsibility to pay property taxes.

PILOTs have been criticized as extortive, inconsistent, and inefficient.⁵ First, some commentators believe that even comparatively powerful nonprofits make these payments under threat.⁶ Nonprofits may fear that their local government will make the day-to-day business of running their organization difficult if they refuse to make these “voluntary” payments.⁷ Similarly, the payments may serve to stave off more formal attempts by the government to eliminate the exemption altogether.⁸ Second, localities have been criticized for pursuing PILOTs in an ad hoc and arbitrary manner.⁹ Third, PILOTs recover only a small portion of what nonprofits would owe if their property holdings were fully taxed.¹⁰

Yet there are strong arguments in favor of making eds and meds contribute through some mechanism to their municipality’s budget. Many towns and cities are in dire economic straits, in part because of shrinking property tax rolls.¹¹ Although nonprofits do provide valuable services to their communities, they also impose costs on them by consuming municipal services such as physical and service infrastructure, from public parking to police

² See generally DAPHNE A. KENYON ET AL., *RETHINKING PROPERTY TAX INCENTIVES FOR BUSINESS* (2012).

³ See *id.* at 2.

⁴ See Evelyn Brody, *All Charities are Property-Tax Exempt, but Some Charities are More Exempt than Others*, 44 N.E. L. REV. 621, 665–66 (2010) [hereinafter Brody, *Some Charities are More Exempt than Others*].

⁵ See KENYON & LANGLEY, *supra* note 1, at 32–33.

⁶ See *id.* at 6.

⁷ See *id.*

⁸ See *id.*

⁹ See *id.* at 3.

¹⁰ See *id.* at 33.

¹¹ See BILL SCHLACHTER, *KEY CHALLENGES AND STRATEGIES FOR LOCAL GOVERNMENT* 3 (Terry Miller et al. eds., 2013).

protection.¹² Furthermore, many organizations, in particular hospitals and universities, have the financial means to contribute to their communities. It is perceived as unfair for prosperous nonprofits to refrain from contributing to the provision of city services from which they benefit.¹³

PILOTs offer municipalities and nonprofits an intermediate solution between full taxation and total exemption. Each of the critiques of PILOTs can be rebutted, if not reframed entirely as a benefit. First, a municipality cannot extort PILOTs from nonprofits without consequence. Local agency decisions are subject to judicial review under an arbitrary and capricious standard,¹⁴ and their local leaders are subject to the political process. Furthermore, the portrayal of PILOTs as extortion neglects the possibility that they are made at least in part out of self-interest of the payor and a desire for good public optics, akin to corporate stewardship of the environment. Additionally, the threat that a city or town could successfully abolish a state exemption is unrealistic. Second, PILOTs offer municipalities flexibility in setting an effective tax rate across different types of nonprofits. It would be expensive and time-consuming to create a single tax system that takes into account what individually negotiated PILOTs can: the nonprofit's landholdings, financial affairs, and contributions to the city.¹⁵ Finally, PILOTs are not properly comparable to the amount of revenue that would be recovered if nonprofits were fully taxable. That comparison assumes that the appropriate tax rate would be the one applied to a similarly situated corporate entity; PILOTs allow municipalities to seek some contribution while still subsidizing nonprofits.

¹² See *id.* at 10.

¹³ See Evelyn Brody, *The States' Growing Use of a Quid-Pro-Quid Rationale for the Charity Property Tax Exemption*, 56 EXEMPT ORG. TAX REV. 269, 270 (2007) [hereinafter Brody, *The States' Growing Use of a Quid-Pro-Quid Rationale*].

¹⁴ See *Pacer Inc. v. City of Middletown*, 635 N.Y.S.2d 704, 706 (N.Y. App. Div. 1995).

¹⁵ Incorporating the value that the nonprofit provides in the form of revenue from payroll and sales tax would be administratively challenging, let alone calculating the value of the community amenities it provides. *But cf.* John Sawhill & David Williamson, *Measuring What Matters in Nonprofits*, MCKINSEY Q. (2001), <https://www.mckinsey.com/industries/social-sector/our-insights/measuring-what-matters-in-nonprofits> (acknowledging that quantifying a nonprofit's community value is difficult, while providing strategies for doing so).

From a policy standpoint, PILOTs are not *prima facie* problematic. In their simplest terms PILOTs offer a compromise between full tax exemption and full taxation of nonprofits. The effectiveness of PILOTs in meeting a municipality's revenue goals deserves analysis despite their reputational shortcomings.

I. BACKGROUND ON STATE CHARITABLE PROPERTY TAX EXEMPTIONS

A. *Legal and Historical Context*

Since the 1890s, the United States federal government has given preferential tax treatment to charitable not-for-profit institutions.¹⁶ Early lawmakers rationalized these charitable exemptions in two ways. First, exemptions served as a governmental stamp of approval on socially desirable behavior.¹⁷ Second, they subsidized organizations that provided a service that would normally fall under the government's purview.¹⁸ Beginning with the Wilson-Gorman Tariff Act of 1894, groups operating with "charitable, religious, or educational purposes" were exempt from the federal government's first attempt at a corporate income tax.¹⁹ Over the next half-century, Congress refined its approach to taxing U.S. citizens and businesses by passing laws cementing a federal income, estate, and corporate tax, all of which included some exemption for charitable organizations.²⁰ The culmination of this federal interest in magnanimous endeavors is present in Section 501(c)(3) of the current U.S. Internal Revenue Code, first created by the Revenue Act of 1954.²¹ In 27 states, an entity that qualifies as a 501(c)(3) organization under the federal statute is also exempt

¹⁶ See PAUL ARNSBERGER ET AL., A HISTORY OF THE TAX-EXEMPT SECTOR: AN SOI PERSPECTIVE 106 (2008).

¹⁷ See *id.*

¹⁸ See *id.* at 105.

¹⁹ See Revenue (Wilson-Gorman Tariff) Act of 1894, ch. 349, § 27, 28 Stat. 509, 556, *invalidated by* Pollock v. Farmers' Land & Trust Co., 158 U.S. 601 (1985).

²⁰ See ARNSBERGER ET AL., *supra* note 16, at 106.

²¹ See *id.* at 124; I.R.C. § 501(c)(3) (1954). Section 501(c)(3) gives a federal income tax exemption to groups that are "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual." *Id.*

from paying state property taxes.²² However, qualification as a charitable organization under federal law does not necessarily mean one qualifies for a state exemption—it is entirely dependent on state law. Although states are free to choose how and whether to provide tax exemptions,²³ many states adopted them for the same reasons that appealed to the federal government.²⁴

The nonprofit property tax exemption was a natural extension of the exemption afforded to government-owned property.²⁵ Government property was exempted to avoid taxing the recipient of the proceeds, which was perceived as an inefficient, empty ceremony that passed money from one government pocket to the other.²⁶ Early property tax exemptions, dating back to seventeenth-century England, were meant to subsidize private parties who alleviated government burdens by maintaining public infrastructure.²⁷ Subsequently, such local exemptions were extended to charitable organizations that built facilities to serve their communities and alleviate poverty.²⁸ Those local communities felt special tax treatment was justified because charities provided services that would otherwise fall to local governments (and be funded by local taxes).²⁹

Today, all fifty states and the District of Columbia offer charitable organizations and nonprofits some form of exemption from property taxation.³⁰ Although property tax regimes vary by state, they are more alike than different.³¹ However, there is variation in whether the exemption is defined by state constitution or legislation, what qualifies as a nonprofit, and how each state's

²² See KENYON & LANGLEY, *supra* note 1, at 11.

