Property Tax Rates and Tax Increment Financing

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Comments Welcome

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Introduction

Economists have long voiced skepticism regarding the efficacy of many economic development incentives. Empirical research into the effectiveness, revenue replacement and overall cost of the programs provide little evidence of their success. This debate becomes of prime importance as Indiana considers the role incentives may play in altering rates for local property tax payers. To better examine this, we review the Tax Increment Financing program in Indiana, review existing literature on tax incentives and estimate the impact of tax incentives on Indiana's property tax rates from 1988-2003. We then summarize our results and offer policy recommendations.

Indiana's Tax Incentives

The Hoosier state is among the more conservative applicants of economic development incentives in the nation. As of this writing there are a little more than a dozen major incentive programs (with more than a $1,000,000 in business related revenues abated annually). Local tax abatements and Tax Increment Financing (TIF) comprise the two dominant property tax abatement efforts in the state.

Local tax abatements and TIF's are expressly designed for two purposes: to lure new firms to areas that would otherwise not see new economic activity and to subsidize infrastructure costs through targeting property tax revenues.

Several dozen of each type of incentive are offered annually (and may persist for up to one year). Indiana provides very specific amounts (by percent) which may be abated. In practice, both Tax Abatements and TIF's often are used to subsidize infrastructure investment. While the use of a TIF to pay for specific road or water service improvements is fairly obvious, Indiana's tax abatements are often used in a very similar fashion. For example, a tax abatement may be offered to a new firm with the agreement that the firm provide specific local infrastructure improvements as part of the abatement. This infrastructure improvement may come at a much lower cost than public sector work on the same project. So, paradoxically, tax abatements may result in lower public sector costs for infrastructure improvements.[1]

Indiana's experience with tax incentives is far more conservative and considered than most state programs. Research on other programs has a long history, and is worthy of consideration when examining incentives.

Existing Studies

Analysis of the role of tax policy on economic growth enjoys an extensive treatment by economists. A 1997 Federal Reserve Bank review of research findings cited over 90 studies that evaluated the role of fiscal policy in economic growth in the United

[1] I should note that I have authored several papers and a book on tax incentives that would fairly be characterized as among the most critical of their application in the academic literature.

States (Wasylenko, 1997). If anything, the past few years have seen an acceleration of this analysis accompanied by the development and widespread application of more robust statistical techniques that enable analysts to evaluate impacts.

Many of these papers attempt to explain differences in growth, wages and industrial composition through analysis of interstate tax policy. An equally large number of studies also evaluate whether expenditures (as evidenced by infrastructure) influence growth (Fox and Porca, 2002). A considerably smaller number of studies have attempted to evaluate the influence of individual targeted tax policies on economic growth (see Bartik, 2002).

Scholarship on business tax incentive programs is mixed as to the impact of government economic development efforts to create jobs and additional wealth or other announced economic goals of these programs. Gabe and Kraybill [2002] examined state economic development incentives on 366 Ohio manufacturing and non-manufacturing establishments that began large expansions between 1993 and 1995. They found empirical evidence to suggest that the incentives offered these firms had little if any actual impact on expected employment growth and what little was found suggested a slightly negative effect on actual growth.[2]

A review of more than 300 scholarly papers on economic development programs found that "studies of specific taxes are split over whether incentives are effective, although most report negative results" (Buss, 2001).[3]

Fisher and Peters [2004] explain the findings of their metareview of academic literature. They examined three questions surrounding government business development programs. First, do incentives improve growth and development where offered more than would occur on its own? Second, is this development directed to low-income populations? Lastly, they ask "how costly to government is the provision of these incentives compared to alternative policies?"[4]

Their conclusion was also mixed, as are many literature reviews, but on balance Fisher and Peters surmise that these programs are either ineffective or carry costs that exceed the alleged benefits derived from them. As to their first question, they conclude that:

> The upshot of all of this is that on this most basic question of all—whether incentives induce significant new investment or jobs—we simply do not know the answer. Since these programs probably cost state and local governments about $40-$50 billion a year, one would expect some clear and undisputed evidence of their success. This is not the case. In fact, there are very good reasons—theoretical, empirical, and practical—to believe that economic development incentives have little or no impact on firm location and investment decisions.[5]

Fisher and Peters [2001] think there may still be a role for government to play in economic development, but it should focus more on the fundamentals, such as infrastructure and education, as well as worker training. They conclude: "[T]he most fundamental problem is that many public officials appear to believe that they can

