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TAXPAYER REPORT

The Site Selection Process: *The Role of Economic Development Incentives*

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Introduction

Economic development is an area of contentious political debate, arousing concern from business owners and legislators alike, as state economies are heavily dependent on the tax dollars generated by a healthy business environment. In an effort to better understand this complex issue, this report focuses on the following question, “Which considerations are most important for companies when making the decision to locate or expand in Colorado as opposed to another state?” Keeping in mind that the conventional wisdom is that tax incentives are the single most important economic development tool, we designed a survey instrument that would help us answer, among others, the following questions:

- Is conventional wisdom correct?
- How do other factors compare in tipping the scales toward one state or another?
- Are there factors unique to Colorado that would either attract or dissuade a company from conducting business here?
- What can be learned about managerial decisions to locate in Colorado?
- What can Colorado do to make itself a more attractive place for corporate location or relocation?
- How knowledgeable are businesses concerning Colorado’s tax laws?

Taking into account the questions posed above, the purpose of this report is to:

- I Provide a brief summary of the literature surrounding the issue of economic development

- II Appraise the Colorado business community's current opinions on the Colorado business climate and the role of economic development incentives
- III Present alternative considerations for Colorado's future economic development initiatives

Economic Development Incentives

Conventional wisdom suggests that tax incentives are the single most important economic development tool available to states in influencing the site selection decisions for companies with location mobility and expansion potential. Tax incentives include a wide range of tax categories that may attract or dissuade a company from moving to or expanding its business in any specific state. For example, a capital intensive firm, in terms of equipment and raw materials, may prefer to locate its operations in a state such as Tennessee that offers favorably low property and sales taxes along with attractive depreciation schedules.¹ Perhaps more than half of the Fortune 500 companies have chosen Delaware as their corporate home because the state does not have a state or local general sales tax, personal property or inventory tax. Delaware also offers the lowest real property taxes in the country as well as corporate income tax credits.² Boeing's decision to move its headquarters from Seattle to Chicago was certainly expedited by the fact that Chicago, aided by the Illinois legislature, lured the company with millions in tax incentives.³ Mercedes made Alabama its site for SUV manufacturing due to Alabama's liberal use of tax incentives.⁴

It is also important to understand that there may be many other attributes that influence a company's site selection decision, including, but not limited to, the presence of an educated workforce, the quality of schools, lifestyle, cost of living, proximity to customer base, cost of energy and level of public services. For example, Colorado is certainly attractive because of its reputation of offering an outstanding quality of life. Colorado may also be appealing to businesses because it has one of the most educated workforces in the country, with 64 percent of its residents aged 25 and older having attended college.⁵ Colorado actually ranks third in the nation behind Washington, D.C. and Massachusetts for percentage of residents with a bachelor's degree.⁶

¹ *Tennessee.gov: Department of Economic and Community Development*. Available: <http://www.state.tn.us/ecd/>

² *Advantage Wilmington Delaware: State Economic Incentives*. Available: <http://www.ci.wilmington.de.us/AdvantageWilmington/stateincentives.htm>

³ Michael Bobelian. *Boeing Shops Around*. June 25, 2003. *Forbes.com*. Available: http://www.forbes.com/2003/06/24/cx_mb_0620boeing.html

⁴ Robert Gavin. *Competing Visions: Unclear Prospects – Economists Say Evidence Mixed on Lure of Incentives*. September 17, 2003. *Boston Globe*. Available: http://www.boston.com/business/globe/articles/2003/09/17/competing_visions_unclear_prospects/

⁵ *U S Census Bureau*. Metro Denver Economic Development Corporation. May 2004. Available: <http://www.metrodenverdc.org/DataCenter/Rankings/>

⁶ *Ibid.*

Colorado, like many other states, also enforces many unique state policies that may either attract or dissuade companies from locating in the state. Several critical policies resulting from amendments to the state's constitution include the Taxpayer's Bill of Rights (TABOR), the Gallagher Amendment, and Amendment 23.

Literature and Policy

While compiling the basic research required for a thorough understanding of the economic development issues facing the state of Colorado, we attempted to focus on three main questions:

1. What does the literature reveal about economic development tools and especially tax incentives in influencing corporate location decisions?
2. Are there other factors which come to bear upon these decisions and how important are any other factors in relation to tax incentives?
3. What specific aspects of Colorado tax law are companies concerned about both at the statewide and local levels?