²³ See Brody, *The States' Growing Use of a Quid-Pro-Quid Rationale*, *supra* note 13, at 269.

²⁴ See KENYON & LANGLEY, *supra* note 1, at 10–11.

²⁵ See H. Woods Bowman, *Reexamining the Property Tax Exemption*, LAND LINES (Lincoln Institute of Land Pol'y, Cambridge, Mass.), July 2003, at 5–6, http://www.lincolnst.edu/sites/default/files/pubfiles/827_July%2003%20final.pdf.

²⁶ See *id.*

²⁷ See *id.* at 7. Examples might include a dock owner that built a seawall that protected his and others property or a carriage owner that fixed pot holes on common dirt roads.

²⁸ See *id.*

²⁹ See *id.*

³⁰ See KENYON & LANGLEY, *supra* note 1, at 2.

³¹ See Brody, *Some Charities are More Exempt than Others*, *supra* note 4, at 624.

property taxing system is applied in practice. Generally, to qualify for this special treatment, a charity must *own* and itself *use* the property for a purpose that qualifies as charitable under the state's constitution or relevant statute.³²

B. *Backlash*

Increasingly, municipalities have exerted pressure on nonprofits to contribute to tax rolls.³³ This effort has two root causes. First, more and more local governments are faced with tightening budgets. Second, some nonprofits have been scrutinized for straying from their wholly charitable missions.³⁴

1. *Budgetary Pressures*

Since the 1970s, municipal budgets have declined due to decreases in both federal funding and local property tax bases.³⁵ In 2007, local governments received roughly half the amount of federal aid they did in 1977.³⁶ Concurrently, the “erosion” of local tax bases is “due to a wide variety of factors, including the growth of tax limitations, exemptions, and other forms of special property tax treatment, none of which are expected to turn around in the foreseeable future.”³⁷

This pressure is disproportionately borne by local, rather than state, governments. Providing for over half of local government revenue, property taxes are the largest source of proceeds fueling the nation's counties, cities, towns, and school districts.³⁸ States rely far less on property taxes than do localities.³⁹ Property taxes account for greater than five percent of the budget of only seven

³² See Brody, *The States' Growing Use of a Quid-Pro-Quid Rationale*, *supra* note 13, at 269. “In some states, charities forfeit property tax exemption by using the property, even in part, for an unrelated business or for investment, while in other states the exemption is apportioned.” *Id.*

³³ TOOL KIT: FACING CHALLENGES TO PROPERTY TAX EXEMPTIONS, NAT'L COUNCIL OF NONPROFIT ASS'NS 1 (2003) [hereinafter NCNA], http://faculty.cbpa.drake.edu/frank/mpa_215_3754_qcgc_fall_2013/outlines_3754/part_10_taxes-challenge/property_tax_tool_kit.pdf.

³⁴ See KENYON & LANGLEY, *supra* note 1, at 7.

³⁵ See *id.* at 9.

³⁶ See *id.*

³⁷ KENYON & LANGLEY, *supra* note 1, at 9.

³⁸ See *How Do State and Local Property Taxes Work?*, TAX POLICY CTR., <http://www.taxpolicycenter.org/briefing-book/how-do-state-and-local-property-taxes-work> (last visited Apr. 9, 2017).

³⁹ See *id.*

states, and fourteen states lack state-level property taxes.⁴⁰ Only one percent of the average state's income comes from property taxes.⁴¹

The city of Syracuse, New York, stands out as the epitome of an eroded property tax base. Fifty-six percent of the property in Syracuse is tax-exempt,⁴² and another 8.5 percent is tax-delinquent.⁴³ As the county seat, Syracuse is home to numerous government-owned buildings (including county, state, and federal courthouses and a county jail), as well as major universities and research centers.⁴⁴ Like many Rust Belt cities, Syracuse experienced a hollowing out when wealthier residents moved to nearby suburbs, which have their own tax rolls.⁴⁵ It is not a coincidence that, in 2015, Syracuse was found to have the highest concentrations of black and Latino poverty (and the fifth highest concentration of white poverty) in the nation.⁴⁶ Ironically, the same study attributed the poverty in part to the development of public housing in the city center.⁴⁷ This practice further reduces the taxable real estate in the city, adding to the revenue reduction

⁴⁰ See *id.*

⁴¹ See *id.*

⁴² See Ryan Delaney, *Syracuse's Nonprofit Problem: Not Enough Land on the Tax Rolls*, INNOVATION TRAIL (Apr. 27, 2012), <http://innovationtrail.org/post/syracuses-nonprofit-problem-not-enough-land-tax-rolls>. “[The situation] is increasingly untenable as state and federal funding grows scarcer,” says Mayor of Syracuse, Stephanie Miner. Tim Knauss, *Mayor Stephanie Miner Talks Nonprofit Syracuse University into Making Payments for City Services*, SYRACUSE.COM (June 9, 2011, 6:06 AM), http://www.syracuse.com/news/index.ssf/2011/06/mayor_stephanie_miner_talks_no.html. “It is unrealistic to expect 50 percent of the taxable land in the city of Syracuse to pay for 100 percent of the services.” *Id.*

⁴³ See Haley Behre, *Syracuse Posts Online Tax-Delinquent Properties Available for Sale*, SYRACUSE.COM (Oct. 28, 2011, 1:35 PM), http://www.syracuse.com/news/index.ssf/2011/10/syracuse_posts_online_tax-deli.html.

⁴⁴ See Delaney, *supra* note 42; *Syracuse City Court*, NYCOURTS.GOV, <https://www.nycourts.gov/courts/5jd/onondaga/city/index.shtml> (last visited Jan. 15, 2018); *Syracuse*, N. DIST. OF N.Y., <http://www.nynd.uscourts.gov/content/Syracuse> (last visited Jan. 15, 2018).

⁴⁵ See Alana Semuels, *How to Decimate a City*, THE ATLANTIC (Nov. 20, 2015), <https://www.theatlantic.com/business/archive/2015/11/syracuse-slums/416892/>.

⁴⁶ See Paul A. Jargowsky, *Architecture of Segregation: Civil Unrest, the Concentration of Poverty, and Public Policy*, THE CENTURY FOUND. 1, 8, 12 (2015); Semuels, *supra* note 45.

