

Evaluating Incentives: A Rational Approach

The use of economic incentives has received a great deal of attention over the past several years.

Critics deride tax incentives as “corporate welfare” and complain states are “giving away” too much in an effort to “buy” new investment. Supporters point to billions of dollars of investment and thousands of jobs as proof of the success of incentives. Either side can make a compelling point in support of their position by cherry-picking the data they use and the assumptions they make. As a result, the conclusions of “analyses” are often predetermined by the underlying assumptions rather than any facts. The issue is far more complex, and misinformation will dominate the discussion until policymakers adopt a clear, standardized, and consistent set of appropriate measures of both the costs and benefits of economic development and incentives.

In this analysis, TTARA identifies some of the common myths about how tax incentives are characterized. We then propose a matrix of factors that may be used as a guideline for evaluating the costs and benefits of projects and the incentives they may use.

Defining “Economic Incentive”

One initial problem the state has in evaluating economic incentives is that it does not even have a standard definition of the term

Texas evaluates incentives all wrong. It fixates on the benefit to the taxpayer as a “cost,” ignoring the true costs and the potential pay-back to state and local governments.

“economic incentive.” For this analysis, the following definition is used:

An economic incentive is a specific offer of a financial benefit to motivate a person to engage in a particular type of economic activity in Texas. Incentives include grants, financing tools, tax credits, tax refunds, and tax discounts.

Tax exemptions, which are available to all taxpayers without specific application, are **NOT** incentives. Exemptions apply to all taxpayers as a way of eliminating the distorting impacts of a tax, rather than incentivizing a specific project or activity.

Myth #1: “Incentive” Equals “Cost”

The state calculates its “cost” of an incentive as the amount of benefit received by the taxpayer. This assumes that the taxpayer would have made the exact same decision had there been no incentive. This is a fundamental flaw in the

state's analysis as the following example demonstrates:

A woman owns a small antique shop. She prices her goods at a sufficient markup so that she will make a 25 percent profit after all her costs are covered. She has a dining table for sale at \$1,000, but it has been sitting unsold for months. A customer comes into the store and is drawn to the table. The shop owner doesn't normally negotiate, but they are both aware there is a similar table for less in a nearby store. The two agree on a sales price of \$900—a ten percent discount from her normal sales price, but one which still allows her a profit of \$100 over her break-even cost of \$800.

If you apply the methodology the state uses to assess incentives, you would conclude the shopkeeper lost \$100. The assumption is made that the customer would have bought the item and willingly paid the full retail price, no matter that a less expensive alternative existed elsewhere. The shopkeeper's discount is a "cost" no different from any other business expense, and no different than if she had to write a check out of her own pocket.

A tax incentive is simply a discount on the amount of tax a business will pay on a project to encourage them to select a specific location—no different from the retailer above offering a discount to her customer as encouragement to make the purchase.

Incentives are not a zero sum game. A business has choices, and will tend to select the site that makes the best sense financially. If the numbers don't work in Texas, they'll look in Louisiana, Florida, or some other state—just as a savvy retail customer will shop around. The taxing jurisdiction is not giving away tax money. Absent the incentive, the project never would have located in Texas and never would have paid those taxes.

If there's a difference between the shopkeeper

and the state, it is that the shopkeeper knows exactly what her "profit point" is. The state does not—at least not with the methodology Texas currently uses.

Done correctly, incentives can provide a "win-win." The taxpayer wins by temporarily enjoying a reduction in the taxes they would normally pay, and the taxing jurisdiction wins by gaining a substantial permanent addition to its tax base.

Myth #2: The Smaller the Incentive "Cost per Job" Means a Better Project

Other analytical approaches used by the state calculate the ratio of the value of the incentive to the number of jobs created (again, assuming that the value of the incentive equals the cost to taxpayers). The higher the ratio, the more the state is "paying" for the new jobs.

