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Incentive Competition: Why Is It So Difficult to Control?

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Much of the popular debate over economic development incentives has focused on the much-publicized deals that states have negotiated in attempting to attract major new industrial facilities, particularly automobile plants. Many economists, public policy analysts, and community activists have called for an end to such "firm-specific incentives." In 1995, for example, a group of over 100 economists and others issued a press release calling for an end to "targeted business incentive programs" (though they favored statewide business tax relief). Others have proposed banning the use of federal funds to underwrite competition. There have been frequent calls for states to enact truces, and multi-state agreements to cease bidding for firms have actually taken place, though the results so far have not been promising.

Often lost in this debate is a recognition of the importance of more broadly based investment or jobs incentives, and indeed the importance of the basic state and local business tax structure, in determining the profitability of alternative locations. To illustrate the range of taxes and incentives that can play a role plant location, consider a "deal" that took place in Iowa in 1994. IPSCO steel corporation, which had been negotiating with several states regarding the location of a new steel mill, was offered a \$75.6 million package of incentives by the State of Iowa. The package included several incentives created especially for IPSCO: a complete exemption from property taxes on all manufacturing machinery and equipment, exemption from sales tax on construction materials, and a 10% investment tax credit. The package also contained incentives from programs that were already in existence (including a \$1.5 million grant from a state program to build access roads, a \$1 million forgivable loan, and a \$1.2 million job training agreement with the local community college), and creation of an economic development TIF (Tax Increment Financing) district that would divert property taxes on the plant to retire bonds issued to pay for plant construction.

This is not the end of the story. The county government agreed to cover about \$1.5 million in additional infrastructure costs, and IPSCO also benefited from the New Jobs Tax Credit program, providing corporate income tax credits based on the 300 new jobs promised. Furthermore, the company's bottom line was undoubtedly enhanced by Iowa's corporate income tax system which, despite a high 12% marginal tax rate, imposes very low taxes on corporations such as IPSCO that export most of their output. This occurs through the use of single-factor apportionment, where a firm's total U.S. profits are apportioned to Iowa solely according to the percentage of total sales that are destined for Iowa.

This incentive package illustrates the whole range of economic development incentives offered to expanding and relocating firms in the U.S. One could organize these incentives into five classes, from the most specific to the most general:

- A. One-time deals negotiated with a specific firm, such as the property tax exemption granted exclusively for IPSCO or an agreement to finance road access to a site.
- B. Grants and loans provided under programs that receive annual state appropriations, where the firm must apply for funding.
- C. Programs that require no explicit funding and that allow a degree of local government discretion. This would include property tax abatements in some places (where the abatement is discretionary).

or the abatement schedule can vary) and TIF districts.

- D. Tax incentives for new investment that function as automatic entitlements: investment tax credits or jobs tax credits under the state corporate income tax, and local property tax abatements in many places.
- E. Features of the tax code that apply to every corporation, but that benefit some more than others and that are often advertised by economic development agencies as reasons to locate in that state. Examples are single-factor apportionment, exemption of inventories from property taxation, and exemption of fuel and utilities from the sales tax.

Critics of incentive competition are usually referring to firm-specific incentives; that is those of type A or B, and possibly C. Is it important to consider incentive competition more broadly? What would be the consequences of focusing restrictions only on the more narrow, firm-specific incentives? It is these questions that we address here.

Trends in the Use of Broad-based Incentives

Our recent research has focused on incentives of type C, D and E: tax exemptions and credits and features of the basic state-local tax system. We developed a model that simulates state and local tax systems and how they affect returns on investment in new manufacturing plants for firms representative of 16 manufacturing sectors. We examined twenty states for the period 1990 through 1998, states that include most of the top states in terms of manufacturing employment. Fifteen of the twenty enacted reductions in the basic corporate income or business sales tax system between 1990 and 1998. The most common change was a movement towards greater reliance on the sales factor in state income tax apportionment formulas. Fourteen states adopted new general incentive programs or made existing programs more attractive; eight states adopted new targeted programs (such as enterprise zones) or made existing programs more generous. Only six states increased any basic tax rates and in three of these the increases were offset by other tax reductions. Only three states tightened or scaled back general incentive programs; another three discontinued incentive programs but replaced them with others, typically more generous. Thus, the overall trend, even in this period of economic expansion and low unemployment, has been overwhelmingly to reduce basic taxes on corporations and to enact or expand both general and targeted incentives for new business investment.

The importance of these tax changes can best be measured by their effect on the overall state-local tax rate on new investment, measured as the reduction in cash flow caused by taxes divided by the pre-tax income generated by the new plant. The median basic tax rate among these 20 states, assuming an average local tax system for each state, was reduced from 8.5% in 1990 to 7.9% in 1998; larger reductions in the median effective tax rate occurred when incentives were added (from 6.3% to 4.9%).