⁴⁷ See Jargowsky, *supra* note 46, at 13.

cycle.⁴⁸

Indeed, charitable organizations tend to locate in cities to be near the populations that they serve;⁴⁹ “the same municipalities that host a disproportionately high share of nonprofit property often suffer a disproportionately high demand for public expenditures.”⁵⁰ Center cities may also disfavor nonprofit exemptions, because the benefits of the charitable work can accrue outside of their borders, but they alone bear the costs of the property tax abatement.⁵¹ For instance, the Central New York region and the State of New York benefit from having Syracuse University within their borders; however, only the City bears its costs.

Nationwide, it is estimated that the loss of property tax income from charitable organizations costs local governments an approximated \$8–13 billion annually.⁵² Though a sizeable sum, this is a small portion of exemptions as a whole—government-owned buildings compose the largest sector of tax-exempt property.⁵³ Why, then, is it that “the exempt status of government land barely provokes complaint . . . whereas exemptions for nonprofit organizations are frequently challenged”?⁵⁴ Charitable and non-governmental holdings are the target of municipal outrage, at least in part, because the public views many modern nonprofits as operating more like for-profit corporations than extensions of the government.⁵⁵

2. *Increased Scrutiny*

In addition to budgetary considerations, criticism of the exemption also springs from a perception that, because many

⁴⁸ Syracuse’s taxable property has also decreased as major manufacturing companies have departed the city. The city saw manufacturing plants for Chrysler, General Motors, Sylvania, and Carrier (namesake of the beloved Carrier Dome) close in recent decades. See Michael Luo & Lydia Polgreen, *Layoffs by Carrier Corp. Strike Syracuse in Heart*, N.Y. TIMES (Oct. 10, 2003), <http://www.nytimes.com/2003/10/07/nyregion/layoffs-by-carrier-corp-strike-syracuse-in-heart.html>.

⁴⁹ See Brody, *The States’ Growing Use of a Quid-Pro-Quid Rationale*, *supra* note 13, at 270.

⁵⁰ *Id.*

⁵¹ See *id.* at 270.

⁵² See *id.* at 269.

⁵³ See *id.* at 269; Bowman, *supra* note 25, at 5.

⁵⁴ Bowman, *supra* note 25, at 5.

⁵⁵ See KENYON & LANGLEY, *supra* note 1, at 7.

nonprofits are financially secure and operate to an extent like for-profit corporations, the original rationale for exemption no longer exists.⁵⁶ Public support for the charitable exemption diminishes when nonprofits engage in commercial activities, even if they are only supplementary to their nonprofit mission.⁵⁷ Hallmarks of commercialism include: “charging user or admission fees, seeking revenues from marketing relationships, research and development partnerships with for-profits, joint purchasing partnerships between nonprofits and for-profits, and engaging in unrelated business activities that have little to do with the nonprofit’s social mission.”⁵⁸ There seems to be a public perception that reinvesting revenue into the organization rather than posting profits is not enough to be considered charitable. Furthermore, nonprofits have increasingly been criticized for lavish expenses, such as the salaries of their leadership (including college presidents and football coaches),⁵⁹ as well as for architecturally significant dormitories and state-of-the-art sports facilities.

In the public imagination, greater transparency in the finances of nonprofits has replaced the image of the soup kitchen struggling to feed the poor with visions of greedy hospital executives charging the uninsured working poor more than their insured counterparts.⁶⁰ When charities are viewed as having commercial aspects, the exemption is viewed as a subsidy for suspicious behavior rather than a government endorsement of good behavior.⁶¹ Public outrage is further fueled by the fact that the exemption applies regardless of the nonprofit’s size or financial need.⁶² Indeed, large, wealthy nonprofits such as universities and hospitals benefit the most from the exemption because the land they own is often extremely valuable.⁶³

In response, some states have begun reining in their

⁵⁶ *See id.*

⁵⁷ *See id.*

⁵⁸ *Id.*

⁵⁹ *See* Jim Baumbach, *Special Report: College Football Coaches’ Salaries and Perks Are Soaring*, *NEWSDAY* (Oct. 4, 2014), <https://www.newsday.com/sports/college/college-football/fbs-college-football-coaches-salaries-are-perks-are-soaring-newsday-special-report-1.9461669>.

⁶⁰ *See* KENYON & LANGLEY, *supra* note 1, at 8–9.

⁶¹ *See* Brody, *The States’ Growing Use of a Quid-Pro-Quid Rationale*, *supra* note 13, at 270.

⁶² *See* KENYON & LANGLEY, *supra* note 1, at 31.

⁶³ *See id.*

exemption in various ways.⁶⁴ For instance, some states tailor their provisions based on whether the land is used in part for an exempt purpose, is leased to another entity, or has an ancillary use like a parking lot or student dormitory.⁶⁵ Other localities have tried to chip away at the exemption through the use of phase-in taxes, moratoriums, and the now-widespread payments in lieu of taxes.⁶⁶ Still, charities have avoided the “nuclear option”—constitutional amendments or state statutes stripping away the exemption in its entirety.⁶⁷

II. PAYMENTS IN LIEU OF TAXES (PILOTS)

A. *Prevalence and Practice of PILOTS*

Payments in lieu of taxes, or PILOTS, are voluntary, negotiated payments made by entities to municipalities. In the for-profit context, these contracts limit the tax burden of the private institution, usually for a certain number of years.⁶⁸ In the nonprofit context they essentially create a tax burden. Nonprofit PILOTS vary in form: some are individually negotiated payments while others are part of a system set up by a municipality.⁶⁹ Some PILOTS are explicitly paid to a city for use by a specific municipal department, like police or fire.⁷⁰ Others are granted without a specific purpose beyond aiding the town in a time of need or giving back to the community in general. In such cases, the mayor or other local leaders have considerable control over how the funds are used.

PILOTS are not just a creature of the current economy. In 1929, Harvard University entered into an agreement to make annual payments to Cambridge, Massachusetts for a period of 20 years.⁷¹ The agreement has been renewed and adjusted multiple

⁶⁴ See Brody, *The States' Growing Use of a Quid-Pro-Quid Rationale*, *supra* note 13, at 283.

⁶⁵ See *id.* at 283–85.

⁶⁶ See *id.* at 270.

⁶⁷ See *id.*

⁶⁸ See PEW CENTER ON THE STATES, EVIDENCE COUNTS: EVALUATING STATE TAX INCENTIVES FOR JOBS AND GROWTH 6 (Lori Grange & Scott Greenberger eds., 2012).

⁶⁹ See KENYON & LANGLEY, *supra* note 1, at 6.

⁷⁰ See Fan Fei et al., *Are PILOTS Property Taxes for Nonprofits?* 94 J. URB. ECON. 109, 111 (2016).