At best, the ratio may offer an indicator of how capital intensive a project is, but otherwise it is meaningless for purposes of evaluating incentives as the following example proves:

Two companies are evaluating locations for their new manufacturing facility. Among the sites both are considering is one in a Texas school district. Since they're looking at the same site, only one project can move forward. Both companies plan to employ 1,000 people at the plant, and both seek a temporary limit on their taxable value for school maintenance and operations taxes under a program authorized in Chapter 313 of the Tax Code. The limitation would save Company A \$51 million each year for 10 years. The benefit to Company B would equal only \$9.4 million annually over the same period.

The number crunchers grab their calculators and do a "cost/benefit" analysis. *Company A* would "cost" the state \$510,000 per job (\$51 million in benefits divided by 1,000 jobs multiplied by the ten years the incentive would be in place). *Company B* would "cost" only

\$94,000 per job (\$9.4 million in benefits divided by 1,000 jobs multiplied by ten years). *Company B* is much more affordable and they get the nod. *Company A* is told to go elsewhere.

It seems like a no-brainer. After all, one is seeking a much lesser benefit and will create the same number of jobs. But did the state get the better project? A more thorough look at the data suggests the answer is “no.” What did the number crunchers miss?

They focused on the amount of the tax benefit offered and ignored the amount of taxes the projects would actually pay.

Several key questions were never asked:

- How long was the plant going to operate?
- How much was each company planning to invest and ultimately put onto the tax rolls?
- What other state and local taxes would the project pay?

A more complete assessment of the project (Figure 1) demonstrates that the decision was NOT the most lucrative for the district or the state. Both projects created an equal number of jobs, but *Company A* would have paid almost 6 times more in overall taxes. Further, it would have doubled the local school tax base, allowing the district’s debt service tax rates to drop by

Figure 1
Assessing the Most Lucrative Project for the State
Dollars are in Millions

School District (before project)				
School Tax Base without project			\$5,000	
School M&O Tax Rate/\$100 of value			\$1.04	
Pre-Project Tax Rate for I&S/ \$100			\$0.20	
Project Parameters		Company A	Company B	
Plant investment & Market Value ¹		\$5,000	\$1,000	
Annual Sales of Goods Manufactured		\$5,000	\$2,500	
Number of Employees		1,000	1,000	
Total Payroll		\$50	\$50	
Life of Project in years		30	20	
Assessing the Project's Economic Impact	Year Value Limit in Place	Year Value Limit Not In Place	Year Value Limit in Place	Year Value Limit Not In Place
Project Tax Savings from School Tax Limit	\$51.0	\$0.0	\$9.4	\$0.0
Project Taxes Paid				
School Property Taxes Paid	\$6.0	\$57.0	\$2.7	\$12.1
City/County Property Taxes Paid ²	\$0.0	\$50.0	\$0.0	\$10.0
Sales Taxes Paid	\$15.6	\$15.6	\$7.8	\$7.8
Franchise Taxes Paid	\$7.5	\$7.5	\$3.8	\$3.8
Other Taxes Paid	<u>\$2.5</u>	<u>\$2.5</u>	<u>\$1.2</u>	<u>\$1.2</u>
Total Taxes Paid	\$31.7	\$132.6	\$15.5	\$34.9
Total Taxes Paid Per Job (dollars)	\$31,665.0	\$132,625.0	\$15,519.2	\$34,879.2
Project Analysis (Life of the Project)				
School Tax Benefit to Taxpayer	\$509.6	expired	\$93.6	expired
Benefit to Taxpayer per Job (dollars)	\$509,600	expired	\$93,600	expired
Total Taxes Paid (years limited & not)	<u>\$317</u>	<u>\$2,652</u>	<u>\$155</u>	<u>\$349</u>
Taxes Paid Over the Life of Project	\$2,969		\$504	

Notes: ¹In this example the investment is equal to the taxable value of the property. ²The project is assumed to have also received a ten year abatement from city and county property taxes.

half, saving local taxpayers millions of dollars. *Company A* also had a longer life span. The plant would have been operational over 30 years, not the 20 years of *Company B*—providing 10 more years of jobs and taxes. It was also a bigger project in the sense that it produced more in sales and economic output than *Company B* and would have consumed more materials and services. Consequently, it would have paid substantially more in sales, franchise, and other taxes in any given year. And the numbers in Figure 1 understate the *total* benefit to the state because they do not include the economic effects from the higher construction payrolls nor the ancillary gains from the increased local economic activity.

