Thoughts on Texas Economic Incentives

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Summary

Observations

- Texas is not a low tax state for business. Consequently, judiciously-used incentives are an appropriate policy tool to encourage economic development **(Pages 1-3).**

- We have no definition of what an "economic incentive" is, making evaluation of our "economic incentives" difficult, if not impossible **(Page 4).**

- Texas' incentive process is dauntingly complex, confusing, and discouraging. Texas incentives are spread across multiple agencies, each with different application procedures, different methods of evaluation, and different reporting requirements. Our monitoring and reporting requirements are overly burdensome, confusing **quantity** of information with **quality** of information **(Pages 5-8).**

- Our methods of evaluating incentives are wrong:

    - We erroneously define cost as equal to the taxpayer benefit **(Page 9**),
    - The focus on "benefit cost per job" is misplaced, leading us to miss sight of the taxes projects ultimately pay **(Page 10)**, and
    - We fail to consider the impact of taxes from the perspective of the taxpayer **(Page 11).**

- Evaluation of projects and the incentives used to lure them is characterized by inconsistency and biased assumptions.

Recommendations

1. **Simplify**. Texas should **simplify** the application and reporting process, focusing on quality of information, not quantify of information.

2. **Consolidate**. Texas should **consolidate** application and reporting requirements, providing a single point of contact to process applications and assist applicants through the process.

3. **Evaluate**. Texas should establish a standardized matrix of factors to be used to objectively **evaluate** a project that seeks incentives, focusing on the potential value and returns to the state. That matrix should include: 1) economic benefits, 2) fiscal benefits, and 3) intangible benefits. The evaluation should also recognize potential costs of a project—not the value of the incentives, but the potential demands for additional public services **(Page 12).**

Tax Incidence

There are two basic types of taxpayers:

1. *Businesses*, and
2. *Individuals*.

In Texas*, individuals* incur direct taxes on many of their purchases and their real estate, but unlike most states, not on their income.

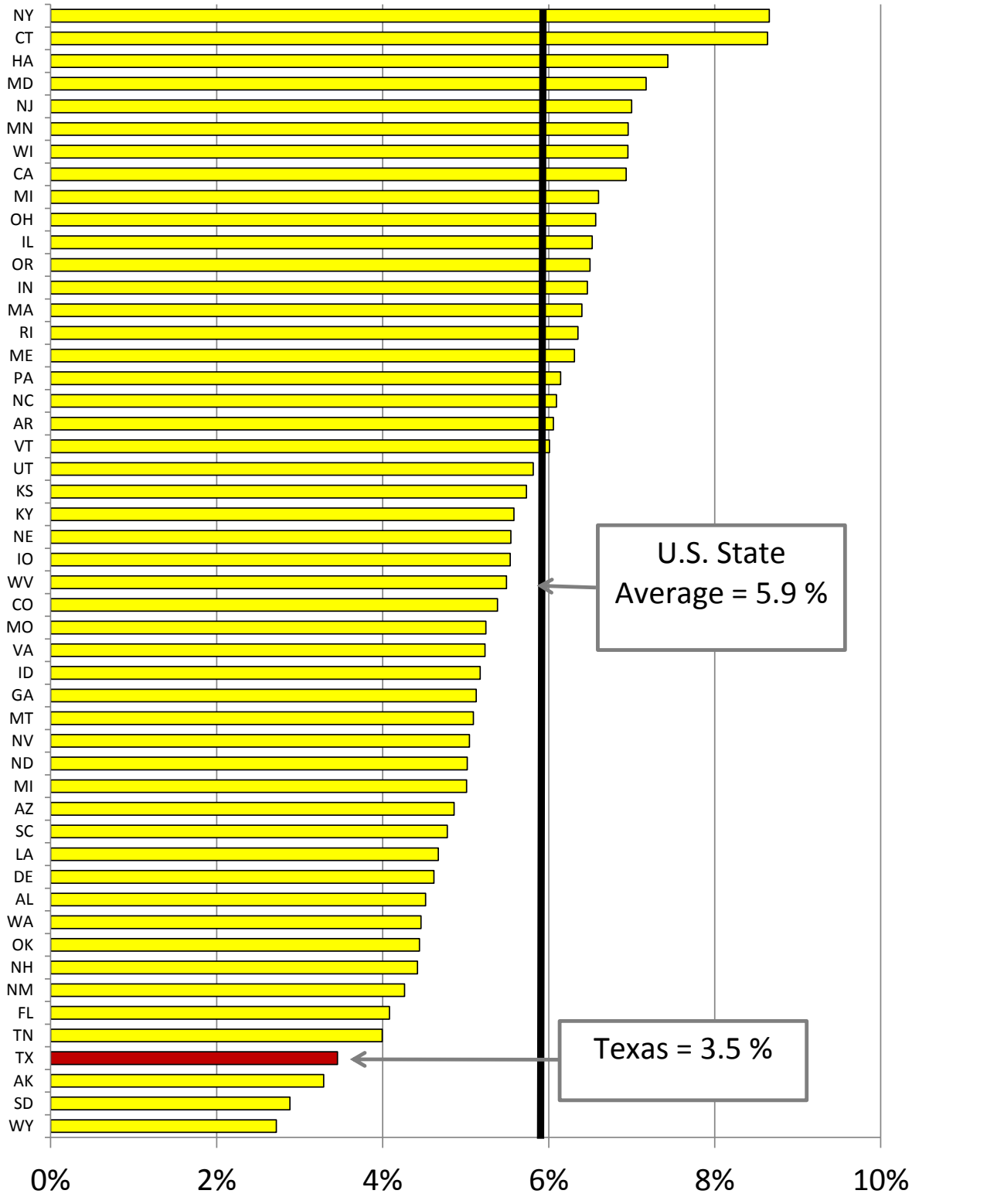
Businesses may incur taxes on their purchases (e.g. sales tax, fuels taxes), their real estate and personal assets (e.g. property tax), and be subject to special industry taxes on gross receipts (e.g. utilities, insurance). Businesses respond to taxes in one of three ways:

1. Pass the cost of the tax forward to individuals in the form of higher prices,
2. Pass the tax backward to owners in the form of lower profits, and/or
3. Pass the tax backward to individuals by reducing expenses, such as payroll or relocating or shifting investment to a lower cost location.

Note about the initial incidence assignments in this analysis…

- Sales and motor vehicle sales taxes: tax due is on the sale of a taxable item and is paid by the *purchaser*. For example, while a retailer collects the tax and remits it to the state, the tax is paid by the purchaser.
- Property tax is paid by the *owner* of the property, whether an individual or a business.
- Though assessed on the refiner, motor fuels taxes are assigned to the consumer, since state law requires the tax be passed on to the consumer.
- Franchise tax is paid by the business entity.
- Severance taxes and industry gross receipts taxes are paid by the business.
- Excise taxes on consumer products (tobacco and alcohol) are predominately paid by the consumer.

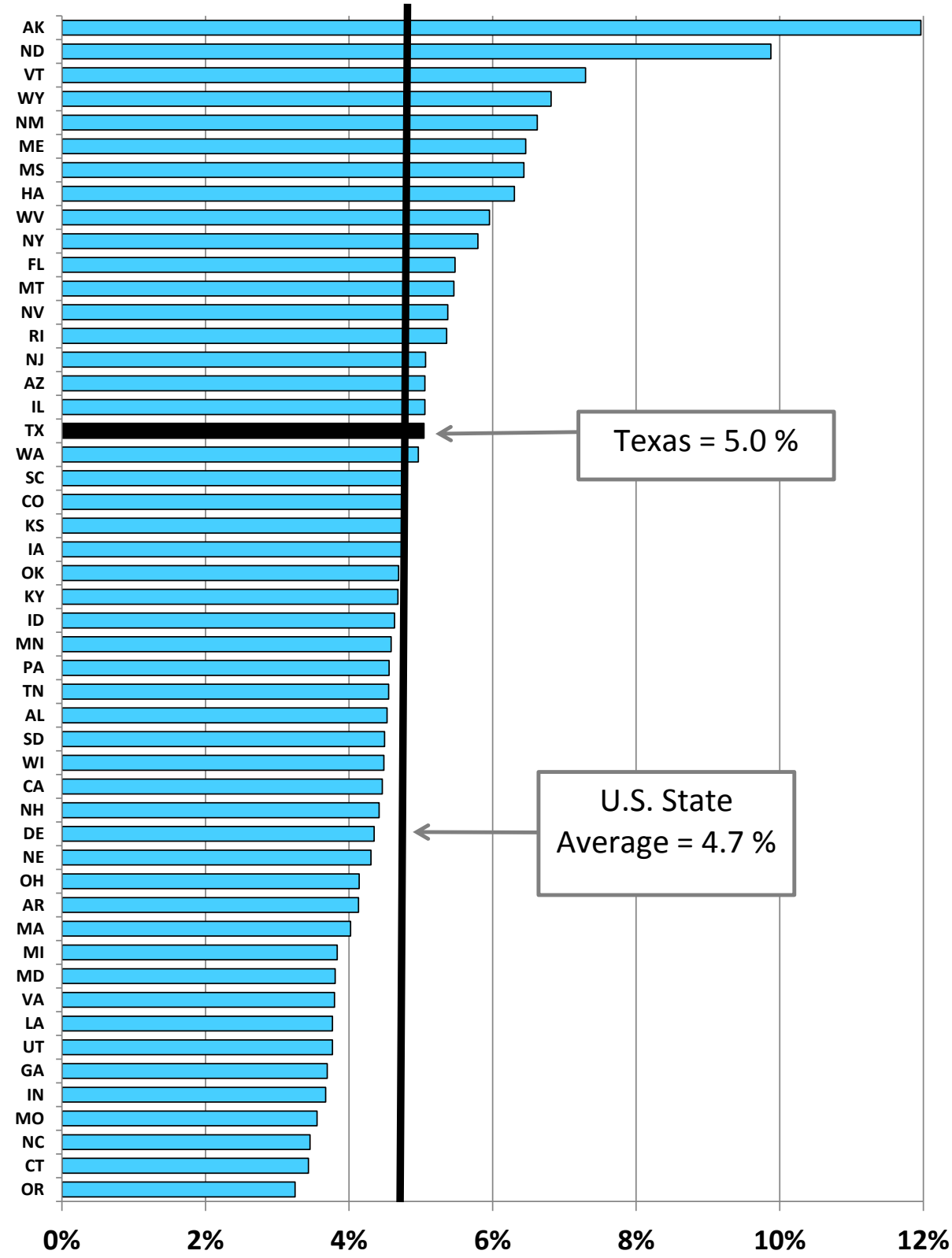
Individual Tax Burden Relative to Personal Income



Source

: Derived from Council on State Taxation: Total State and Local Business Taxes, 2013.

Business Taxes Relative to Private Economic Output



Source: Council on State Taxation: Total State and Local Business Taxes, 2012.

Key Texas Taxes Compared to Other States

Tax	Current Rate and Base	Comparison