⁷¹ See Janne Gallagher, *The Legal Structure of Property-Tax Exemption*, in

times since,⁷² and in the 10 year period from 2004 to 2014, the University paid over \$45 million in PILOTs.⁷³ As of 2012, 218 localities in 28 states received PILOTs.⁷⁴ PILOT payments are most prevalent in the Northeast, and 92 percent of PILOT revenue came from universities and hospitals.⁷⁵

As discussed in Part I, municipalities have numerous reasons for pursuing PILOTs. The rationale for nonprofit entities, however, is less intuitive. Nonprofits are exempt from property taxation—why pay something when you could pay nothing? Two rationales are proffered to explain why nonprofits make PILOTs. Some argue that nonprofits pay PILOTs out of a sense of fairness, i.e., because they realize that they consume municipal resources like roads, utilities, and police.⁷⁶ In the same vein, nonprofits may make them because they recognize that they depend at least partially on the overall health of the city in which they reside.⁷⁷ Others believe nonprofits concede to them due to government pressure and fear of retribution.⁷⁸

B. Criticisms

Numerous criticisms have been levied against PILOTs. They have been decried as extortion, inconsistent, and inefficient.⁷⁹

1. Extortion

Certainly, it is unlikely that nonprofits would make payments

PROPERTY-TAX EXEMPTION FOR CHARITIES: MAPPING THE BATTLEFIELD (Evelyn Brody ed., 2002).

⁷² See *id.*

⁷³ See Christine Y. Cahill & Amna H. Hasmi, *Official's Defend Harvard's Payments to Local Governments*, HARVARD CRIMSON (Oct. 30, 2014, 1:20 AM), <http://www.thecrimson.com/article/2014/10/30/harvard-defends-pilot-contributions/>.

⁷⁴ See Fan Fei et al., *supra* note 70, at 111.

⁷⁵ See *id.* In response to the perfect property-tax storm in Syracuse, the city's mayor, Stephanie Miner, sought PILOTs from the major nonprofits in the area, including Syracuse University and SUNY Upstate Medical University and Hospital. See Delaney, *supra* note 42. The mayor was successful in securing payments from Syracuse University, but the state declined to give SUNY Upstate the authority necessary for it to enter into such an agreement. See *id.*

⁷⁶ See KENYON & LANGLEY, *supra* note 1, at 6.

⁷⁷ See *id.* Certainly, this is a more self-interested motive than one of pure fairness.

⁷⁸ See *id.*

⁷⁹ See *id.* at 31–32.

to their localities absent political pressure.⁸⁰ Municipalities must induce nonprofits to pay either by carrot or stick. Some towns invite PILOTs by offering services above the baseline (an appealing carrot) or by persuading nonprofits that giving back to the town is an essential part of the organization's role as a responsible inhabitant.⁸¹ Additionally, some nonprofits may view PILOTs as a necessary facet of their public relations outreach. Alternatively, some towns insinuate or outright declare that they will impose costs on organizations that refuse to make payments (the proverbial stick).⁸²

Materials provided by the National Council of Nonprofit Associations (NCNA) indicate a belief among organizations that PILOTs are more stick than carrot. NCNA's *Tool Kit* outlines the likelihood that nonprofits will be solicited for PILOTs based on various characteristics, and lays out a decision matrix for nonprofits to use when considering whether to petition or concede to a request for payment.⁸³ For instance, a nonprofit should consider how the cost of the payment will affect its overall budget and ability to continue operating, in addition to taking a political stance in support of the exemption and helping to preserve the financial security of the sector as a whole.⁸⁴ However, NCNA also counsels organizations to consider the upside of paying. Avoiding negative publicity and strained relationships with, or outright retaliation from, their local government may make payment the wise choice.⁸⁵

Nonprofits, like for-profit corporations, inevitably encounter local governments while carrying out their business. There are considerable opportunities for municipal governments to be

⁸⁰ See Fan Fei et al., *supra* note 70, at 112.

⁸¹ See *id.*; *The States' Growing Use of a Quid-Pro-Quid Rationale*, *supra* note 13, at 287. As part of RISD's agreement to pay the city of Providence \$2.5 million over ten years, the school was given access to 70 parking spaces near campus on public streets and an option to rent them after the payment period expired. See MATTHEW M. CLARKIN, JR., REVIEW OF REAL ESTATE & PILOT AGREEMENTS 23 (2015), <http://www.providenceri.gov/wp-content/uploads/2017/05/Review-of-RI-PILOT-Agreements-Narrative-September-29-2015.pdf>. As part of its agreement to pay the city \$3.8 million over ten years, Providence College received marketable title to roughly 80,000 square feet of municipally owned land. See *id.* at 18.

⁸² See Fan Fei et al., *supra* note 70, at 112.

⁸³ See NCNA, *supra* note 33, at 12.

⁸⁴ See *id.*

⁸⁵ See *id.*

unhelpful. Localities have great discretion in withholding necessary building permits and zoning amendments sought by organizations.⁸⁶ They can fail to make reasonable exceptions to onerous local rules, in addition to constraining access to publicly available services.⁸⁷ For instance, Northwestern University, which has had a historically strained relationship with its hometown of Evanston, Illinois, alleged that the city designated the neighborhood surrounding the University as a historic district as revenge for its failure to contribute a PILOT to city coffers.⁸⁸ Fei et al. provide further illustrative examples:

There are many more recent examples of localities pressuring nonprofits for voluntary payments. In one case, the plaintiff church complained that the town supervisor and commissioners threatened to reject a request for a parking lot permit if the church did not make a PILOT or donate a fire truck. In another case, tax-exempt hospitals alleged that the government units were attempting to “coerce” or “force” tax-exempt member hospitals to make payments in lieu of taxes by “indicat[ing] that those [hospitals] which [did] not agree to such payments and/or agreement ‘in lieu of taxes’ [would] have their tax exempt status challenged, [would] be likely to run into difficulties in obtaining zoning approvals, and [would] not be offered the opportunity to provide services to the taxing authority.”⁸⁹

Nonprofits also operate under the fear that their jurisdiction will pursue some sort of legal challenge or state legislative action affecting their exemption.⁹⁰ Certainly, the most severe recourse a state could take would be to pass a constitutional amendment or statute stripping away the exemption entirely.⁹¹ Numerous universities have been faced with legislation that attempts to do so, including Yale University and Harvard University.⁹² However, both proposals ultimately failed.⁹³

⁸⁶ See KENYON & LANGLEY, *supra* note 1, at 6.

⁸⁷ See Fan Fei et al., *supra* note 70, at 111.

⁸⁸ See *id.* at 6.

⁸⁹ *Id.* (internal citations omitted).

⁹⁰ See KENYON & LANGLEY, *supra* note 1, at 6.

⁹¹ See *id.*

⁹² See Martha W. Kessler, *Yale Property Tax Bill Dies in Connecticut*, BLOOMBERG (May 6, 2016), <https://www.bna.com/yale-property-tax-n57982070776>; Brody, *The States' Growing Use of a Quid-Pro-Quid Rationale*, *supra* note 13, at 287.

⁹³ See Brody, *The States' Growing Use of a Quid-Pro-Quid Rationale*, *supra* note 13, at 287, n.89; see Kessler, *supra* note 92.