Ironically, the higher the “cost,” as measured by the amount of the benefit, the bigger the ultimate return to the taxing entities.

So what was the more lucrative project for the community? The one that got away.

Myth #3: The “Best Deal” Is the Best Deal

Acme Manufacturing is looking to build a new, state-of-the art \$1.5 billion project:

- \$0.1 billion for land
- \$1.0 billion in construction costs, and
- \$0.4 billion for machinery and equipment.

The plant will also hold an average inventory of raw materials and finished product worth \$0.4 billion. The plant will have a life span of 25 years.

Acme has narrowed its choices to three states: Texas, Pennsylvania, and Alabama. *Acme* views all three states equally, except for property taxes, which is a huge consideration given that the plant is very capital intensive. Ultimately, *Acme* advises the states that the one with the lowest property tax bill will get the project.

Pennsylvania weighs in first, offering a package

of property tax reductions worth \$75 million over the first ten years of the project’s life. Alabama ups the ante with a ten year package of \$125 million in property tax savings. Texas confidently steps up to the plate and tells *Acme* that its ten year package is worth a whopping \$315 million of total local property tax relief.

Acme’s number crunchers go to work and report to the CEO, who calls a press conference to announce that the new project goes to...

...Pennsylvania.

How did the state that offered the smallest package lure the investment?

It’s simple. What mattered to the company was not the taxes it would not pay (those abated by the taxing authorities); what mattered was the taxes that it would pay (Figure 2).

Pennsylvania and Alabama had some distinct advantages over Texas. First, both states have dramatically lower property taxes than Texas. While that may not have mattered as much during the first ten years of the project, when the incentives would have been in place, it made a huge difference during the remaining 15 years of the project in which the incentives were not in place.

Second, neither Pennsylvania’s nor Alabama’s property tax applies to inventories of either raw materials or finished goods, while Texas’ does. Texas is one of only 9 states that includes business inventories under the property tax. While local taxing units are able to exempt “Freeport Goods,” this is a local option exemption that applies only to goods to be shipped out of state and it does not apply to inventories of raw materials. And Pennsylvania had a further advantage over both Alabama and Texas because it doesn’t tax business personal property—industrial equipment, machinery, etc.—under the property tax.

Finally, Texas’ package was not nearly as good

as it initially appeared. While Acme would have benefitted from school tax reductions that would have totaled \$135 million, school districts typically demand the project rebate as much as 40 percent of the tax savings back to the school district as supplemental payments. Acme could be expected to write checks totaling \$54 million to the Texas school district in which it was located, substantially reducing their net tax benefit.

So when the company’s number crunchers put pencil to paper, they determined over the life of the project they would pay \$269 million in property taxes in Pennsylvania, \$363 million in Alabama, and \$879 million in property taxes and supplemental payments in Texas. Texas wasn’t even close to being the best choice, in spite of the package it offered.

Policymakers are at a clear disadvantage in “selling” Texas if they can’t understand what matters most to their prospective customers.