Sales Tax Rate	State Tax Rate: 6.25% Local Taxes: Generally capped at 2.0 %; average is 1.9% Average Combined Rate: 8.15%	State Rate: 11th (tied) highest Combined Rate: 11th highest
Sales Tax Base	Generally applies to all sales of tangible personal property excluding food, medicine and residential or industrial utilities; and a number of services	Texas' base is generally broader than that of other states because we tend to tax more services than other states (only 7 states tax more services)
Property Tax Rate	Residential property: average effective tax rate in 2013 was just under 2.0 percent of market value Industrial property: average effective tax rate in 2013 was just under 2.6% of market value	Residential property: Texas' effective tax rates rank us 16th highest nationally Industrial property: Texas' effective tax rates rank us 6th highest nationally
Property Tax Base	Texas taxes all real estate plus any tangible personal property used for business purposes (equipment and inventory); goods in interstate commerce are exempted at local option (i.e. Freeport property)	Texas' base is generally broader than that of other states: 11 states exempt all business tangible personal property; inventories are generally exempt in all but 7 states.
Business Franchise Tax	Texas' franchise tax is unlike the net business income tax levied by most other states; Texas' effective tax rate relative to economic output was 0.35% in 2013.	Relative to economic output, Texas' franchise tax ranks 27th highest among the states, about 10 percent below the national average.

