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Are local property tax breaks for businesses and nonprofits broken?

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On November 30, 2012, the Federal Reserve Bank of Chicago, Metropolis Strategies, and the Civic Federation held a workshop to explore the role of property tax incentives in supporting business growth, as well as the tax treatment of properties owned by nonprofits.

Some materials presented at the workshop are available at www.chicagofed.org/webpages/events/2012/property_tax.cfm.

Local governments increasingly find themselves caught in a vise. On the one hand, they want to stimulate economic development by attracting (and retaining) businesses, often through the use of property tax incentives. On the other hand, they grow concerned about the erosion of their tax base as the number of property tax incentives for businesses—as well as the amount of properties owned by tax-exempt nonprofits—increases. Government officials, business owners, nonprofit leaders, and researchers gathered at the workshop to discuss these and related issues affecting local economic growth and tax revenues.

Role of business property tax incentives

Daphne Kenyon, Lincoln Institute of Land Policy, presented her recent report on property tax incentives offered by state and local governments to entice businesses to move to (or stay in) their jurisdictions.[1] Kenyon noted the continued growth in the use of three major types of incentives: 1) tax abatements, which offer a full or partial reduction in property tax liability for industrial and commercial real estate over a temporary period (most commonly, a decade); 2) tax increment financing, or TIF, which involves earmarking future property tax revenue gains to subsidize current improvements (often in designated blighted geographic areas); and 3) enterprise zones, which are designated economically depressed areas in which tax and regulatory relief is offered to entrepreneurs and investors to encourage business development. In 2010, 37 states allowed tax abatements, 49 permitted TIF programs, and 42 authorized enterprise zones.[2] Kenyon questioned the effectiveness of these incentives in developing business activity, noting that property taxes tend to account for a very small share of the total costs for most businesses. On average, property taxes equal 0.3% of total costs (for a manufacturer), whereas labor costs equal 21.8%.[3] That said, property tax incentives can be an effective means to draw businesses into specific parts of a metropolitan area. By altering the relative costs of running a business within a metro region, these incentives can influence business location. Kenyon explained, however, that copycat behavior by neighboring states and jurisdictions often reduces the effectiveness of offering incentives to induce business investment.

According to Kenyon, the use of these incentives lacks transparency and independent evaluation. While 44 states produce tax expenditure reports, only 18 include property taxes—with merely eight estimating forgone local property tax revenues due to incentives.[4] To highlight the importance of independent evaluation, Kenyon cited two reviews of Minnesota's Job Opportunity Building

Zone (JOBZ) program. The state agency's report stated that about 5,500 jobs had been created by the JOBZ initiative; in contrast, an independent evaluation later found that the number was closer to 1,000, at a cost that was about five times greater than the agency's estimate.

Given such concerns, Kenyon recommended alternative strategies, local policy reforms, and state policy reforms. Her favored alternatives involved several nontax policies, such as job training customized to individual firms' specifications, labor market intermediaries (programs that help workers match with firms), and regulatory assistance (to help resolve problems with state or federal agencies). Kenyon's other nontax policies included business incubators for start-ups and business improvement districts, where property owners agree to pay for expanded public services, such as more police patrols and street cleaning, which may raise property values.

For local governments, Kenyon suggested five policy reforms. First, local governments should set explicit criteria for granting incentives that account for not only the probability of the firms locating elsewhere with or without the incentives, but also the impact that successfully drawing the firms to their jurisdictions will have on local fiscal health. Second, they should limit incentives to firms that export goods and services out of the region, since such firms create greater economic value for local areas than nonexporting firms (like retailers). Third, they should limit the number or the total dollar value of incentives, treating them more like direct expenditures subject to annual appropriations, which would make granting incentives more selective. Fourth, they should use an open process for deciding on incentives, involving not only politicians and economic development officials but also tax administrators and taxpayer groups, to better ensure forgone tax revenues do not outweigh potential economic benefits. And finally, they should use incentives in cooperation with other local governments to prevent inefficient bidding wars for business investment.