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[2] Gabe, Todd M. and Kraybill, David S. "The Effect of State Economic Development Incentives on Employment Growth of Establishments," Journal of Regional Science, Vol. 42, No. 4, 2002, p. 703.
[3] Buss, Terry F. "The Effect of State Tax Incentives on Economic Growth and Firm Location Decisions: An Overview of the Literature," Economic Development Quarterly, Vol. 15, No. 1, Feb. 2001: p. 99.
[4] Peters, Alan and Fisher, Peter "The Failures of Economic Development Incentives," American Planning Association, Journal of the American Planning Association; Winter 2004; 70, p. 27.
[5] Ibid., p. 32

influence the course of their state economies through incentives and subsidies to a degree far beyond anything supported by even the most optimistic evidence."[6]

In addition to the presence of a range of findings in the literature, policy recommendations are further challenged by the absence of few findings extrapolated to a benefit-cost framework. Even if a robust econometric finding of a positive impact of targeted fiscal incentives is made, this does not necessarily translate into a clear policy recommendation. For instance, if a study of a state or region concluded that there was a statistically significant link between targeted tax incentives and new jobs, the tax incentives might still be bad policy if the ensuing net benefits are non-positive.

Further, evaluation of targeted incentives has been more sporadic than analysis of general fiscal policy. Also, the methods employed by state economic development agencies are better suited to management efforts than evaluation of economic growth.[7] Thus, a review of findings regarding targeted tax incentives will leave an unbiased reader hungry for more substantive analysis.

Hicks and LaFaive (2005) evaluated Michigan's MEGA economic development incentive program from 1995-2003. They found that the roughly $1.5 billion in tax abatements had none of the intended consequences. The program, which targeted manufacturing, wholesale, high technology and corporate headquarters only managed to influence construction jobs. The job creation in construction came at a revenue cost of roughly $125,000 per job.

Bartik (2002) provides an admirable survey of methods for evaluating targeted incentive policies. The estimation provided in this study is a direct result of Bartik's recommendations, and conforms to the multiple methods of econometric estimation reviewed in his paper.

Tax Incentives and Property Tax Rates

In order to evaluate the role tax incentives play on local property tax rates we construct a model of Indiana counties from 1988 through 2003. Using annual data on tax rates and tax abatements (including TIF's) from the Department of Local Government Finance we estimate the impact tax abatements in any year have on tax rates in subsequent years. The values are the county total abatements (in inflation adjusted dollars) and county average property tax rates.

From this basic model we attempt several versions extending the lagged effect through three years, examine changes (not levels) in property tax rates and examine the possibility that non-linear relationships may exist. We tested for several different statistical concerns and transformed the data into percentages, weighted the regions by population, incomes, and created variables that account for "unobserved region specific variation." [8] No specification offered the hint of a positive relationship between property tax rates and previous (or current) tax abatements. Indeed, the most recurring result was a very modest negative relationship between property tax rates and property tax

[6] Ibid., p. 35.
[7] Specifically, the use of firm specific reports of gross job flows may be a useful management tool, but is particularly ill-suited to economic analysis.
[8] We are most concerned about the traditional spherical errors and endogeneity.

incentives. These results require additional analysis before this linkage is asserted more broadly. What we can conclude, without reservation, is that there is absolutely no evidence that tax abatements lead to higher property tax rates at the county level.

An under appreciated body of research on local property tax rates and incentives was offered by Zorn, Mikesell and Dalehite (2003, 2005). Their examination of tax incentives and local property tax rates provided both an innovative case study of one Indiana county and a finding that tax incentives did influence local tax rates at the township level.

Summary

Existing research on tax incentives does not provide a strong call for their use. However, Indiana's policies towards incentives is far more restrained and likely more efficacious than the programs evaluated by scholars for other states. Contrast with Michigan's MEGA program, which showed absolutely no signs of efficacy are but one example. However, the purpose of this paper is to examine the role these incentives play on local property tax rates.

When combining the findings presented in this paper, that examine county level property tax rates and assessments for more than a decade, with the careful work by Zorn, Mikesell and Dalehite, two findings one policy recommendation emerge. First, at the county level, tax incentives have not caused rates to climb, but at the local level they might. This argues strongly for consolidation of property tax decision making at the county level – not a complete overhaul of the abatement and TIF programs.

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