



# REGIONAL POLICY LETTER

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## Property Tax Incentives and Economic Development

Local governments are actively engaged in the business of economic development. Local officials hear the demands of community residents for jobs and growth and are not content to await the actions of federal or state governments, or the tides of the national economy. Their efforts often involve local fiscal incentives—tax breaks and infrastructure spending directed at businesses—and are often controversial.

This essay describes the primary property tax incentives used by local governments, discusses the fiscal impacts of these incentives on enacting governments and on local schools, and offers a test for deciding whether an incentive is needed.

### Property Tax Incentive Options

**Tax increment financing (TIF)** uses the added property tax revenue generated by economic development to support needed local government infrastructure investment. Once a county, city, or town creates a TIF district, property tax revenues generated by growth in real (and sometimes personal) assessed value within the district are assigned to the enacting unit of government, rather than to overlapping governments. The enacting government can use the revenue to pay for infrastructure which facilitates development. Assessed value in existence when the district is

established remains in the general property tax base.

Tax increment financing has become an increasingly popular development incentive in Indiana since 1987. In 1994, county and municipal governments in 32 counties used TIF. Almost one percent of all Indiana gross assessed value was in TIF districts, with governments in Marion, St. Joseph, and Tippecanoe counties accounting for three-quarters of the total.

**Property tax abatements** reduce business taxes to encourage firm location or expansion. In Indiana, abatements apply a percentage reduction to the assessed value of new business facilities, real or personal property, subject to taxation. Real property abatements apply a percentage reduction to the assessed value of new construction, beginning at 100% the first year, and declining to zero in three, six, or ten years. Personal property abatements reduce the taxable assessed value of new manufacturing equipment, with the abatement declining from 100% to zero over five or ten years.

Property tax abatements were used by governments in 65 of 92 Indiana counties in 1994. More than two percent of all gross assessed value in Indiana has been abated. Eleven counties abated five percent or more of their gross assessed value, with Owen,

Scott, and Shelby abating more than seven percent.

An important question for local government leaders is **whether tax incentives influence firm location**. Research has found that taxes and government services can affect firm location and investment. Bartik reviewed 48 studies and found that on average a 10% reduction in local business taxes, with no change in service provision, increases local economic activity by about three percent in a state or metropolitan area. States and localities differ, so Bartik gives a range of responses to a 10% tax cut of between one and six percent.

Several studies have found that local government spending on services valued by businesses, such as roads or education, also boosts development. Studies differ on whether a "balanced budget" increase in business taxes and business-related spending has a net positive or negative effect on economic activity.

### Fiscal Impact on Local Governments

One criterion for evaluating the use of development incentives is their effect on revenues and spending of the enacting government and on governments with overlapping boundaries, such as local school corporations. Development should increase local government revenues,

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but property tax incentives reduce some of this added revenue.

Development should increase local government costs, though TIF revenue may offset some added costs. The net effect is in doubt. What factors should be considered in measuring the net fiscal impact?

### Factors to Be Considered

One, a new firm location, expansion, or investment implies new structures, equipment, inventories, and land use. Each should cause **direct increases in assessed value**. An increase in assessed value could increase property tax revenue available for local government services. However, in Indiana, property tax controls fix the annual increase of most non-school operating levies. Assessed value increases are likely to decrease the property tax rate, rather than increase revenues. The dollar value of tax cuts to taxpayers will equal the existing property tax rate times the increase in assessed value. Thus, if added revenue for government services are considered equivalent to added after-tax income for private citizens, the tax rate times the additional assessed value should be included in the fiscal impact regardless of the local government revenue effect.

Two, firm location or expansion usually generates economic activity beyond the firm's direct investment, and this could cause **indirect increases in assessed value**. Existing firms may expand, and other firms may locate in the community to supply materials or business services to the new firm. Commercial businesses may expand and new ones start to serve the needs of new employees. New housing may be built. This is sometimes called the "multiplier effect." The full impact of a firm location on economic activity is a multiple of the direct investment. Expanded business activity and new housing will add to assessed value. The tax rate times the extra assessed value will measure the dollar amount of local government revenues or tax reductions.