City leaders in New Haven, Connecticut have challenged Yale University's tax-exempt status in court periodically since 1899.⁹⁴ The University currently pays \$8.5 million per year in voluntary payments to New Haven—this is the largest PILOT made by a university in the nation.⁹⁵ The state of Connecticut also compensates localities such as New Haven for up to 77 percent of the tax revenue lost due to the nonprofit exemption.⁹⁶ In 2009 alone, New Haven received \$37 million in such payments from the state.⁹⁷ However, in 2016 the Connecticut legislature introduced a bill that would strip Yale of its nonprofit exemption.⁹⁸

Yale vociferously opposed the legislation, objecting to the portrayal that it was not contributing its fair share to the support of New Haven.⁹⁹ Press releases highlighted its record-breaking PILOT agreement as well as the millions of dollars in taxes paid by the University for its commercial properties.¹⁰⁰ In addition to defending its community stewardship, Yale made clear that it would challenge the legislation as unconstitutional if it passed.¹⁰¹ Yale argued that the University's charter, adopted in Connecticut's constitution, includes a non-taxation clause—any state legislative action in contravention of that clause would, therefore, be

⁹⁴ See *FAQs on State Legislation to Tax Yale's Academic Property*, YALE NEWS (Apr. 21, 2016), <http://news.yale.edu/2016/04/21/faqs-state-legislation-tax-yale-s-academic-property>.

⁹⁵ See *id.*

⁹⁶ See Evelyn Brody, *Payments in Lieu of Taxes: 'Contributions,' Say the Towns; 'Extortion,' Say the Colleges*, CHRON. HIGHER EDUC. (Jan. 31, 2010), <http://www.chronicle.com/article/Payments-in-Lieu-of-Taxes-/63804> [hereinafter Brody, *Payments in Lieu of Taxes*].

⁹⁷ See *id.*

⁹⁸ See *FAQs on State Legislation to Tax Yale's Academic Property*, *supra* note 94. Though the University is not named in the pertinent amended statutes, the new language strips the exemption away from institutions with holdings of "real estate consisting of land, buildings and equipment valuing more than *two billion dollars* in the aggregate and the activities on such real estate afford the institution an annual income of more than six thousand dollars"; Yale University is the only one that fits that description. Raised B. No. 414, Conn. Gen. Assemb., Feb. Sess. 2016 (Conn. 2016) (emphasis added). Furthermore, the Substitute Senate bill acknowledges that it will apply only to Yale, and notes that Yale would have paid upwards of \$65 million if it were not a property tax exempt entity. See S.414, 136th Gen. Assemb., Reg. Sess. (Conn. 2016).

⁹⁹ See *FAQs on State Legislation to Tax Yale's Academic Property*, *supra* note 94.

¹⁰⁰ See *id.*

¹⁰¹ See *id.*

unconstitutional.¹⁰²

Ultimately, the Connecticut Legislature failed to pass the bill during the 2016 term.¹⁰³ If history is any indication, proposed changes to Yale's exemption will continue; "previous generations of city leaders tried in the courts to tax Yale academic properties in 1899, 1935, 1950, 1975, and 1976" and a similar bill in 2004 was ultimately unsuccessful.¹⁰⁴ What can one make of the fact that Yale, which makes the largest PILOT of any university to a municipality, has faced such persistent attempts by government to strip away its exemption? Perhaps the payments are made to fend off more aggressive attempts to institute a formal tax.

Like Yale, Harvard University committed to a record-breaking PILOT arrangement. In September of 2002, the University pledged to pay \$3.8 million per year to the town of Watertown, Massachusetts until 2054.¹⁰⁵ The University and the town had differing rationales for the agreement. President Larry Summers announced the deal as emblematic of a "new Harvard principle" or commitment to pay the equivalent of taxes on newly acquired property, rather than remove it from the city's tax rolls.¹⁰⁶ However, "[t]he town manager cites as the turning point in negotiations the introduction of a bill in the state legislature to impose a tax on properties that account for more than 2.5 percent of a community's tax base," which would include much of the land owned by Harvard.¹⁰⁷ It is unclear if a sense of fairness or fear of the proposed tax was the true motivator.

2. *Inconsistent*

Local governments have been criticized for their ad hoc approach to soliciting PILOTs.¹⁰⁸ The vast majority of towns and

¹⁰² See *id.*

¹⁰³ See Kessler, *supra* note 92.

¹⁰⁴ *FAQs on State Legislation to Tax Yale's Academic Property*, *supra* note 94; Marissa Levendis, *University Can Pay Fair Share to New Haven*, YALE DAILY NEWS (Mar. 30, 2004), <http://yaledailynews.com/blog/2004/03/30/university-can-pay-fair-share-to-new-haven/>.

¹⁰⁵ See *Watertown, University Announce Agreement*, HARVARD GAZETTE (Sept. 26, 2002), <http://news.harvard.edu/gazette/story/2002/09/watertown-university-announce-agreement/>.

¹⁰⁶ Brody, *The States' Growing Use of a Quid-Pro-Quid Rationale*, *supra* note 13, at 287.

¹⁰⁷ *Id.*

¹⁰⁸ See KENYON & LANGLEY, *supra* note 1, at 31–32.

cities have neither a standard procedure for selecting organizations to pursue, nor for negotiating with them once they do. Not all localities in a given state seek PILOTs. Not all nonprofits in a given locality are solicited for them. Even two similarly situated nonprofits can end up paying different amounts. Critics often highlight both the irrationality of the payment amounts and their “arbitrary” and “secretive” reputation.¹⁰⁹

Despite the ad hoc nature of solicitations, a trend has emerged. Most PILOTs focus on “eds and meds”—or institutions of higher education and hospitals.¹¹⁰ These institutions are targeted because of their financial security, and some view this focus as a de facto income tax on “profitable” nonprofits.¹¹¹ Still, within the eds and meds community, there is no set and standardized payment rate, and different institutions within the same city will contribute different amounts based on individualized negotiations.¹¹²

3. *Inefficient*

Finally, PILOTs have been criticized for being ineffective and inefficient.¹¹³ Compared to full taxation of nonprofits, PILOTs do not bring in much revenue.¹¹⁴ To highlight one example, Brown University agreed to pay \$35 million to Providence, Rhode Island from 2012 to 2023.¹¹⁵ This seems like a hefty sum until one

¹⁰⁹ Daphne A. Kenyon & Adam H. Langley, *The Municipal Fiscal Crisis and Payments in Lieu of Taxes by Nonprofits*, LAND LINES, (Lincoln Institute of Land Pol’y, Cambridge, Mass.), Apr. 2011, at 11; *see also* Brody, *Some Charities are More Exempt than Others*, *supra* note 4, at 662.

¹¹⁰ *See* Brody, *Payments in Lieu of Taxes*, *supra* note 96, at 625.