Kenyon argued that state-level policy should limit the number of local governments permitted to use property tax incentives for businesses and restrict the use of such incentives to communities with the greatest need. Additionally, Kenyon contended states should require these tax incentives be approved by all affected governments (e.g., those of the municipality, county, school district, and special-purpose district)—and not by just the government offering the incentives.

> Because local tax bases remain stressed, property tax incentives for businesses and the tax treatment of nonprofits' properties will remain prominent in public policy discussions.

In line with Kenyon's analysis, Richard Dye, Institute of Government & Public Affairs at the University of Illinois, said that a key problem with property tax incentives is the inability of governments (and independent third parties) to measure their effectiveness because of a lack of sharply defined goals. Dye suggested that as a starting point, each community should establish what it has to offer to businesses and what it wants from business development.

Dye explained that TIF strategies often produce hidden debt, taxes, and governance. For example, while the incremental property tax revenues produced by a TIF program should be used for economic development, they also can be shifted to other budgetary needs. In addition, TIF and other incentives can provide public aid to economic development that would have occurred anyway. Dye argued for more rigorous analysis to ensure that incentives are only granted in cases where business investments would not have otherwise occurred. Finally, Dye warned of "incentive creep," i.e., firms expecting or demanding tax incentives beyond the initial property tax incentive granted.

William Stafford, who serves as chief financial officer of the Evanston Township High School District 202 in Illinois, agreed that the tools for evaluating the effectiveness of providing business property tax incentives could be better, and argued that state governments are the most appropriate parties to improve these tools. As Stafford pointed out, some communities lack the financial tools to do sophisticated pro forma analysis, particularly if strategies affecting multiple taxes are involved. In addition, some local governments lack the capabilities to do credit and risk analyses and to structure "clawback" provisions if economic development targets are not met by the businesses granted incentives.

Moreover, Stafford countered many traditional notions about the use of property tax incentives to draw businesses. First, in response to the negative views on TIF, he highlighted Evanston, where four TIF developments were used. All four led to significant incremental increases in tax revenues; and the ones that matured came back on the general tax rolls, providing significant new revenues to the school district and other governments. Second, he questioned whether policy should restrict the use of such incentives to low-income communities. He contended that developers require a vibrant market before making investments and that business property tax incentives will often not be large enough to generate investments in communities lacking good market conditions. Similarly, he questioned the wisdom of limiting these incentives to only manufacturing and other export firms, since retailers make up such a large segment of the business base of most communities. Finally, Stafford pointed out that most communities in Illinois are classified by state law as non-home-rule, meaning that their municipal legislative authority, including their ability to adopt local taxes, is limited by the state. Given such limitations, Stafford said he is against states placing restrictions on non-home-rule communities' use of property tax incentives for businesses, since doing so hinders their ability to manage their own economic development.

Thomas Cafcas, Good Jobs First, noted some recurring problems in using property tax incentives to spur economic development. For instance, many local development strategies are not well targeted because localities often favor large firms; indeed, small firms usually lack the economic clout to get business property tax incentives, although their business investment could also help local economic development. Additionally, the provision of tax incentives frequently amounts to a zero-sum game, where jobs and economic activity are simply reallocated from one location to another without creating new value. Finally, Cafcas also pointed out the lack of fiscal transparency and systematic evaluation of outcomes from offering such incentives.

Cafcas suggested several remedies to these problems. First, he endorsed collaboration among communities in these matters. For example, early warning systems should be created to alert communities in proximity of one another about firms possibly relocating; such systems would also allow communities to focus on retaining current businesses. Second, he encouraged greater online disclosure of incentive awards and outcomes. Good Jobs First has created a database tracking the use of incentives, but Cafcas argued that broad disclosures by local governments and firms themselves would benefit everyone. More specifically, when incentives are given, local governments and firms should report the resulting job creation, including information on wages and benefits of new employees (relative to the market) and the ability for jobs to be maintained over the subsidy period (and beyond). All the disclosed results should be verified independently. Finally, Cafcas said that the cost of incentives should be printed on local property tax bills and that neighboring jurisdictions should work toward producing a unified economic development budget to avoid bidding wars and eliminate redundant efforts.