Three, **incentives may abate some of the assessed value increase**. Some

of the direct assessed value increase is untaxed if a firm has been granted tax abatements. If TIF is used, some direct and indirect assessed value growth in the TIF district is not available for general taxation by the adopting unit or for taxation by overlapping units. Note that use of abatement or TIF does not necessarily imply that potential revenue has been lost or that other taxpayers pay higher rates. It may be that these development incentives were necessary to bring in the investment, so that without the incentive no added assessed value would be available for taxation.

Four, many local governments have significant **non-property tax revenue**. In Indiana, most counties have local income taxes, all collect revenue from the motor vehicle excise tax, and all collect revenue from a wide variety of other taxes, charges, and fees (DeBoer). When economic activity expands because of a firm location, non-property tax revenue should increase. New employees may locate in the community, people may take higher paying jobs, and previously unemployed people will get jobs. This may increase taxable income and eventually increase income tax receipts. More people with higher incomes may purchase more vehicles, increasing motor vehicle excise tax revenue. Charges and fees may also rise.

Five, most local schools receive a substantial share of their revenues from **state aid**. Local schools in Indiana receive over \$2.5 billion in state aid each year, accounting for more than half of their budgets. The current state school funding formula fixes both general fund spending per pupil and general fund tax rate. Aid per pupil is determined by multiplying the fixed tax rate times assessed value and subtracting from fixed spending. Increases in assessed value resulting from development will thus reduce the amount of state aid received. Likewise, reductions in assessed value due to TIF or abatements will increase aid. If new employees bring families with children, enrollment will rise and so will state

aid.

Six, new firms and new residents may demand **added government services**. Firms may require additions to public infrastructure or increases in operating funds for fire protection and public safety. Development may create in-migration, affecting demands for residential police and fire protection, park and recreation facilities, and roads and streets. More families mean more school enrollment. While economic development should bring in added revenues, it is also likely to increase the cost of providing local government services.

Some of the added infrastructure demands of the enacting unit may be paid for by TIF funds. Increases in assessed value within a TIF district will generate additional funds to pay for the utility, road, and other infrastructure needs required for the development. Tax abatements do not generate funds targeted for infrastructure investment.

### Measuring Fiscal Impact

The **fiscal impact** of a development project can be measured by adding the six factors described here. Direct and indirect assessed value increases, less abatements, add to property tax revenue. Non-property tax revenue may increase, but state aid to schools may decrease. The cost of extra service demands must be subtracted, though some of this cost is offset by TIF funds.

A county, city, or town which enacts TIF or abatements may receive extra property tax revenue from development through increases in direct and indirect assessed value, but Indiana's property tax controls assure that the bulk of these increases will go to reduce property tax rates. A larger multiplier effect results in greater indirect assessed value increase, greater added revenue, and tax cuts. Larger abated assessed value results in smaller added revenue and tax cuts. Non-property tax revenue could be substantial, especially from local income taxes. Extra service demands depend on population immigration and on how intensively existing facilities are being used. The net cost increase of added service demands is lessened by the use of TIF funds for infrastructure purposes.

On net, the fiscal impact may be positive or negative, depending primarily on the amount of non-property tax revenue relative to new service demands. Fiscal impact is more likely to be measured positively if tax cuts received by residents are counted as equivalent to tax revenue increases received by the local government.

Suppose a school corporation has boundaries which overlap those of an enacting government. A school corporation might be able to tax the added direct and indirect assessed value, though not the portion that is abated. However, general fund assessed value increases are likely to reduce state aid per pupil. A school corporation would receive some added non-property tax revenue, principally motor vehicle excise taxes, since corporations get little local income tax revenue. Added enrollment would probably increase spending requirements. How much depends on whether a school corporation's current facilities and staff are being used to capacity. None of the TIF revenue would go to the school corporation.

