Local Economic Development - Competition and the Industrial Revenue Bond

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Local economic development is a key component of the role of municipal government. “Local economic development is a process by which local governments manage resources to stimulate private investment opportunities in order to generate new jobs and taxes” (Falk, 25). “Because economic development creates jobs, tax revenues, and wealth, and because the benefits of a vibrant local economy are shared by everyone, it is in the interests of cities to pursue growth” (Goetz, 86). In the pursuit of these shared benefits, cities have developed a package of business incentives in order to create a positive business climate that would entice new businesses to locate in the community or for the expansion of current businesses.

The pursuit of economic development is an ongoing process as cities and governments compete for ever more mobile businesses. This mobility has created a race to the bottom between communities in their efforts to expand the tax base to pay for the increasing costs of city services. With this external competition comes internal competition. “Economic disparities also increased between central cities and their suburbs. These contrasting patterns of growth and decline were often reflected in economic development struggles over downtown versus neighborhoods, economic development as job generation versus real estate development, and the rich and powerful versus the poor and marginalized” (Krumholz, 83). The overriding goal of creating jobs, equalizing economic prosperity, and expanding the tax base is the “public purpose” of economic development policies, but who actually benefits from the incentives is unclear.

The development of sound economic development policy should include several components. These components would be “data gathering and analysis; selecting local development goals, strategies, and criteria; selecting local development projects; building
action plans and analyzing financial alternatives; specifying feasibility and project
details; preparing the overall development plan; and scheduling its implementation”
(Krumholz, 83). Unfortunately, few if any of these steps are actually carried out by
policy makers. The lure of large development projects to show the voters usually
overrides the rational decision making process that should be in place when developing
an economic growth policy. Krumholz tells us that, “surveys find that practitioners spend
most of their time not on research and analysis, but on public relations, marketing,
advertising, and sales. Leadership is provided by private developers or real estate
entrepreneurs seeking their own objectives, rather than public officials and citizens
seeking public objectives” (84).

The ability of economic development policy to actually deliver on the promises of
increasing jobs and an expanding the tax base has not been supported by the evidence.
Most of the research that has been done is empirical studies of local economic
development or a state-wide review of economic development policy. In either case, the
evidence shows that economic development policy is usually reduced to a zero-sum game
in which one community is taking jobs and capital from another. Because of this and
other factors, the ability of economic development policy to actually provide public
benefit is questionable, at best. A study done by Margery Ambrosius on the efficacy of
state-wide economic development policy showed that “none of the [economic
development] policies had a demonstrable effect on…the economic health of the state”
(289). While there could be localized differences of the efficacy of economic
development policy, based on the empirical evidence, I believe that these same results
would hold up at the local level as well.
Because of the zero-sum nature of economic development policies, cities compete to offer the most generous development package that they can create to lure the companies into relocating. Unfortunately, the reality of this competition is that businesses have an asymmetrical information relationship with the cities that are trying to lure them. This disparity is based on the fact that only that business “knows” how much it actually will cost to relocate or to expand. In fact, “a large body of empirical evidence supports the proposition that state and local governments’ economic development policies have less influence on firms’ location and investment decisions than economic variables such as available markets, characteristics of the labor force, and other direct costs of production” (Feiock, 643).

Should cities spend millions of dollars on economic development policies that do not work? Richard Feiock believes that the case that economic development policies are ineffective “often overlook the fact that government policies may stimulate economic development indirectly through their contribution to a community’s overall business climate and by focusing attention on investment opportunities that would otherwise go unnoticed” (645). More studies need to be completed that can capture a more accurate assessment of the level of impact that local incentives might have on the local economy. Spillover effects from local economic development also need further study to gauge their impact as well.

Since the efficacy of economic development incentives can not show actual direct benefit, why pursue them? Besides the promises of jobs and an expanded tax base, the first answer I have already discussed, the zero-sum game. A community cannot afford to have perceived losses in its economic base because of a neighboring community’s
incentive package. This race to the bottom compels localities to try and offer the most attractive incentive package it can, even if the company does not need it. This is reflected in the prisoner’s dilemma in game theory (Nunn, 575). The second answer is political. Because of the short time horizons for elected officials, being able to tout a new development deal or the potential of job growth is essential to the political planning for re-election. With these two reasons, the best package of incentives usually includes tax abatement as the centerpiece of economic development.