Proposed Definition of "Economic Incentive"

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

Incentives operate in two ways:

1. **Tax Reductions:** allowing the activity to pay a lower amount of taxes than normally required.
   Examples: Property tax abatements, Chapter 313, tax credits, enterprise refunds.

2. **Awards of Supplemental Funds:** an award to the activity of funds beyond the taxes they pay.
   Examples: Texas Enterprise Fund, Events Funds, Skills Development Funds.

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.

Selected Texas Economic Development Programs

Office of the Governor & Texas Economic Development Bank

- **Texas Enterprise Fund (Government Code, Chapter 481.078)**
- Texas Enterprise Project Designation
- Texas Emerging Technology Fund (Government Code, Chapter 490)
- Defense Economic Adjustment Assistance Grants (Government Code 2310.403)
- Texas Moving Image Industry Incentive Program (Government Code, Chapter 485)

Office of the Comptroller

- **School Tax Limitations (Tax Code, Chapter 313**
- **Enterprise Zone Sales Tax Refunds**
- Events Trust Fund (V.A.C.S., Article 5190.14)
- Major Events Trust Fund (V.A.C.S., Article 5190.14)
- Motor Sports Racing Trust Fund ((V.A.C.S., Article 5190.14))
- Special Events Trust Fund (Local Government Code, Chapter 398)

Texas Workforce Commission

- **Skills Development Fund (Labor Code Chapter 303)**
- Skills for Small Business Program (Labor Code Chapter 303)

Texas Department of Agriculture

- Rural Economic Development and Incentive Program (Agriculture Code (12.0271)
- Texas Rural Investment Fund Program (Agriculture Code 12.046)
- Texas Agricultural Finance Authority (Agriculture Code, Chapter 58)
- Agricultural Loan Guarantee Program (Agriculture Code, Chapter 58)
- Texas Capital Fund (Government Code 487.351)

Local Governments

- County Assistance Districts (Tax Code, Chapter 387)
- City Economic Development Sales Tax (Local Government Code, Chapters 501-505
- City or County Enterprise Zones (Government Code Chapter 2303)
- City and County Property Tax Abatements (Tax Code, Chapter 312)
- School Property Tax Limitation (Tax Code, Chapter 313)
- City and County Tax Increment Financing (Tax Code, Chapter 311)

Chapter 313 Forms

Application Forms	Pages
• **Form 50-296A Application for Appraised Value Limitation on Qualified Property** To be filled out by an applicant seeking an appraised value limitation and submitted to the school district. The school district submits a completed application to the Comptroller for review and approval.	9
• **Form 50-300 Application for Tax Credit on Qualified Property** (PDF) To be filled out by an agreement holder after paying property tax for the last complete tax year of the qualifying time period and submitted to school district.	4
Agreement Forms	
• **Form 50-286 Texas Economic Development Act Agreement** (PDF) To be used by the applicant and school distract as a template for a value limitation agreement. The school district submits a draft agreement to the Comptroller for review and approval. *Only applies to agreements resulting from applications determined to be complete after Jan. 1, 2014.*	29
Reporting Forms	
• **Form 50-772A Annual Eligibility Report** (PDF) To be filled out by agreement holders and submitted by an authorized representative of each company to the school district by **May 15th of every year** using information from the previous tax (calendar) year. School districts should review the submitted forms, retain the original and submit PDF scans of the completed and signed forms and any attachments to the Comptroller's office by June 15th of every year.	4
• **Form 50-773A Biennial Progress Report** (PDF) To be filled out by agreement holders and submitted by an authorized representative of each company to the school district by May 15th of each even-numbered year. The Comptroller's office requests that companies complete the spreadsheet version of this form, submitting both an unsigned electronic version and a signed hard copy version—with any attachments—to the school district. School districts should forward to the Comptroller's office by June 15th of each even-numbered year.	7
• **Form 50-287 Biennial School District Cost Data Request** (PDF) School districts are also requested to submit the Biennial School District Cost Data Request Form to the Comptroller's office by July 15th of each even-numbered year, indicating—for each project—actual and estimated property values, tax rates, payments in lieu of taxes, extraordinary educational expenses, and revenue protection payments.	1
• **Form 50-825 Job Creation Compliance Report** (PDF) To be filled out by agreement holders and submitted by an authorized representative of each company directly to the Comptroller's office annually. *Only applies to agreements resulting from applications determined to be complete after Jan. 1, 2014.*	4