Tax abatements or TIF districts appear to have only a small effect on schools. The higher is the abatement, the smaller is the net increase in assessed value, and the smaller is the

non-general fund increase in property tax revenue. But general fund revenue is the bulk of school property taxes, and increases or decreases in such taxes are largely offset by changes in state aid. The more that assessed value is abated or "TIFed," the less is the decrease in state aid resulting from development.

It is possible, however, that the development itself—even without incentives—could produce a negative fiscal impact for schools. Added spending could exceed added revenues, especially if the development brings a lot of new pupils. In that case, the incentive could be considered detrimental to a school corporation if it was decisive in bringing the development about.

### **Do Incentives Help Achieve Local Development Goals?**

Community leaders offer property tax incentives to attract or retain firm investment, leading to jobs and income for local residents. Fiscal impacts associated with the incentive depend upon changes in assessed value, tax rates, and other revenue changes described above. Accurately predicting these impacts is difficult.

What would the fiscal impact have been without the incentives? Perhaps direct and indirect assessed value would have increased more without the abatements, non-property tax revenue would have increased the same amount, state aid to schools would have increased less, and added service demands would have increased more without the TIF revenue to help pay for them. If the fiscal impact with the incentives was positive, perhaps it would have been more positive without the incentives. If the impact was negative, without the incentives it could have been positive.

This discussion assumes that the development would have happened even if the incentive had not been used. Bartik notes that communities cannot "read the minds of firms to tell whether a subsidy is really needed" (p.853). Was the infrastructure or tax abatement

needed to get the firm to locate in the community, or would it have come anyway? If the incentive was necessary to bring about the development, the fiscal impact without the incentive is zero. No additional development would have occurred. But if the incentive was not necessary, the development would have occurred anyway, and the community would lose some of development's benefits.

Morse and Farmer (1986) evaluate incentives by looking at their costs as a share of the gross fiscal impact. The gross fiscal impact does not count the costs of the development incentives, in effect measuring the fiscal impact if the development had occurred without the incentives. If the incentives are but a small share of the gross impact, it does not matter much whether they are necessary or not. The community gets most of the positive fiscal impact with or without incentives. In such a case, incentives might be justified, even if the community suspects the development would happen anyway.

Suppose, however, that the incentives are a large part of the gross fiscal impact. Perhaps most of the direct increase in assessed value is abated, and there is little indirect increase. Then, if the incentives are not needed, the loss to the community is great. In such a case incentives should be used only if the community is very sure that the incentives are needed to bring the development about. If the incentives are needed and the fiscal impact with incentives is still positive, then the community gets benefits it would not have otherwise. Without the incentives the fiscal impact would be zero. If the incentives are

not needed, the fiscal impact of development could have been more positive, and the community has lost benefits it could have had. Finally, if the fiscal impact is negative, the local government does better if the development does not take place at all.

### **Conclusion**

Many local governments use property tax incentives to encourage economic development. Property taxes are abated, and tax increment financing is used to provide for the infrastructure needs of businesses. Development has a fiscal impact on local government, and the use of incentives can alter that impact. Development can increase revenues, through direct and indirect increases in assessed value and through increases in non-property tax revenue. But development can decrease some revenues, if state

school aid drops with assessed value increases, and it can increase costs, as new firms and residents demand more services. Abatements and TIF reduce the amount of new assessed value available for general taxation. If the incentives take up only a small share of the overall fiscal impact, they are probably worthwhile. If incentives take up a large part of the overall fiscal impact, they should be offered only if local officials are sure that they are needed to promote development.

Fiscal impact is not the only criterion for deciding whether to provide a property tax development incentive or not. It is possible that a development project could add to a community's wellbeing—through more jobs, better shopping choices, cultural or environmental advantages—and still have a negative fiscal impact. Nonetheless, communities would do well to consider the fiscal impact of

development and incentives as part of their decision process.

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