PROPERTY TAX INCENTIVE PITFALLS

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This paper relies on a review of the literature on property tax incentives for business, a new database on property tax economic development incentives, and several state case studies to identify pitfalls in using this economic development tool. Several potential reforms are identified.

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I. INTRODUCTION

Property tax incentives for business are one of many tools used by state and local governments to promote economic development. Although Kenyon, Langley, and Paquin (2012) conclude that state and local governments spend $5 billion to $10 billion per year on property tax incentives, amounting to 1 to 2 percent of total state and local property tax revenues, such incentives frequently fall short of achieving their economic development goals. This article aims to identify several of the major pitfalls in using property tax incentives for business, and suggests potential reforms.

Property tax incentives for business take many forms: (1) property tax abatement programs; (2) tax increment financing; (3) enterprise zones; (4) firm-specific property tax incentives; and (5) tax-exempt industrial development bond (IDB) issuance when it is combined with full or partial property tax exemption. To obtain information on the first three types of property tax incentives, this paper relies heavily on detailed appendix tables in Kenyon, Langley, and Paquin (2012), which in turn rely heavily on the online database entitled Significant Features of the Property Tax, published since 2008 by the Lincoln Institute of Land Policy and the George Washington Institute of Public Policy.¹


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Property tax abatement programs, which have a very long history, allow partial or full reduction in property tax liability for certain manufacturing, commercial, or retail parcels. Tax increment financing (TIF), which was first used in the 1950s, generally earmarks growth in property taxes or other revenues in a designated geographic area to pay back bonds issued for infrastructure improvements in the area. Enterprise zones are designated geographic areas, usually economically distressed, within which state and/or local governments provide special tax preferences and other incentives to encourage business investment. Not all enterprise zone programs include property tax incentives. Firm-specific property tax abatements, which are typically part of a package of financial incentives that is individually negotiated, allow partial or full reduction in property tax liability for specific firms. Finally, when local governments issue tax-exempt IDBs on behalf of a firm, the government typically holds title to the property where the development is taking place so the firm incurs no property tax liability unless a special provision is made to require the firm to compensate the local government for some or all of the property tax revenue forgone.

The objective of this paper is to use case studies on property tax incentives across the United States to highlight pitfalls in their use and make suggestions for reform. Our research has found eight major property tax incentive pitfalls, described below.

II. GRANTING INCENTIVES THAT DO NOT AFFECT LOCATION DECISIONS

The most fundamental error in extending property tax incentives to business is providing a tax incentive that does not change a firm’s location decision. Sometimes a business lobbies policymakers for tax concessions after it chooses a site based on a variety of factors. One reason that property tax incentives may not affect location decisions is that property taxes are typically a small part of a firm’s cost. Input costs account for three-quarters of the average manufacturing firm’s total costs, and labor accounts for most of the remainder. More specifically, between 2004 and 2009, labor accounted for 21.8 percent of total costs for the manufacturing sector, and property taxes accounted for 0.3 percent (Kenyon, Langley, and Paquin, 2012).

One example of a property tax incentive that apparently had no impact was the 2008 award of a property tax abatement to the pharmaceutical company Speracor by the City of Marlborough, Massachusetts. Speracor began construction of a new facility in Marlborough in 2007, the same year it applied for a property tax incentive, and the city awarded the incentive in 2008, when the project was already underway (City of Marlborough, 2008; Crocetti, 2008a). One city council member objected to granting this abatement, noting the absurdity of trying to provide incentives for investment that had already occurred (Crocetti, 2008b). The firm’s executive director of facilities responded that, “It’s an incentive for us to continue in Marlborough (Crocetti, 2008b).” Nevertheless, it appears that Speracor had already decided to locate in Marlborough before the incentive was granted.

One approach policymakers can take to increase the chance that property tax incentive dollars are not spent frivolously is to gather information in order to answer two
key questions: (1) Are property taxes a significant component of a firm’s total costs? and (2) Does the firm serve a national or international market? If the answer to both of these questions is yes, there is a greater chance that the property tax incentive can affect the firm’s location decision and that the local government is spending its property tax incentive dollars wisely. Even before applying that rule of thumb, policymakers should make it clear that not all firms applying for a property tax incentive will be granted one.

III. GRANTING INCENTIVES WHEN COSTS EXCEED BENEFITS

A second fundamental error in local government use of property tax incentives is that without judicious use of the incentives, the cost of the tax incentives can exceed the benefits provided by the firm receiving the incentives. If the incentive does not change the firm’s location decision, the net benefit is likely to be negative, but there are other considerations as well. A local government assessing whether the benefits of providing a tax incentive exceed the costs should look at fiscal effects, labor market effects, and economic and social effects.