Texas Enterprise Fund Forms

Nominating Forms	
• **Nominating Ordinance or Order or Resolution** City must make take formal action to nominate a project as an "enterprise project," and provide documentation to the Office of the Govenor, Economic Development Bank. .	5
• **Corporate Resolution** Board of Directors must adopt a resolution approving the Enterprise Project Application to be submitted to the Office of the Governor, Economic Development Bank.	1
Application Forms	
• **Texas Enterprise Project Application** To be filled out by applicant and submitted to the Office of the Governor, Economic Development Bank with application fee ranging from $750 to $2,250. Application MUST be filed in a three-ring binder with supporting materials.	31
• **Form JCF-01 Application for Program Benefits** To be filled out by a designated enterprise project to receive certification that the applicant has met the criteria making it eligible for file for benefits. The application is to be filed with the Office of the Governor, Enterprise Zone Program and must be accompanied with a non-refundable check for $500. Required back-up documents include: ○ Verification of Zone Resident Status ○ Verification of Economically Disadvantaged status ○ Qualified Business Recertification forms ○ Documentation of "Contribution to Community" ○ Copy of Power of Attorney (if required) ○ Spreadsheet of qualified jobs	5
Benefits Forms	
• **Enterprise or Defense Readjustment Project Claim for Refund of State Sales and Use Tax** To be filled out by enterprise project and filed with the Comptroller's Office. Sales tax refund is $2,000 per job for enterprise projects. Refund only applies to state sales taxes.	1

Texas Skills Development Fund Forms

Application Forms	
• **Proposal Submission Form** Application is made to the Texas Workforce Commission per requirements set in the Texas Labor Code, Chapter 36.	6
• **Private Partner Information Form** A separate form must be completed for each private partner participating in the proposed project. Information must include title of each occupation, standard occupational classification, hourly wage range, and the number of new workers receiving training.	5
• **Curricula and Budget Management Forms.** The applicant must report all training courses by category, training hours, and administrative and direct program costs for the propose project. Separate forms include: ○ Business Technical Training Curricula and Direct Training Cost Detail: Program Services ○ General Technical Training Curricula and Direct Training Cost Detail: Program Services ○ Non Technical Training Curricula and Direct Training Cost Detail: Program Services ○ Training Curricula and Direct Training Cost Detail Summary ○ Equipment Purchases ○ Curricula & Budget Management Form	14
• **Local Workforce Development Board Review and Comment Form** This form must be completed and signed by the Local Workforce Development Board in the workforce area where project participants will be employed at the completion of the training project.	1
• **Signed Agreement Between the Applicant and Private Partner** This agreement must outline each entity's roles and responsibilities if a grant is awarded and must be included as an appendix to the Proposal Submission Form	1

Fallacies of Incentive Evaluation #1: Taxpayer Benefit = Public Cost

This is fallacy stems from the assumption that a project receiving a benefit would have located in Texas whether a benefit was offered or not. Consequently any benefit is a gift to a company that is a direct cost to the government offering it.

Companies typically consider a number of states before narrowing their options to a short list of prospect locations. States and local governments may offer a package of incentives—the largest part of which is typically a discount the company may receive against their tax liability that would normally be due.

In fact, a tax discount is no different from the price discount a retailer offers a customer for an item "on sale." The discount is offered to encourage the customer to purchase an item from the retailer—just like a tax discount may be offered to a company to encourage them to locate in the state.

The true direct net cost/benefit to a government resulting from a project is:

Net taxes paid by the project (i.e. gross taxes paid less incentives received)

Minus: *Cost of additional public services resulting from the project.*

This is analogous to the retailer, who may offer a sales discount but still sell an item at a price that ensures they will cover their operating costs and make a profit.

In the case of a tax discount, the greater the value of the discount to the taxpayer often means the greater the potential tax gain to the taxing jurisdiction once the incentive expires. So in fact, a greater discount can yield a greater eventual <u>GAIN</u> to the taxing jurisdiction.