Tax treatment of nonprofits' properties

Kenyon presented her other recent research, which analyzes payments in lieu of taxes (PILOTs) voluntarily made by tax-exempt private nonprofit organizations.[5] This research surveys the wide range of tax-exempt nonprofits, including universities and hospitals, that make PILOTs to their local governments and describes the terms under which the contributions are negotiated. Kenyon noted that interest in PILOTs has become heightened since the early 1990s on account of growing revenue pressures on municipalities (particularly those with significant amounts of tax-exempt properties within their borders) and increasing scrutiny of the nonprofit sector. In addition, *Governing* magazine reports that compared with five years earlier, the assessed value of tax-exempt properties makes up a higher share of the assessed value of all taxable and tax-exempt properties combined (for either 2011 or 2012) in 16 of the 20 most populous U.S. cities with available data; however, this share's variation from city to city is quite large today.[6]

Among nonprofits making PILOTs, higher education and health care organizations lead the pack, Kenyon said; combined, these two types of organizations account for 46% of all nonprofits making PILOTs. Additionally, the postsecondary education and health care sectors account for 92% of all PILOT revenues—with universities and colleges alone contributing over two-thirds of all such revenues. That said, Kenyon stressed that PILOT revenues typically form a very small share of the general revenues of localities collecting them. Of the ten communities receiving the most PILOT revenues in recent years, seven of them received nearly 1% or less of their general revenues from PILOTs.[7]

Kenyon presented arguments both in favor and against PILOTs. In support of PILOTs, some might argue that nonprofits should pay for the public services they consume. Indeed, some say that PILOTs help address the imprecise nature of a nonprofit subsidy, i.e., when its value is not directly related to the fiscal impact that the nonprofit places on the municipality. The arguments against PILOTs include the following:

- PILOTs might lead nonprofits to raise fees or cut services.
- Given that PILOTs are often negotiated, they can be a limited and unreliable revenue source.
- PILOTs are often ad hoc, secretive, and contentious.
- Inequities may arise when similar institutions negotiate different PILOTs.

In conclusion, Kenyon offered three alternatives to PILOTs for communities interested in raising revenues from nonprofits—namely, user fees, special assessments, and municipal service fees. User fees are fees that may be charged to nonprofits for services such as water, sewer, and garbage collection. Special assessments may be appropriate in cases where the government provided improvements to a specific area in which the nonprofit is located. Finally, municipal service fees may be collected from nonprofits to fund a public good, such as street maintenance.

Michael Pagano, University of Illinois at Chicago, said that PILOTs are an important policy option for local governments with a high reliance on property taxes. However, he noted that some municipalities have access to sales and income taxes, which may offset or obviate the need to use PILOTs or raise property taxes. Like Kenyon, Pagano suggested levying fees from nonprofits for services like water. In addition, Pagano promoted

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four practices for revenue-strapped municipalities, especially those with a large share of nonprofit properties:

- Use audits to ensure that nonprofits are in compliance with their 501(c)(3) tax-exempt, charitable status.
- Reconfigure fiscal systems so that users (including nonprofits) of city services pay for them commensurately.
- Redesign fiscal systems to be less reliant on property taxes and more reliant on earnings, income, and payroll taxes.
- Consider innovative alternative fees or taxes—such as a university tuition tax, which reflects the costs associated with hosting a large (mostly transient) student population.

Sarah Wetmore, Civic Federation, presented a case study of the tax treatment of a nonprofit hospital in Urbana, Illinois—namely, Provena Covenant Medical Center—which failed to meet the standard for charitable (free and discounted) care according to the Champaign County Board of Review and the Illinois Department of Revenue. The hospital disputed their assessment; however, the Illinois Supreme Court eventually ruled against the hospital in 2010 after a series of hearings in lower courts.[8] This particular ruling prompted the revenue department to revoke tax-exempt status for three other hospitals in 2011. In response, the Civic Federation launched a task force to clarify standards for hospitals to gain and retain tax-exempt status.