Besides the revenue forgone when an incentive is granted, one important fiscal effect of attracting a new facility is the potential increase in public service costs due to construction of a new facility or growth in employment and population. If a local government has underutilized infrastructure, the cost of providing services to a new facility may be small, but otherwise new public service costs can easily outweigh benefits provided by the new facility (Altshuler and Gómez-Ibáñez, 1993).

With respect to labor market effects, it is important to not only look at the number of new jobs but also consider how many jobs go to existing city residents versus commuters into the city or in-migrants. It is also important to consider the pay for the jobs. If the new jobs pay only minimum wage, attracting a firm to a city is much less likely to produce a net benefit for its residents (Bartik, 2004).

Finally, there is a range of other economic and social effects to consider. For example, what impact does the attracted firm have on the profits of firms already part of the community? A new firm might purchase goods and services produced by existing firms and thus have a positive impact, but a new firm might also compete with an existing firm or drive it out of business. Attracting a new firm might increase property values or enhance a community’s character, but it could also impose environmental or congestion costs.

A recent case where many of these issues arose was the creation of a TIF district in 2012 for big-box home improvement chain Menards in Garden City, Kansas (Ahmad, 2012a). The city council approving the plan expected that the development would draw more shoppers to Garden City and create new retail jobs. The TIF project involved major infrastructure improvements including extending a road, widening an existing road, and adding turning lanes and signals, some of which were likely necessitated by the new retail development. After the city council approved the TIF, a group of local businesses appealed to the Finney County Commissioners to block the plan, arguing that the new development would not strengthen the economy, but they were unsuccessful. One existing business owner argued, “All we’re doing is splitting up the pie (Ahmad,
In addition, the Menards development is less than a mile away from a Home Depot store, part of another big-box home improvement chain, which was granted a tax incentive in 2003 (Ahmad, 2012b).

IV. ENGAGING IN DESTRUCTIVE BIDDING WARS WITH NEIGHBORING JURISDICTIONS

Property tax incentives have been used either alone or together with state tax incentives in economic development battles that degenerate into destructive bidding wars. The Kansas City metropolitan area, which spans 15 counties in Kansas and Missouri, is a case in point. As of 2012, Kansas and Missouri had spent over $750 million over five years in tax incentives and bonds for business development in the Kansas City area, which did not include local incentives which were estimated to be millions more (Hanna and Lieb, 2012). One particularly egregious example is Applebee’s moves of its headquarters back and forth across state lines, and between Kansas localities, many of which appear to have been motivated solely by tax incentives. Applebee’s moved from: Atlanta to Kansas City, Missouri in 1988; moved to Overland Park, Kansas in 1993; received a 10-year, 90 percent property tax abatement to move to a different Kansas locality in 2007; and then announced in 2011 that it was moving back to Kansas City, Missouri (Collison, 2012; Hanna and Lieb, 2012).

In August 2011, a group of businesses asked the governors of Kansas and Missouri to stop using incentives to lure businesses from one jurisdiction to another within the Kansas City metropolitan area. In a letter to the governors, the businesses referred to both states’ efforts to woo businesses over the border with incentives as an “economic border war.” So far the governors do not appear interested in declaring a truce (Greenblatt, 2011).

New York City and Jersey City have long used tax incentives, including property tax abatements, to compete for business development. Recently New Jersey Governor Chris Christie made headlines for stepping up the pace of this tax competition through extensive use of the Urban Transit Hub Tax Credit Program. In one case, Prudential Insurance, which had already received property tax abatement under the Urban Enterprise Zone Program, was offered $250.8 million to move a few blocks away within the city of Newark from old office space to a newly constructed office tower (Bagli, 2012).

The Metro Denver Economic Development Corporation, whose members include 70 cities, counties and economic development organizations, offers a useful contrast to the bidding wars in the Kansas City and New York City metropolitan areas (Metro Denver Economic Development Corporation, 2004). In the mid-80s this organization adopted

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a Code of Ethics, which includes such guidelines as: (1) promote Metro Denver first and individual communities second, and (2) never solicit another member’s prospects. This agreement was tested in 2011 when Denver and Aurora, a Denver suburb, found themselves in competition for the National Western Stock Show and Rodeo, which had just been released from a 40-year lease within the city of Denver (Jackson, 2011a). When the stock show proposed relocating to Aurora and an independent study showed Denver would lose millions in tax revenue as a result of the relocation, discussions among the two city councils and mayors ensued (Castellanos, 2011). At a meeting of the two mayors, Denver Mayor Michael Hancock stated, “The guiding principle of this region is that we cooperate and work together” (Jackson, 2011b). Aurora Mayor Steve Hogan dropped his bid to attract the show (Illescas, 2011).