¹¹¹ *Id.*

¹¹² Compare the payments promised by Brown University (\$31.5 million) and the Rhode Island School of Design (about \$2.5 million) over the same ten-year period. *See* CLARKIN, *supra* note 81, at 9, 23. A comparison between Harvard University and Northeastern University provides a particularly stark example. Although the landholdings of both universities have approximately the same valuation, in 2009, Harvard paid approximately \$2 million to Cambridge, MA, while Northeastern paid only about \$30,000. *See* Daphne A. Kenyon & Adam H. Langley, *Evaluating Payments in Lieu of Taxes According to Desirable Features of a Tax System*, 103 ANN. MEETING OF THE NAT’L TAX ASS’N 204–06 (2010).

¹¹³ *See generally* Kevin Kiley, *A Pseudo-Taxing Debate*, INSIDE HIGHER ED (Apr. 26, 2011), https://www.insidehighered.com/news/2011/04/26/cities_seek_more_voluntary_payments_from_colleges_as_local_budgets_tighten.

¹¹⁴ In 2013, Yale University’s property tax burden would have been \$65.2 million, but it contributes only \$8.5 million in PILOTs annually. *See* S.414, 136th Gen. Assemb., Reg. Sess. (Conn. 2016); *supra* notes 94–95.

¹¹⁵ *See* Elaine S. Povich, *Should Nonprofits Have to Pay Taxes?*, PEW

considers what Brown's property tax liability would be if it were a corporate entity: \$38 million *a year*.¹¹⁶ For struggling cities, PILOTs are often a drop in the bucket—as one Penn State representative stated, “[y]ou can’t plug a deficit in a city based on increasing a PILOT agreement alone.”¹¹⁷

III. AN ECONOMIC ANALYSIS OF PILOTs

A. *An Answer to the Critics*

1. *Extortion*

Some commentators criticize local governments for the tactics they use to induce payments from nonprofits organizations.¹¹⁸ As noted above in Part 2.B, the “sticks” used by municipalities range from low-level foot-dragging, to outright retaliation by local agencies, to threats to lobby to repeal the exemption at the state level. Each of these “threats” is not equally concerning. The judicial system and legislature offer adequate safeguards against the latter two. However, retaliation that does not meet the legal standard of arbitrary and capricious may well be the most worrisome form. It would be difficult to attain a judicially imposed remedy for acts in cases where a nonprofit cannot prove the municipality's retaliatory motivation or when it can hide behind a colorable, but pretextual reason. Still, the symbiotic nature of the relationship between nonprofit and local government should quell most of these fears, at least in theory.

Local governments have monopolistic power over many nonprofits. Because of the difficulty of relocating a nonprofit's client base and reputation, most eds and meds must peacefully co-exist with their municipality. Co-Unlike individual citizens, they lack the ability to “vote with their feet” and the Tiebout hypothesis has limited implications as applied.¹¹⁹ In this way, nonprofits are

CHARITABLE TR. (Mar. 5, 2015), <http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2015/3/05/should-nonprofits-have-to-pay-taxes>

¹¹⁶ *See id.*

¹¹⁷ Kiley, *supra* note 113.

¹¹⁸ *See* Darryll K. Jones, *Hill Street Blues: Pittsburgh Set to Tax Tuition as End Run Around University Tax Exemptions*, NONPROFIT LAW PROF BLOG (Dec. 16, 2009), <http://lawprofessors.typepad.com/nonprofit/2009/12/hill-street-blues-pittsburgh-set-to-tax-tuition-as-end-run-around-university-tax-exemptions.html>.

¹¹⁹ “Tiebout sorting refers to the sorting of households into neighborhoods and communities according to their willingness and ability to pay for local public

disadvantaged as compared to their corporate counterparts. The thought of a university relocating completely is almost unimaginable. First, the cost of replicating a campus built up over decades would be astronomical. Indeed, one wonders if the university's initial capital expenditures could have been made without the tax exemption. Second, there is limited demand for the purchase of an existing university campus.¹²⁰ Third, many universities highlight their location as an integral part of their branding in order to attract students.¹²¹

Although nonprofits do not have the same mobility that many businesses have, they do have legal recourse from what is effectively extortion. Certainly, there are instances in which a local municipal agency has denied permits or refused to offer its services to a nonprofit because the entity failed to make a PILOT.¹²² However, nonprofits are not powerless against agencies or local actors that abuse their discretion in this way. Fortunately,

goods (tax-supported amenities and services—such as K-12 education—provided to residents of a local jurisdiction).” Sean P. Corcoran, *Tiebout Sorting*, in *ENCYCLOPEDIA OF EDUC. ECON. & FIN.* 787 (Dominic J. Brewer & Lawrence O. Picus eds., 2014). If nonprofits were able to relocate more easily, the Tiebout hypothesis would dictate that they would choose their location in part based on the cost of local goods, in this case the number of PILOTs sought by local governments. Potentially, there would be a “race to the bottom” as localities competed for nonprofit presence by lowering PILOTs. In the post-World War II technology revolution, eds and meds have expanded beyond single flagship campuses through massive on-line open courses (MOOCs) and the construction of foreign satellite campuses. *See* PENN INSTITUTE FOR URBAN RESEARCH, *THE POWER OF EDS AND MEDS* 3 (2014).

¹²⁰ *See* Rick Seltzer, *Closing out a College*, *INSIDE HIGHER ED* (Jan. 5, 2017, 3:00 AM), <https://www.insidehighered.com/news/2017/01/05/virginia-intermonts-campus-sale-begs-questions-how-colleges-close-accounts>, for one college's difficulty in selling its landholdings.

¹²¹ The front page of Northwestern University's website highlights that it is “[b]ordered by a Great Lake and a global city.” *NORTHWESTERN*, <http://www.northwestern.edu> (last visited Apr. 9, 2017). Located “in the heart of Cambridge . . . , Harvard College gives you all the benefits of a city, as well as the feeling of a quiet haven, separate from the hustle and bustle of city life. It truly is the best of both worlds.” *Campus Location*, *HARVARD COLLEGE*, <https://college.harvard.edu/about/campus-location> (last visited Apr. 9, 2017). Even Syracuse, with all its problems, is highlighted in its eponymous University's materials: “With a gorgeous campus in the heart of New York State, a global footprint, and nearly 150 years of history, our university is made for those who want a quintessential college experience.” *About Syracuse University*, *SYRACUSE UNIVERSITY*, <https://www.syracuse.edu/about> (last visited Apr. 9, 2017).