“According to an International City Management Association analysis of successful economic development programs, tax abatement strategies are perceived by many city planners and administrators as powerful instruments for business development. At the start of the 1980’s, 26 states authorized the use of tax exemptions and abatements to attract new industry and businesses” (Nunn, 574). Now, most states, and under home rule thousands of municipalities, are offering an assortment of tax abatements to attract and retain businesses and industries within their jurisdictions (Nunn, 574). As more governments offer tax abatements under an economic development policy, there has developed some criteria that seem to be standard practice. These criteria include:

1) Existence of Economic Benefit: Evaluation of the project’s economic benefit may include, but not be limited to the amount of capital investment, whether the project produces value-added products and services, and whether the project provides a positive fiscal impact and economic impact (City of Olathe)

This statement is a key performance measure for the community. This requires that the company provide the City with information that can show not only positive economic impact in the form of jobs and new industry, but also positive fiscal impact in the form of an expanded tax base.
2) Type of Business: The project must be identified as desirable to stimulate the local economy and improve the quality of life for its citizens. (City of Olathe)

This criterion is part of the effort that communities are making to diversify their local economies. As the Rust Belt cities learned, dependence on one type of industry can prove disastrous if the economy shifts away from that industry or if new, cheaper producers can be found. This criterion also shows the commitment of economic development policy to be linked to the public good.

3) Level of Incentive: The type of project/jobs should determine how much tax to abate or development incentive to offer. (City of Olathe)

This criterion has been developed to try to tie economic and fiscal growth to actual performance on the part of the company receiving benefits. This is direct response to the problems that researchers noted when trying to calculate the actual benefits provided by economic development policies.

4) Maintain Existing Tax Base: Assistance will be given to new industries that invest in new buildings, building expansion, or acquire new machinery and equipment, but the amount of property taxes or special assessments on the existing land and facilities shall not be reduced for new development projects. (City of Olathe)

This criterion is recognition that in order to produce a net fiscal gain, the city needs to ensure that businesses are not just “shuffling the deck” by moving from one part of the city to another. This also acknowledges that the city needs to try and protect the businesses that are currently in place. By offering incentives, the city is, in fact, interfering with the market and changing the cost of doing business. In a highly competitive industry, these changes to costs can put some businesses at a disadvantage. If an existing business closes or moves due to incentives to a new competitor, this will have a net negative impact on the economic and fiscal position of the city. These and
other criteria such as location requirements, wage requirements, and length of incentives are designed to guide policy makers when offering incentives.

Tax abatement incentives take on a variety of forms - tax increment financing (TIF), transportation development districts (TDD), industrial revenue bonds (IRB) and non-profit corporate revenue bonds. Tax abatement policies are popular among political actors because “tax abatements allow city officials to actively support economic development without an apparent diversion of budgeted funds from other local government services. This creates the perception that property tax exemptions to business are largely costless” (Nunn, 574). Abatements also largely remove the public from the economic development process. Citizens usually have little to no input in economic development policy or how abatements are utilized. This is problematic since tax abatements can be considered a form of a tax increase because the costs are shifted to current payers who did not receive abatement. One form of abatement that seems to have less controversy and costs to the city is the industrial revenue bond.

The industrial revenue bond is a form of tax abatement that cities provide to businesses to help them gain favorable rates in the capital bond markets. Industrial revenue bonds are a private activity bond. This is because the debt that is issued is used to finance the private business activities of the company. This is different than the TIF or TDD bond because no direct city revenues are used to pay off this debt. This debt is privately held and it is the responsibility of the business to pay off the debt as agreed. These bonds have very limited uses. Generally, they must be used for a state-sanctioned manufacturing or industrial purpose. End-use retail (point-of-sale businesses such as Wal-Mart) cannot use industrial revenue bonds except to exempt certain sales taxes on
purchases for expansion or construction. Property taxes cannot be exempted by these types of businesses.

When the business wants to use industrial revenue bonds, what it is requesting from the city is a tax-exempt status. It achieves this status because the city becomes the owner of the property. The site is then leased back to the business for its use. When the city takes over the ownership of the property, it is no longer assessed on the tax rolls. This exempts the business from paying property taxes on the land to the city and other taxing jurisdictions, it does not pay sales tax for items purchased for the use of the facility, nor does it pay federal tax on the interest that is earned on the debt. The business can actually get a tax credit for that interest from the federal government. This tax relief displaces the costs of the incentives largely to the federal government as it is the biggest loser from the exempt status (Rasmussen, 19).

Congress passed the Tax Reform Act of 1986 in response to the rapid increase of tax-exempt bond issuance. “The Treasury estimated that the revenue loss from tax-exempt debt increased fourfold (to $16.4 billion) between 1976 and 1984” (Aronson, 400). Even with these new restrictions, the amount of bonds allowed is over $200 million annually and varies depending on the state of issue. These restrictions have done little to change the use of industrial revenue bonds by cities and mainly impact state use of the bonds.