An Appropriate Method of Evaluating Projects and the Effectiveness of Incentives

All three of the previous examples share a common thread: **it is not the amount of the incentive that matters to the project, it is the amount of taxes ultimately due.** Taxing jurisdictions, and public interest groups, tend to fixate on the amount of the benefits offered, erroneously equating that to public cost. But if a project will pay a billion dollars in taxes after

**Figure 2
State Incentives Versus Tax Liability**

Item	Gross Value	Taxable Value		
		Pennsylvania	Alabama	Texas
Land Value	\$100	100	100	100
Plant	\$1,000	1,000	1,000	1,000
Equipment	\$400	0	400	400
Inventories	\$400	0	0	400
Total Value	\$1,900	\$1,100	\$1,500	\$1,900
Average Tax Rate per \$100		\$1.25	\$1.25	\$2.40
Project Life	25 yrs	25	25	25
Gross Taxes, Life of Project		\$344	\$488	\$1,140
Reduction from Incentive		(\$75)	(\$125)	(\$315)
Supplemental Payments		0	0	\$54
Net Taxes & Payments Due		\$269	\$363	\$879

Notes: Alabama school districts are not allowed to offer a property tax abatement. Pennsylvania school districts may, although none is assumed in this example. Texas school districts do not offer direct tax abatements, but may offer a temporary limit on the taxable value of the new investment.

incentives, what does it matter if the state offers an incentive of \$100 million or \$500 million? What should matter is the return on the incentive, not the incentive itself.

So how should returns be measured?

First, policymakers must discard the fool’s mission to attempt to assess the effectiveness of incentives by a single measure or two. Economic development is far too complex. A more holistic approach is necessary.

Still, some simplification can be offered. While there are many factors that enter into decisions to encourage economic development, they can be condensed into three basic categories:

1. Economic Impacts,
2. Fiscal Impacts, and
3. Intangibles

All of these should be a part of the evaluation process—not only for the operational period of the project, but also the construction period, and not only for the direct project itself, but also the ancillary economic activity the project may generate. Some projects may fare poorly

on one measure, but that alone should not disqualify them if they score well on others that policymakers deem important. Elements should be evaluated objectively and qualitatively, resisting the temptation to reduce the process to simple math, which ultimately requires assigning arbitrary weights to the different categories (Figure 3).

Factor #1: Economic Impacts

Economic gains are not only those attributed directly to the project, but also the ancillary gains as the business and its workers spend money and how those dollars reverberate throughout the local and state economy.

Investment is a measure of the project’s initial costs that will be spent in the community—site development, construction, etc. It will immediately inject dollars into the local economy as construction crews are put to work and local companies are engaged. Both the construction and operations period create a gain in business activity or the area’s economic output.

Policymakers place a great deal of emphasis on job creation, which is clearly a beneficial result of economic growth, but it is not one without cost. Jobs create additional demands on government. As job opportunities encourage more people to live in an area, school enrollments grow, traffic increases, demands on water, wastewater, and other public services multiply. The new jobs a project may bring to an area can be a great benefit to the economic

Figure 3
Assessing the Costs/Benefits of Incentive Projects

Factors for Evaluation	Benefits		Costs	
	Direct Project	Ancillary Activity	Direct Project	Ancillary Activity
Economic Factors				
Investment				
Business Activity				
Jobs				
Wages and Income				
Fiscal Factors				
Tax and Other Revenues				
Public Service Costs				
Grants and Financing				
Intangible Factors				
Prestige				
Publicity				
Lifestyle Considerations				
Diversification/ Infrastructure/ Other Issues				

well-being of an area, but they can place substantial new demands on government budgets. Income growth is also a positive, but not without ancillary considerations. High wage jobs are preferred, but if the skills of the local workforce are not sufficient to fill the new jobs, the project will likely require hires from outside the area, placing greater demands on housing.

Factor #2: Fiscal Impacts

In 2013, Texas rewrote the provisions of its school tax limitation program under Chapter 313 of the Tax Code to require the Comptroller to evaluate the tax benefits to the state of each project. This figure is to be compared to the amount of benefits received by the taxpayer. If the state gets a better deal than the taxpayer, the project is deemed worthy, and the Comptroller is to approve it. Projects in which the taxpayer’s benefit is greater than that of the state are likely to be denied.

While a step in the right direction, this “benefits to benefits” comparison still misses the point. It is simply a test of who got the “best deal,” not whether the project was an overall net benefit to the state or the local community.