¹²² *See, e.g.,* *Pacer Inc. v. City of Middletown*, 635 N.Y.S.2d 704, 705 (App. Div. 1995).

they can seek recourse in the courts, as well as the public arena, for blatantly retaliatory acts. Local agency action can be overruled as arbitrary and capricious.¹²³ Such claims have been successful in numerous cases involving local land use decisions made against nonprofits because they refused to pay PILOTs.¹²⁴ Fortress Bible Church successfully challenged the denial of its land use application as arbitrary and capricious on the basis that it declined to make a PILOT.¹²⁵ Similarly in *Pacer v. City of Middletown*, the city denied the owner of a special needs boarding home a special use permit because the owner declined to make a payment in lieu of taxes, and the court ordered the city's planning board to issue the permit.¹²⁶

Local agencies may not be so brash in their retaliation as the ones just mentioned. Still, if a nonprofit feels it is being treated unfairly because it refused to make a payment, it can try its case in the court of public opinion. The local politicians who negotiate these payments are subject to the political process. Politicians may be wary to pursue agreements that are viewed by their constituents as unfair or extortive. Likewise, they may be wary to antagonize nonprofits seen as providing a valuable public service. Even less sympathetic local universities and hospitals could rally students and patients if they showed PILOTs would force them to raise the cost of their services.¹²⁷

¹²³ See *id.*

¹²⁴ See *id.*

¹²⁵ See *Fortress Bible Church v. Feiner*, 734 F. Supp. 2d 409, 503 (S.D.N.Y. 2010), *aff'd*, 694 F.3d 208 (2d Cir. 2012). About a week after the church declined to donate a fire truck that the town board requested, the board found the church would have to undergo a lengthy environmental review process before expanding and ultimately rejected its building application. *Fortress Bible Church v. Feiner*, 694 F.3d 208, 213–15 (2d Cir. 2012).

¹²⁶ See *Pacer Inc.*, 635 N.Y.S.2d at 705. The Third Circuit also upheld a nonprofit's ability to sue a city for threatened discrimination against nonprofits that did not make voluntary payments. See *Hosp. Council of W. Pennsylvania v. City of Pittsburgh*, 949 F.2d 83, 90 (3d Cir. 1991) (upholding plaintiff's standing to sue the city).

¹²⁷ Yale University publicized its plight widely, publishing stories in its alumni news magazine and student newspaper and hosting news conferences with local press. See *Yale Opposes Legislation to Revoke its Tax-Exempt Status*, YALE NEWS (Mar. 31, 2016), <https://news.yale.edu/2016/03/31/yale-opposes-legislation-revoke-its-tax-exempt-status>; *Who Pays?* YALE DAILY NEWS (Feb. 21, 2014), <https://yaledailynews.com/blog/2014/02/21/who-pays/>; Kathleen Megan, *Yale and Business Leaders Say Bill Would Harm State's Economy*, HARTFORD COURANT (Apr. 27, 2016), <http://www.courant.com/education/hc->

The nature of the relationship between eds and meds and their local governments also constrains the potential for reprisal. Both are repeat players who have considerable incentives to act within reason to avoid future retaliation.¹²⁸ The parties must account for the effect that extortion will have on their future dealings. Although it would be difficult for nonprofits to relocate, they do hold political sway in their communities. Organizations could leak to the press cases of extreme unfairness and justify withdrawing services that do directly benefit the surrounding city, such as community outreach and extended learning programs.¹²⁹

Finally, towns and cities have threatened to strip the exemption entirely.¹³⁰ The viability of this threat is questionable. Towns and cities cannot by themselves revoke an exemption embedded in state law. As such, a local government would need to lobby the state to amend its constitution or statutory exemption. State lawmakers have less incentive to dispatch the exemption than do local representatives. As noted above, states rely far less on property tax for revenue than do local governments. States reap the benefit of having prestigious universities and healthcare facilities within their borders, yet do not bear the cost in the same way that

yale-property-tax-0428-20160427-story.html.

Certainly, if the organization is perceived as having deep pockets this may backfire. In this case, residents may support the PILOT, and the court of public opinion would view it as justified rather than extortive. Indeed, students at Brown University and University of Pennsylvania protested in support of the school paying their cities. See David Klepper, *Cities Seek More Money from Tax-Exempt Colleges*, SAN DIEGO UNION-TRIB. (May 7, 2012), <http://www.sandiegouniontribune.com/sdut-cities-seek-more-money-from-tax-exempt-colleges-2012-may07-story.html>; Jennifer Wright & Jessica Washington, *Protesters Take Over Gutmann's Holiday Party*, THE DAILY PENNSYLVANIAN (Dec. 9, 2014), <http://www.thedp.com/article/2014/12/protesters-take-over-gutmanns-holiday-party>.

¹²⁸ See ROBERT AXELROD, THE EVOLUTION OF COOPERATION 10–11 (1984).

¹²⁹ In a press release, Yale University noted that it currently makes academic property available for public uses such as youth hockey games and artistic performances. See *FAQs on State Legislation to Tax Yale's Academic Property*, *supra* note 94. Because SB 414 would impose a tax on buildings used for non-academic purposes, the University stated that it would have to cease use of its buildings by community groups. *Id.* After making a \$2 million PILOT to Providence, RI, Brown University was compelled to cut over \$600,000 from an urban health and education program it supported. See KENYON & LANGLEY, *supra* note 1, at 34. Of course, public opinion also cuts the other way. Nonprofits who are perceived as being commercialized may be motivated to make a voluntary payment to get back in the public's good graces. See *supra* note 127.

¹³⁰ See *FAQs on State Legislation to Tax Yale's Academic Property*, *supra* note 94; Brody, *The States' Growing Use of a Quid-Pro-Quid Rationale*, *supra* note 13, at 287.

localities do. This may be the reason that no state has repealed its charitable exemption to date. The case of Yale and Connecticut is the exception that proves the rule. Yale does impose direct costs on the state itself through Connecticut's reimbursement of localities with 77 percent of the revenue they lose due to the charitable exemption.¹³¹ This, combined with the PILOT Yale makes, means that the City of New Haven recovers roughly 95 percent of its lost property tax revenue.¹³² Perhaps this is the reason that state legislation stripping the exemption is so often proposed in Connecticut—the state, and not just its towns and cities, would benefit significantly.

2. *Inconsistent*

A second critique of PILOTs is that local governments target only specific nonprofits, or types of nonprofits for payments.¹³³ However, this is a feature, not a flaw, of PILOTs. The critiques of commercialism and opulence do not apply to all nonprofit organizations equally. Individually negotiated payments allow local governments to distinguish between the humble soup kitchen and the gilded foundation. Furthermore, PILOTs give local governments the ability to tailor contributions based on their current needs, without having to amend the state constitution or local tax code. Finally, it is unclear whether or not instituting a system of taxation would solve the problem of inconsistent application. Connecticut's experience shows that a system of taxation can be just as targeted as a PILOT—proposed legislation has used value thresholds to apply a tax only to Yale.¹³⁴ A local government could design a system of taxation that takes into account not only the assessed value of a nonprofit's landholdings, but also its operating budget and the countervailing benefit it provides the community. However, this would be complex and costly to execute. Alternatively, if an across-the-board tax system based solely on assessed value were instituted, organizations could

¹³¹ See Rute Pinho, Conn. Gen. Assemb., 2015R-0091, Payments in Lieu of Taxes 1 (2015).