The abatement that is offered to businesses can be up to 100 percent of the property taxes, but usually the figure is around 50 to 65 percent. This exemption is limited to a ten year period, even if the debt that is financed through industrial revenue bonds is for a longer period. For the use of an expansion of a business, the property tax is
frozen at its current assessed level, but any potential increases in the assessed value due to expansion are then exempted as well as the standard re-assessment of the property.

Another aspect of industrial revenue bonds that reduces the impact to the local taxing jurisdictions is the PILOT payment. PILOT (payment in lieu of taxes) allows for the recovery of some of the lost property tax and sales tax revenue over the 10 year period of the abatement. This payment is calculated based on the starting property tax rate and sales tax rate and then is graduated over the next 10 years. This graduated payment system allows the business to pay the PILOT over time rather than a large lump sum at the beginning. It also provides a schedule of payments that the taxing jurisdictions can count on when they are in their budget cycles. Even with the PILOT, the savings from industrial revenue bonds can be significant.

A case study in the use of industrial revenue bonds would be a new hotel project in Bonner Springs, KS. The project was to spur development along the I-70 corridor to take advantage of the neighboring economic re-development in Kansas City, KS. The use of public bonds to finance a new race track and retail development center has provided an influx of visitors and revenues to Kansas City, KS. As a neighboring jurisdiction on the main route into the area, Bonner Springs can use its location to capture some of that growth. A national hotel chain approached the city in order to get development incentives for a new location in Bonner Springs. The State of Kansas has designated hotels as an industry because of the transition nature of the business. Because of this designation, one of the incentives that the city offered the hotel is industrial revenue bonds.
The process of applying for and receiving the abatement is usually takes about 90 days. The hotel makes an official application to the city. The level of the abatement requested was 50 percent of the property taxes and tax-exempt status on the purchase of equipment and furniture used for the construction and furnishing of the hotel. This application requires specific information from the business, such as the number of people to be employed, the estimated revenues to be generated, and even the where the construction crews for the project will be hired from. This helped the city to determine if there could be a positive economic impact. Because of the questionnaire, most businesses receiving IRB in Kansas will hire a large percentage of the contractor work locally. The downside is usually that the higher paid, management level position are filled from outside the city. Also, the city has no enforcement mechanism besides denial if the company does not utilize local workers.

After the application and questionnaire was submitted, the city was required by the state to do a cost-benefit analysis on the project. The Kansas Department of Revenue supplied the projected tax revenue figures in order for the city to generate a PILOT payment schedule. Using the figures from the company and the state, the PILOT was calculated on a graduated scale, usually starting at a 95 percent abatement for year 1 and ending with a 5 percent abatement at year 10. The cost-benefit analysis is shown in Figure 1 in Appendix A. Even with the PILOT payment, the amount of savings that the company receives is significant. The PILOT payment is then distributed among all of the local taxing jurisdictions.

Once the PILOT is agreed to, the state law requires that the City Council express its intent to issues industrial revenue bonds. This gives all of the other taxing
jurisdictions an opportunity to voice concern as well as any citizen. Because of the PILOT payment, the other taxing jurisdictions usually do not object to the bonds, though they could request additional payment within the PILOT that would have to be negotiated. Once a business accepts the offer, the Council holds a public meeting to pass an ordinance to authorize the bonds (since the property is technically City property) and the debt is issued. This meeting is the second and final opportunity for the public to express their opinion about the deal.

Economic development policy is a component of all local governments. Competition for jobs, expanding tax base, and a highly mobile economy forces local governments to offer more and more incentives to lure and retain key businesses and industries. Unfortunately, many localities do not have the capacity to adequately evaluate the effectiveness or the true costs of these incentives. Studies have shown that the impact of economic development incentives has a minor, indirect impact on the decision making process for the business. Furthermore, the tax revenues that are forgone may actually account for a net negative fiscal and economic impact on the locality. Even if the locality negotiates clawback agreements and performance metrics within the development agreements, most do not have the ability or motivation to enforce them.

Industrial revenue bonds provide an example of this type of incentive. Unlike TIFs or TDDs, these incentives do not require any city revenues to re-pay debt. This makes this type of incentive “safer” for municipalities to offer. The displacement of costs to the federal government and PILOT payments offer cities the ability to offset some of the lost revenues and costs of this incentive. But with all economic incentive packages, there are costs are ultimately paid by the tax payer.
### Appendix A

#### Figure 1.

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<th>Description</th>
<th>Amount</th>
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<td>Total Tax to be Collected</td>
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<tr>
<td>Estimated PILOT Payment</td>
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<td>Estimated Savings with IRB</td>
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<td>Estimated Sales Tax Savings</td>
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<td>Subtotal Estimated Savings</td>
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<td>Less Total Fees</td>
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<tr>
<td><strong>Total Savings</strong></td>
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References