The proper measure of the *fiscal* benefit of economic development is whether the taxes a project pays ultimately meet or exceed the additional costs the development brings to a jurisdiction—from more cars on the road, more students in school, etc. This approach is commonly used in traditional socio-economic impact assessment studies.

But a detailed analysis of a project’s impacts can be complex, involving detailed economic modeling of additional populations and public service demands. These are clearly important, but a simpler methodology might assess how the taxes a project pays relative to the jobs it creates compares to the economy as a whole, which would be considered to be at “equilibrium.” If a project has a higher ratio of net tax paid per employee than the economy as a whole, it will create a fiscal gain. On the other hand, if a project pays less in taxes relative to the jobs it creates, it may create additional fiscal pressures.

The Council on State Taxation, a Washington-based tax association, compiles an annual assessment of the state and local tax burdens on businesses and individuals across the 50 states. Their 2013 data reveals that for every person a Texas business employs, the business paid \$6,077 in state and local taxes—local property, state and local sales, franchise, severance, etc. In effect, each new employer locating in the state paying taxes equal to \$6,077 per employee per year would create no direct additional fiscal burden to the state—they would simply maintain the status quo. New employers paying less than that amount in taxes could conceivably create a financial burden; those paying more than that amount would create a fiscal benefit.

Going back to *Companies A and B* in Figure 1, the cost/benefit analysis clearly shows that on the fiscal front, *Company A* clearly had the best pay-back to the state. Over the 30 years of the project, it would pay \$98,966 in taxes per employee each year—far exceeding the increased cost to the state of providing for the additional population, and far exceeding the \$25,200 per employee *Company B* would pay during its 20 years of operation. From a fiscal perspective, both projects “make money” for the state, but *Company A* by far brought the best “bang for the buck” to the table.

The vast difference in tax liability is the result of Texas’ heavy tax burden on capital intensive industries. *Company A* is very capital intensive, and is hit hard by Texas’ high property taxes. But even in those years the incentive is in place, the project would pay over \$30,000 in taxes per employee—well above the state’s “break even” point. Solely from a fiscal perspective, while some might express concern over the \$51 million in tax discounts received from the government, what should draw greater attention, and what should weigh far more heavily with policymakers is the nearly \$3 billion in taxes the project would actually pay.

Factor 3: Intangibles

But even then, a fiscal test may not always be the appropriate measure for all projects. Economic development should not simply be about governments seeking to financially profit from growth, but also about creating greater opportunity for its citizens.

Projects can bring prestige, publicity, or lifestyle considerations (such as entertainment events) that benefit an area. For example, the state and local communities used incentives to lure a Formula 1 race to Austin. While the calculation of fiscal returns from the race may be debatable, there is no question that visitors come to Austin from around the world that would not have come to Austin otherwise; and

no question that a worldwide television audience watching the race sees promotional information about Austin, its surrounding areas, and the state of Texas as a whole.

Jurisdictions may use incentives to diversify their economy, such as broadening their economic base so that the community is not as exposed to a downturn in a single industry. Jurisdictions may use incentives to encourage pollution control, investments in renewable energy, or investments in infrastructure.

Conclusion

Texas evaluates its economic incentives all wrong. It fixates on the amount of the benefit to the taxpayer erroneously assigning this number to the state as a “cost.” The state then

looks to the number of jobs the project creates as a “benefit” while ignoring the potential costs of additional public services.

Instead, incentives and the projects they attract should be evaluated on a variety of factors: economic, fiscal, and intangible. Some beneficial projects will create jobs; some will not. Some beneficial projects will swell tax rolls; some will not. Some will be marquee projects that put Texas in the nation’s, or even the world’s eyes; some will not. But if Texas is to rationally assess the diverse projects that look within our borders the state must evaluate the pluses and minuses of each and look at the totality of the data to determine if they are worth the extraordinary application of an incentive.