Although metro area agreements are far from common, localities in the Bay Area of California, South Florida, and Columbus, Ohio area have reached similar agreements (Patton, 2006; Ball, 2007). In 2011, the economic development organizations in Fort Wayne, Indiana signed a similar agreement after witnessing the “powerful collaborative culture in Denver” (Northeast Indiana Regional Partnership, 2011). Of course avoiding destructive inter-local tax competition within a single state is easier than in metropolitan areas spanning two or more states.

V. ALLOWING PROLIFERATION OF INCENTIVES

The good news with respect to using the property tax to promote economic development is that empirical evidence shows that property tax differentials within a metropolitan area can have a significant impact on business location. A review of the literature found that a 1 percent reduction in a jurisdiction’s property taxes will increase economic activity (measured by employment and firm births and relocations) by 1.59 to 1.95 percent (Bartik, 1991).

But studies of the effectiveness of property tax abatements find that they are only temporarily effective (Anderson and Wassmer, 2000). This apparent discrepancy can be explained by the proliferation of such abatements. A single jurisdiction may be able to significantly boost business investment through property tax incentives, but this effect disappears over time as the copycat behavior of nearby jurisdictions leads them to adopt similar policies, which reduce the impact of the first jurisdiction’s incentives. Over time it is possible that all competing jurisdictions will have lower effective property tax rates without any jurisdiction gaining a permanent advantage over another.

Illinois’ experience with TIF is an example of proliferation followed by a period of reform (Talanker, Davis, and LeRoy, 2003). TIF was authorized in Illinois in 1977 and eight years later the state had 27 TIF districts. Once the districts became eligible for state aid, the number increased until by 2002 there were 782 such districts. Although the finding of blight was one requirement for TIF enactment, upon occasion wealthy districts were allowed to establish TIFS. A period of reform followed in which the standards for qualifying as a blighted area were narrowed and requirements for notification and public hearings were added.
There will always be political pressure for broadening of the criteria for eligibility for property tax incentives, but it is important for state policymakers to resist this pressure. If they do not, the effectiveness of such incentives declines and the only result is that local government revenues are reduced.

VI. LACK OF TRANSPARENCY

Most state and local governments provide very little information about property tax incentives for business. It is possible to ascertain whether a state has an enterprise zone, property tax abatement or tax increment finance program and the qualifications for those programs, but there is often no basic information on firm-specific tax incentives or property tax exemptions used together with issuance of tax-exempt industrial development bonds. In order to evaluate the effectiveness of these tax incentives, however, one must have information about the firm receiving the incentive, the amount of the incentive, and the responses to the incentive, such as resulting increases in employment.

State governments are in the best position to provide information on tax incentive programs. Currently 44 states produce tax expenditure reports, but only eight states include tax expenditure estimates for the local property tax (Connolly and Bell, 2011). Nonprofit groups can also help promote transparency. Good Jobs First has compiled information on economic development subsidies in an online database called the Subsidy Tracker. Although it has information on many subsidy programs, with information on individual businesses, for the most part the database does not have information on property tax incentives.

Maryland is an example of a state that does not provide information on the incentives in its enterprise zone program. Maryland has 28 enterprise zones that offer firms a credit against corporate income taxes as well as property tax credits. However, the identity of the recipients of these credits is not disclosed (Pew Center on the States, 2012). In contrast, the State of Oregon has a government transparency initiative that has been expanding. In 2011, the legislature enacted a requirement for more transparency on tax breaks, including most enterprise zones (Robyn, 2011). The state now provides information online on the name of the business, its address, the total amount of credits it receives, and program outcomes and other information.

VII. LACK OF EVALUATION

A recent study of state evaluation of tax incentives found that 16 states did not publish a document between 2007 and 2011 that assessed the effectiveness of a tax incentive (Pew Center on the States, 2012). The challenge of evaluating property tax incentives is greater because local governments typically have fewer resources and expertise than state governments.

