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Who offers tax-based business development incentives? ☆

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ABSTRACT

Many American communities seek to attract or retain businesses with tax abatements, tax credits, or tax increment financing of infrastructure projects (TIFs). The evidence for 1999 indicates that communities are most likely to offer one or more of these business development incentives if their residents have low incomes, if they are located close to state borders, and if their states have troubled political cultures. Ten percent greater median household income is associated with a 3.2% lower probability of offering incentives; 10% greater distance from a state border is associated with a 1.0% lower probability of offering incentives; and a 10% higher rate at which government officials are convicted of federal corruption crimes is associated with a 1.2% greater probability of offering business incentives. TIFs are the preferred incentive of communities whose residents have household incomes between $25,000 and $75,000; whereas TIFs are much less commonly offered by communities whose residents have household incomes below $25,000. The need to finance TIFs out of incremental tax revenues may make it infeasible for many of the poorest of communities to use TIFs for local business development.

1. Introduction

Local governments in the United States compete with each other to attract businesses and thereby enhance the economic prospects of local residents. This competition takes many forms, commonly including offers of tax-based incentives to firms that can be induced to establish, expand, or maintain local business operations. These tax-based incentives consist of direct tax benefits, that include abatements of existing taxes or credits against potential tax liabilities, and the use of tax increment financings (TIFs) of business-oriented infrastructure projects. There is widespread use of these incentives: 56% of American communities report offering tax-based business development incentives in 1999, a fraction that rose to 59% by 2004. The US aggregate dollar value of business development incentives is not known, though journalistic accounts put the annual figure in the neighborhood of $80 billion.[1]

Despite the attractiveness of encouraging local business activity, many jurisdictions in the United States have been unwilling to provide tax-based business development incentives. This reluctance stems from many sources, including the potential revenue costs of such concessions, doubts about their effectiveness in encouraging business activity, a philosophy that across the board tax reductions are more effective than targeted tax incentives, and perhaps an evaluation that the benefits of greater business activity are not worth the costs. Communities with differing economies and demographics may well evaluate these tradeoffs differently. Furthermore, even governments of communities that agree on the potential value of targeted tax incentives may not all offer them, given the realities of bureaucratic and political barriers to implementing programs that require effective action.

The goal of this paper is to understand why cities and counties offer the tax-based business incentives that they do. The analysis

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[1] The New York Times reports identifying 1874 state and local business development programs with an aggregate value of $80.4 billion/year; see http://www.nytimes.com/interactive/2012/12/01/us/government-incentives.html. Fractions of communities reporting that they offered incentives in 1999 and 2004 are based on the Economic Development 1999 survey and the Economic Development 2004 survey from the International City/Council Management Association; the 1999 survey is described in detail in Section 3.

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starts by identifying the characteristics of US communities that are associated with provision of tax-based business incentives. Then the empirical work considers only those communities that provide incentives, distinguishing features associated with providing TIFs from features associated with providing tax abatements and credits.

Several patterns are evident in the data. Heavily populated cities and counties, those with low median incomes, and those with larger concentrations of manufacturing industries, are the most likely to offer business incentives. The correlations of these characteristics and the provision of business incentives at least in part reflect the value that communities with strong economic needs attach to attracting new employment opportunities, and the willingness of these communities to forego tax revenue in return.

Communities with lower incomes are more likely than others to offer business tax incentives, but this proclivity is no more pronounced among those with higher fractions of very poor residents (below $25,000 household income) than it is among communities with higher fractions of middle income residents ($25,000–$75,000 household income). The need for economic activity may be greatest in the poorest communities, but business tax incentives somewhat less effective there than elsewhere, and more difficult for local governments to implement.

Two additional noteworthy features characterize communities offering business tax incentives. The first is that communities located close to state borders are significantly more likely than others to offer incentives. Proximity to other states increases the competitiveness of the environment for attracting business, driving communities to offer attractive packages even to retain existing businesses. Furthermore, the prospect of attracting businesses and accompanying tax revenue from other states may increase the willingness of state governments to offer financial and other assistance to their own communities that provide business development incentives.