Based on the task force's analysis, the Civic Federation first recommended that the Illinois General Assembly establish a clear quantitative threshold of public benefits that a hospital must provide in order to get a property tax exemption, said Wetmore. This threshold should be equal to the estimated tax bill for the hospital property (based on the local property tax rate and the property's assessed value) had it not received a tax exemption. Given this standard, the administrators of a hospital would know how much charitable care the hospital would need to deliver annually in order to qualify for tax exemption. The Civic Federation also recommended that the Illinois General Assembly consider certain additional expenditures made by a hospital beyond the value of charitable care when determining which types of activities and expenditures should count toward the quantitative threshold. Specifically, the federation advised the following items be counted: unreimbursed expenses for Medicaid and other similar programs, unreimbursed Medicare expenses, and a portion of bad debt (from patients who did not disclose their inability to pay when admitted but who would have otherwise qualified for charitable care). These expenses are often incurred when a hospital serves low-income and uninsured patients; however, by legal definition, such expenses do not count as charitable care.[9]

Providing an economist's perspective, Woods Bowman, DePaul University, explained that economic theory offers three primary positions regarding the tax treatment of nonprofit properties:

- Every property owner, including governments and nonprofits, should pay property taxes, since they all benefit from government services.
- All (not just some) nonprofits should be exempt from the property tax. Also, given that nonprofits are incorporated by the state, the state should pay localities for the lost property tax revenues if an exemption is granted by the state.
- If the first two positions are politically unacceptable, then recognize that consumer surplus from property taxes gets capitalized into property values. If this is correct, old property tax exemptions have little or no economic effects on current taxpayers, since their effects have already been fully capitalized. The issue then becomes the treatment of new property tax exemptions, and concerns about such exemptions can be neutralized by one-time "impact fees" levied on the nonprofits.

As a possible alternative to PILOTs, Bowman discussed the "quid pro quo" property tax treatment of nonprofits, or "services in lieu of taxes." Under this type of property tax treatment, nonprofits must provide charitable services whose value matches that of the property tax exemption, but only the charitable services provided to local residents would count.

Conclusion

Because local tax bases remain stressed, property tax incentives for businesses and the tax treatment of nonprofits' properties will remain prominent in public policy discussions. Communities need to understand the potential impacts of both issues on economic development, as well as on the collection of tax revenues to provide public services.

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1 Daphne A. Kenyon, Adam H. Langley, and Bethany P. Paquin, 2012, *Rethinking Property Tax Incentives for Business*, Cambridge, MA: Lincoln Institute of Land Policy, available at https://www.lincolninst.edu/pubs/dl/2024_1423_Rethinking%20Property%20Tax%20Incentives%20for%20Business.pdf.

2 Ibid., p. 5.

3 Ibid., pp. 23–24.

4 Ibid., p. 46.

5 Adam H. Langley, Daphne A. Kenyon, and Patricia C. Bailin, 2012, "Payments in lieu of taxes by nonprofits: Which nonprofits make PILOTs and which localities receive them," Lincoln Institute of Land Policy, working paper, No. WP12AL1, available at https://www.lincolninst.edu/pubs/dl/2143_1469_Langley_WP12AL1.pdf; and Daphne A. Kenyon and Adam H. Langley, 2010, *Payments in Lieu of Taxes: Balancing Municipal and Nonprofit Interests*, Cambridge, MA: Lincoln Institute of Land Policy, available at https://www.lincolninst.edu/pubs/dl/1853_1174_PILOTs%20PFR%20final.pdf.

6 Mike Maciag, 2012, "Tax-exempt properties rise as cities cope with shrinking tax bases," *Governing*, November, available at www.governing.com/topics/finance/gov-tax-exempt-properties-rise.html.

7 Langley, Kenyon, and Bailin (2012, p. 5).

8 For details, see www.state.il.us/court/Opinions/SupremeCourt/2010/March/107328.pdf.

9 For more details, see www.civicfed.org/civic-federation/publications/position-statement-charitable-property-tax-exemptions.