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Thus there is a state role for either reviewing the effectiveness of local property tax incentives for business or aiding local governments in their efforts to do so. The Connecticut General Assembly passed a law in 2010 requiring an assessment of the economic and fiscal impact of the state’s tax credit and abatement programs every three years. In the first such report, the Connecticut Department of Economic and Community Development (2010) recommended elimination of the Enterprise Zone property tax abatement program because it did not benefit the state.

It is important that such evaluations be done by an organization that is independent of the entity granting the tax incentives. Minnesota’s experience with its Job Opportunity Building Zone Program (JOBZ) is instructive. Eligible businesses in these zones obtain credits against property, income, sales, corporate franchise and employment taxes.5

The JOBZ program, which was established in 2004, had been annually evaluated since 2007 by the economic development agency administering the program, but it received its first independent assessment in 2008. The independent evaluators estimated that only 21 percent of the new jobs reported by the zone businesses were attributable to the incentives. They further estimated the cost per job generated at $26,900 to $30,000 rather than the $5,000 to $6,000 estimate produced by the economic development agency (Yunker and Kirschner, 2008).

VIII. ALLOWING ONE LOCAL GOVERNMENTS TO TAKE REVENUE FROM ANOTHER

This flaw is most prevalent with the earmarking device known as TIF. As Youngman (2011, p. 324) describes:

By far the greatest moral hazard posed by TIFs concerns the ability to freeze the assessment base of overlapping jurisdictions, such as school districts. The municipality establishing the TIF district may be able to appropriate value increases, including those resulting only from inflation, from independent districts with no power to block that transfer.

When this is the case, it gives the local government creating the TIF an incentive to use TIF financing even when it does not generate economic growth. Throughout the United States there is a great deal of variety in state laws on TIF approval (Kenyon, Langley, and Paquin, 2012). In 2010 there were five states in which only the community redevelopment agency had to approve a TIF program (California, Florida, Hawaii, New Jersey, and Rhode Island). In these states the potential for such abuse is greatest. Indeed, the tendency for local governments to appropriate property tax

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revenues from school districts is one reason that California recently ended TIFs (Youngman, 2011).

Eight states require school districts to approve TIF. Two states have the most inclusive approval process, which could present the best arrangement. In Oregon, the city, county, school district, state and “all taxing entities” must approve TIF. In South Carolina the requirement is similar in that all “affected taxing entities” must approve TIF (Kenyon, Langley, and Paquin, 2012, pp. 70–71).

IX. STATE GOVERNMENT REIMBURSEMENT

State governments can affect the use of property tax incentives in other ways, one of the most important of which is whether states reimburse local governments for the revenue forgone when they grant property tax incentives. According to Dalehite, Mikesell, and Zorn (2005), state governments reimburse local governments for use of property tax incentives in Colorado, Connecticut, Kansas, Maine, Michigan, Oklahoma, and Vermont. It stands to reason that if local governments do not have to worry about the cost of tax incentives they are more likely to use them. As Dalehite, Mikesell, and Zorn (2005, p. 165) argue, the “state subsidy may induce local jurisdictions to award abatements indiscriminately.”

The state of Arizona takes a different approach. Instead of reimbursing local governments for the use of property tax incentives, it penalizes local governments in the Phoenix area that use tax incentives to attract retail establishments. The law implementing this policy was enacted in 2007 (Mitchell, 2007). When Governor Janet Napolitano signed the legislation she made the following statement:

"Today, I signed House Bill 2515, which will put an end to the practice of some cities in Maricopa County giving huge tax breaks to retail businesses for locating within their municipalities. These tax breaks have gotten out of control and have been offered to a host of businesses, many of whom were likely to locate in Arizona regardless of whether they were offered a tax incentive. The use of tax incentives to pit Maricopa County towns and cities against each other is not in the interest of Arizona or its taxpayers."

Cities and towns that award incentives must report them to the state. Then the municipality’s state aid is reduced by the amount of the incentive awarded, spread over five years. Incentives awarded prior to 2007 are exempt. The law also does not prohibit incentives that apply to all retail businesses in a town nor does it apply to redevelopment projects in areas with lower than average household income.

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X. CONCLUSION

Although tax competition for economic development has a long history in the United States and its reform appears to be an intractable challenge, there is reason to be optimistic about improving the use of property tax incentives. State governments control local government taxing powers, and as this paper illustrates, several states have taken action to make better use of property tax incentives. Other states could follow their lead. Local governments also have tools, such as metropolitan area cooperation agreements or guidelines for offering tax incentives, which can help them use property tax incentives for business more effectively.

REFERENCES