Fallacies of Incentive Evaluation #2: The Higher the Ratio of *Taxpayer Benefit per Job Created,* the More "Expensive" the Project

The higher the measure of the *taxpayer benefit per job created* is at best a measure of how capital intensive a project may be, but is otherwise meaningless.

For example, consider two projects that would both be eligible for a Chapter 313 school tax value limitation, both of which would create 1,000 new jobs. With their value temporarily capped at $100 million (for 10 years) Company A would save $501 million in property taxes over ten years, or $51,000 for each job created during the year the limit was in place." A $100 million value cap would save Company B $94 million in property taxes over ten years, or $9,400 per job per job for each year the benefit is in place. Since both create the same number of jobs, Company B may be thought to be the better project because it seeks a lower benefit

This simple analysis misses a number of critical points. It ignores the investment associated with each project, the taxes that will be paid once the benefit expires, and the life span on the project. In fact, Company A would be far more lucrative for the taxing jurisdiction because it will place more property on the tax rolls and pay much more in taxes than Company B. Further, Company A would be paying taxes for 30 years, not the 20 years of Company B.

This clearly demonstrates that the higher the taxpayer benefit, the greater the eventual benefit to the taxing jurisdiction.

Factor	**Company A**	**Company B**
Jobs Created	1,000	1,000
Chapter 313 Benefit per job per year of benefit	**$51,000**	**$9,400**
Investment (Property Tax Base)	$5 billion	$1 billion
Annual School M&O Taxes Due During Incentive Period (10 years)	$1.0 million	$1.0 million
Annual School M&O Taxes Due After Incentives Expire	$51 million	$10.4 million
Life of the Project	30 years	20 years
Total Net Taxes Paid Over Project Life	**$1.05 billion**	**$114 million**

Fallacies of Incentive Evaluation #3: The "Best Deal" is the Best Deal

Acme Manufacturing is looking to build a new, state-of-the art $1.5 billion dollar project. The plant will also hold an average inventory of raw materials and finished product worth $0.5 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 that offers the lowest property taxes will get the project.

Pennsylvania offers 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 package of $125 million. Texas confidently steps up to the plate and tells Acme that its ten year package is worth a whopping $315 million (see the green colored row below). Acme's number crunchers go to work and announce 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.** Texas was at a disadvantage because our tax local property tax rates are much higher than Pennsylvania and Alabama. Texas' property tax base is much larger, as well. Texas' property tax applies to business inventories, which are exempt in both Pennsylvania and Alabama. Pennsylvania also exempts business personal property—machinery, equipment, etc., so its property tax base is much narrower. In the case of property tax abatements, they amount to tax relief. Alabama and Pennsylvania offered less property tax relief because their property taxes are not as burdensome as Texas'. Further, the value of Texas' abatement was actually less than advertised, because school districts typically require the taxpayer share their benefits with the district. When Acme looked at the actual taxes they would be liable for, **Texas was the highest costing tax state**!

Item	Project Description	Taxable Value		
		Pennsylvania	Alabama	Texas
Land Value	**$100**	100	100	**100**
Plant	**$1,000**	1,000	1,000	**1,000**
Equipment	**$400**	Exempt	400	**400**
Total Investment Value (subject to tax)	**$1,500**	$1,100	$1,500	**$1,500**
Inventories	**$500**	Exempt	Exempt	**400**
Total Property at Site	**$2,000**	$1,100	$1,500	**$2,000**
Average Tax Rate per $100		$1.25	$1.25	**$2.40**
Project Life	**25 yrs**	25	25	**25**
Gross Property Taxes, Life of Project		$344	$488	**$1,200**
Reduction from Incentive		($75)	($125)	**($315)**
Supplemental Payments to Schools		0	0	**$54**
Net Obligation		$269	$363	**$939**

A Matrix for Evaluating Incentives and Projects

Projects seeking incentives should provide some type of benefit to the state, be it:

- economic,
- fiscal, or
- intangible.

In evaluating those incentives, the state should look not just to the **operational** period of the project, but also the impact of **construction**. Further, the state should consider the **ancillary** (indirect and induced) economic impacts of the project. In evaluating the "cost" of a project, the state should look at the cost of providing public services to the project and the population it attracts.

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