¹³² The State of Connecticut paid New Haven 77 percent of its full tax burden (\$37.5 million) for lost taxes in the year 2009. Yale University has pledged to pay the equivalent of another 18 percent of lost revenue. As a result, New Haven will have recovered 95 percent of the revenue lost to the exemption.

¹³³ See KENYON & LANGLEY, *supra* note 1, at 31–32.

¹³⁴ See *FAQs on State Legislation to Tax Yale's Academic Property*, *supra* note 94.

presumably negotiate their tax burden down just as businesses do now, failing to quell fears of inconsistency.¹³⁵

3. *Inefficient*

Finally, some criticize PILOTs for recovering only a small fraction of what a nonprofit's tax burden would be if the exemption were completely lifted. This assumes, without evidence, that subjecting nonprofits to full taxation is the optimal tax rate. The original justifications for exemption still exist to an extent. Eds and meds do contribute to their communities by offsetting the government's burden to educate and provide healthcare for its citizens. The optimal tax rate for a nonprofit should take into account these benefits, resulting in a nonprofit paying less than a for-profit company (or less impactful nonprofit). Rather than viewing PILOTs as inefficient, they can be viewed as nuanced attempts to adjust the tax rates of nonprofits, in the same way that tax breaks alter the effective tax rates of corporations.

Even though many nonprofits will find it difficult to relocate to a jurisdiction with a lower tax rate, showing the limits of the Tiebout hypothesis, one cannot assume that full taxation would produce the optimal level of nonprofit activity. Nonprofit demand for land in its community is inelastic as compared to most businesses.¹³⁶ In part, this justifies the disparate treatment of nonprofits and corporations by local governments. Corporations must be lured, so they are given tax breaks.¹³⁷ Nonprofits are captive audiences, so their effective tax rate can be increased. Still, PILOTs affect nonprofit land use decisions and revenues. For instance, Fei et al found that PILOTs do discourage nonprofit activity in Massachusetts—"a one percentage point higher PILOT

¹³⁵ See Norton Francis, *State Tax Incentives for Economic Development*, TAX POL'Y CTR. (Feb. 28, 2016), <http://www.taxpolicycenter.org/publications/state-tax-incentives-economic-development/full>. The discount afforded would be not to entice an organization to locate there for the purpose of economic development, *see id.*, but to relieve their operating expenses because they provide a valuable public good.

¹³⁶ *See supra* notes 119–120.

¹³⁷ See Rick Moriarty, *Destiny USA Gets Tax Deal for Proposed 209-Room Syracuse Hotel*, SYRACUSE.COM (Apr. 14, 2016), http://www.syracuse.com/business-news/index.ssf/2016/04/destiny_usa_gets_tax_deal_for_proposed_209-room_syracuse_hotel_1.html. Onondaga County Industrial Development Agency negotiated a PILOT with Destiny USA, a megamall, that will exempt its new, \$48 million hotel from taxes for its first eight years. *Id.* This will cost the city \$6.84 million in taxes. *Id.*

rate is associated with 0.8% lower real property ownership by local nonprofits, 0.2% lower total assets, and 0.2% lower revenues of local nonprofits.”¹³⁸ Even if most nonprofits cannot completely relocate due to their community ties, it makes sense that they would decrease expansion of their holdings if subject to taxation. PILOTs allow municipalities flexibility in setting an effective tax rate that meets the municipality’s and its nonprofits’ needs. Certainly, a low-level property tax rate or one with a system of smaller exemptions could achieve the same. PILOTs are an option that should not be precluded from use from the start.

B. *Policy Implications*

PILOTs may or may not be the policy option that best balances municipal need and nonprofit need. At the very least, PILOTs are the canary in the coal mine, indicating that the current legislative entitlement of full exemption was not optimally placed. At least from the point of view of many local governments, the entitlement overcompensates nonprofits for their contribution to society. Fortunately, the nature of the relationship between municipalities and the nonprofits residing in them has allowed for this intermediate bargaining to take place. Some municipalities should continue to use PILOTs rather than invest in a more complicated tax system. Others will find that a more formulaic approach suits their needs.

In his article, *Transaction Costs, Resource Allocation and Liability Rules: A Comment*, then-Professor Guido Calabresi explained what transaction costs meant for policymakers deciding, not only if, but how to intervene in market interactions. If high transaction costs necessitate the institution of a liability rule or property entitlement, the policymaker’s aim is clear: “approximate, both closely and cheaply, the result the market would bring about if bargaining actually were costless.”¹³⁹ In this way, “problems of misallocation of resources and externalities are not theoretical but empirical ones.”¹⁴⁰

Lacking such a quantification and clear path towards it, policy makers must consider the likelihood of misplacing the entitlement

¹³⁸ Fei et al., *supra* note 70, at 109.

¹³⁹ Guido Calabresi, *Transaction Costs, Resource Allocation and Liability Rules: A Comment*, 11 J.L. & ECON. 67, 69 (1968).

¹⁴⁰ *Id.*

and reaching the *wrong* result.¹⁴¹ To illustrate this point, Calabresi uses the example of placing the liability for car accidents on pedestrians or car owners:

Suppose we are not sure whether rubber bumpers or wearing fluorescent clothing is the “cheapest way” of handling the car-pedestrian accident problem. In this case it may become necessary to consider the following question: Is an erroneous placing of liability on car owners or an erroneous placing of liability on pedestrians more likely to be corrected in the market? Whether car owners (or car makers) can bribe pedestrians more cheaply than pedestrians can bribe car owners or makers, becomes the relevant issue.¹⁴²

In the case of PILOTs, local governments would argue that the tax exemption entitlement was erroneously granted to nonprofit organizations. Fortunately for governments, the distribution lent itself to “extortion.” In this way, extortion can be seen as an aid in correcting for an original misplacement of the entitlement.

Had nonprofits not been granted the entitlement, one would imagine that they would have sought out traditional tax breaks, as for-profit corporations currently do. However, because of their immobility, they would have a far less valuable bargaining chip. In light of this, the original policy choice is justifiable if one considers how it decreases the power local governments would have over captive eds and meds. With the status quo of no property taxation, the state would have to repeal the exemption before a locality could fully tax its nonprofits. If the baseline were full taxation, the locality already has permission to set the burden up to the maximum under state law. The split of the power to tax between the state and local governments reduces the bargaining power of the municipalities, equalizing the bargaining positions to some extent.

CONCLUSION

The economic need of local governments is well documented. They are struggling to provide critical services to their constituents, in part because of a depleted property tax base. Nonprofits share in the responsibility of supporting local residents. When they stray from this mission, or consume more city

¹⁴¹ *See id.*

¹⁴² *Id.* at 72.

resources than they provide, it is rational for the municipality to cut down on their tax exemption. Payments in lieu of taxes have emerged as one efficient option to do so, yet local governments have been criticized for using them as a means of generating revenue. However, the critiques of PILOTs can be parried and should not deter policymakers from keeping them in their policy toolkit.