If we focus only on state corporate income taxes, we find another trend in the 1990s: increasingly it has become possible for new investment to face negative income tax rates. This occurs when the incentives exceed the additional tax liability produced by the new plant. In 1990, negative income tax rates were easily produced in three states. By 1998, negative tax rates were common (that is, they were produced in 4 or more of the 16 sectors we simulated) in eleven of the twenty states modeled.

Our simulation model also shows that sectoral targeting is implicit in many state and local tax systems and incentive programs. There is substantial variation among firms even within the manufacturing sector with respect to asset composition (the relative importance of working capital, plant and land, machinery and equipment, and inventories) and cost structure (the share of costs accounted for by wages or energy, the average wage level). As a result, there is wide variation in tax burdens across industries for any given location. States that rely heavily on local property tax financing for provision of local services will have lighter corporate income and sales tax burdens and higher property tax rates, which will advantage firms with high profit rates and disadvantage firms with a high proportion of real property (plant and equipment) in their asset base. Similarly, a sales tax exemption for fuel and electricity could be worth several times as much to an energy-intensive manufacturer as to the average manufacturing establishment.

We have found, for example, that the exemption of machinery & equipment from the sales tax represented a savings of 17% of total state-local taxes for an auto firm, but only 9.4% for an instrument manufacturer, while the exemption of fuel and electricity was worth 1.2% of taxes for a large drug firm but 6.6% for a small plastics company. Exemption of inventories from the property tax was worth twice as much to the large instruments manufacturer as to the large drug firm. By locating in a state where real property is taxed but all personal property is exempt by statute, a firm will earn a higher after-tax return on investment than in another state that taxes personal property but that advertises a local exemption for machinery and equipment.

Returning to the IPSCO steel example, the property tax exemption for machinery and equipment was a "firm-specific incentive" originally. But it subsequently was extended to all manufacturers. Is it still an incentive? Should Iowa be prohibited from such an incentive, which is now targeted to all manufacturers, when Pennsylvania has always exempted all personal property simply because it taxes only real estate?

What Would Happen if Special Deals or Targeted Incentives were Prohibited?

If the federal government were to succeed in ending the firm-specific deals, would the outcome be more less tax competition and less erosion of the tax base? There is reason to be skeptical. States and localities are very likely to respond to such prohibitions by exercising their ingenuity in devising other ways of providing indirect subsidies to particular firms; the provision of free infrastructure and other free services would very likely become commonplace. It would be very difficult to monitor such activities or to define a practice that could feasibly be prohibited, since much infrastructure is already provided free in many places.

Secondly, states may respond to such prohibitions by granting tax breaks to all firms instead of only to particular firms. This has already been happening. A major tax concession granted in the heat of battle to one firm, becomes a politically contentious issue when other firms, long-time fixtures in the local economic landscape, demand equal treatment. The solution is to extend the tax break to all manufacturing firms. The firm-specific incentive has been exchanged for a sector-wide incentive. This process could be accelerated if firm-specific deals were ended. If so, the loss of state revenues and the erosion of financial support for schools and infrastructure and social services would end up being much greater than it would have been if we had let the states make deals with individual firms.

The point is this: it is very difficult to define precisely what a firm specific or targeted incentive is. Even the special deals for IPSCO were granted to "any firm" that located in a new kind of enterprise zone between two dates in 1994. It was meant to be a firm-specific deal that didn't sound like one. If we cannot define what we wish to prohibit, we will merely change the form of incentives or the degree of targeting. It will push us in the direction of more broadly based tax reductions.

While broad-based tax reductions on business appeal to many economists, many community activists and other critics of incentives argue that they are inefficient precisely because they are too widely available: they are given to many firms whose location decisions were unaffected by the incentive. They propose that state and local economic development incentives should be negotiated on a firm-by-firm basis, not made entitlements to a broad class of firms.

The array of choices open to state and local governments to reduce the tax burden on new business investment is too wide to define a subset that constitutes an unacceptable competitive practice. We cannot mandate a certain tax structure, by requiring all states to tax personal property, for example, or to apply the sales tax to manufacturing machinery, or to finance all local government services with the property tax. Since we can't do that, how can we prohibit property or sales tax exemptions for manufacturers in states that do generally tax these things, on the grounds that they are targeted incentives, while other states do not tax them to begin with? And if we define a narrower set of prohibited practices, say only ones that are specific to a firm, we will probably induce localities to give away more tax revenue, not less.

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