The second feature is that cities and counties in states with troubled political cultures demonstrate the greatest willingness to offer business development incentives, the evidence indicating that increasing the rate at which government officials are convicted of federal corruption crimes by 1 per 100,000 residents over a 13 year period is associated with a 2.9% greater chance that a community will offer business incentives. One possibility raised by this evidence is that small numbers of corrupt and quasi-corrupt government officials in these jurisdictions provide business incentives in return for cash, political support, or other forms of payouts. A different, and perhaps only slightly more flattering, interpretation is that jurisdictions in states with troubled political cultures are more likely than others to have dysfunctional tax and regulatory systems that make it difficult for them to compete for businesses except by offering special incentives.

The second part of the paper's empirical investigation considers only those communities offering some business tax incentives, identifying the characteristics associated with provision of direct tax reductions, in the form of tax abatements or tax credits, rather than provision of infrastructure improvements (such as new roads and sewer facilities) facilitated by tax increment financing. Tax increment financing typically entails debt-financed projects for which subsequent additional revenue (arguably) attributable to enhanced business activity is devoted to paying off the debts incurred in undertaking the infrastructure improvements. Among jurisdictions that offer incentives, those with significant numbers of households with incomes less than $25,000 are the most likely to offer tax reductions rather than TIF-supported infrastructure programs, whereas those with significant numbers of households with incomes between $25,000 and $75,000 are the most likely to offer TIFs rather than tax reductions. By this measure TIFs appear not to be effectively directed toward the lowest-income communities. And political culture appears to influence the form as well as the level of development incentives: increasing the rate at which government officials are convicted of federal corruption crimes by 1 per 100,000 residents over a 13 year period is associated with a 5.9% greater probability that a community will offer tax reductions rather than TIFs.

The empirical patterns are consistent with purposeful choice of business development incentives. Communities with low-income residents stand to benefit from employment and other economic opportunities that accompany greater business operations, but are often unable to use TIF programs due to the inability of even enhanced business activity to generate sufficient local tax revenue to retire debts acquired in undertaking the accompanying infrastructure projects. Self-interest of a different kind may be at work in the proclivity of communities in states with higher rates of federal corruption convictions to favor direct tax benefits over TIFs, though this pattern may also reflect bond market skepticism of the ability and willingness of troubled political systems to repay in full any obligations incurred in the course of providing business infrastructure.

Section 2 of the paper discusses the challenges that communities face in using business development incentives to attract and retain business activity. Section 3 describes the available data on the practices of American communities in offering tax-based business incentives in 1999. Section 4 presents the results of estimating the determinants of who offers business incentives; Section 5 presents the results of estimating, among communities offering some kind of incentive, the determinants of who offers tax reductions or TIFs to the exclusion of the other. Section 6 is the conclusion.

2. Business development incentives

Business development incentives have the potential to attract investment, employment, and net tax revenues to communities offering them. Diamond and Mirrlees (1971) identify the efficiency costs that jurisdictions incur by attempting to tax returns earned by mobile business capital. From their analysis it follows that taxes on less-mobile factors are apt to entail smaller costs with the same distributional effects, particularly for jurisdictions that are too small to affect market rates of return.[2] Tax abatements, tax credits and TIFs, if offered on a selective basis to the most mobile businesses, and those that generate spillovers to other firms, can permit communities to maintain business, property, and sales taxes that generate revenue without reducing business activity to the same degree that they would in the absence of incentives.[3] As a practical matter, however, given the difficulty of distinguishing businesses on the basis of potential mobility, and the restricted set of tax instruments available to local communities, governments face tradeoffs between raising tax revenues and attracting business activity.

2.1. Consequences of business development incentives

Despite their obvious appeal to investors, it is not guaranteed that business development incentives encourage local economic activity, as incentives can be costly, possibly coming at the expense of general tax reductions, education or infrastructure improvements, or other uses of funds that could impact business activity to an even greater extent than do incentives. Bartik (1991) offers a critical survey of earlier empirical studies of the impact of state

[2] See Gordon (1986) for an elaboration of this argument and Gordon and Hines (2002) for a further exposition.

[3] Keen (2001) and Hong and Smart (2010) analyze the welfare consequences of distinguishing the tax treatment of more-mobile and less-mobile investments in settings in which jurisdictions compete for mobile investments; Garcia-Mila and McGuire (2002) consider tax incentives in an environment in which there are agglomeration economies.