A seminal document from the University of Kansas Policy Research Institute, *Business Taxes and Costs: A Cross-State Comparison, 2003 Update*⁷, provided us with a significant amount of general information as well as considerable substance regarding business and tax incentives within Colorado.

The University of Kansas report focused on the structure of state and local business taxes, tax incentives, and operational costs, generally from the point of view of the effects on economic development, and especially on the location of mobile or "footloose" corporations. The study compared Kansas with five nearby states, examining effects on ten types of firms (new versus mature firms in five industries).

More important than any particular figure is the total cost of doing business. Notably, labor costs appear to be far more significant than taxes. An Economic Policy Institute study published in March of 2004 "found that state and local taxes account for only .8% of a company's costs and pale in importance next to the availability of qualified workers, proximity to customers, and the quality of public services. Tax breaks also sap budgets for education and roads. But the political dividend from bringing in a factory or a new headquarters, the study's authors admit, often trumps economics."⁸

"Many tax incentives depend on the particular industry. Also, different industries differ in the composition of inputs, and hence differ in the relative importance of different costs. Therefore the locational effects of each tax or cost item differ by industry, and consequently, the analysis should be disaggregated by industry,

⁷ <http://www.kansasinc.org/pubs/PRI/Tax/Tax2003.pdf>

⁸ "Taxing Matters: A Pricey Way to Get Job Growth", by Michael Eidam. Business Week, May 3, 2004.

with costs appropriately weighted for each industry. The analysis should also be disaggregated by stage of development. Newly established firms have different input needs (most importantly, capital investment) and face different tax preferences than established firms.”⁹

For new firms in the highly capital-intensive manufacturing industry, Colorado yielded profits 18 percent below the regional average. Despite those high costs, Colorado arguably has the most successful economy in the region.

Kansas attempted to achieve what we believe to be a reasonable goal, for any state: tax neutrality. “It found that no good case can be made for across-the-board tax relief, or for other preferences intended to reduce business costs, either at that level or using even more general categories.”¹⁰

“What seem important for economic development leadership in this region are non-cost factors. According to research in other scholarly literature, those factors might include good education, good transportation, skilled workforce, local availability of risk capital, and quality of life. All of these factors are responsive to well-crafted state and local government policy, but significant amounts of tax revenues are needed in order to implement effective policies.”¹¹

Colorado was found to be relatively high for the region with respect to tax dollars per capita, but relatively low with respect to tax share of personal income, reflecting the fact that Colorado has a higher level of average income than other states in the region. “The composition of state and local taxes has important consequences for the stability and long-run growth of tax revenues, the distribution of the tax burden among income groups, the overall efficiency of the economy, and for specific economic outcomes such as the location of industry.”¹² In regard to tax policies, Colorado has three important and often conflicting amendments to its constitution which may alternately entice and dissuade companies from locating within the state: the Taxpayer’s Bill of Rights (TABOR), the Gallagher Amendment, and Amendment 23.

TABOR represents “the strictest taxing and spending diet that any state has ever experienced.”¹³ TABOR is a revenue limit, not a spending limit which limits any and all tax revenue to an annual ceiling that cannot exceed the rates of inflation and population growth combined. When there is a significant revenue shortfall, the following year’s revenue is still limited by the aforementioned ceiling, producing a so-called “ratchet down” effect. Limits on spending and debt can be weakened only by direct voter approval, circumventing the usual course of

⁹ <http://www.kansasinc.org/pubs/PRI/Tax/Tax2003.pdf>

¹⁰ Ibid.

¹¹ Ibid.

¹² Ibid.

¹³ http://www.coloradobudget.com/tabor_101.cfm

representative democracy. Some see this amendment as providing “tax insurance” for businesses wishing to locate within the state, an absolute decree against unpredictable tax increases. Others see the amendment as a limitation on the provision of reasonable state services to business.

The Gallagher Amendment, passed in 1982, was written to assure homeowners that they would forever be able to afford real estate taxes as property values increased. The amendment provided for a 45/55 split between the total amounts of taxes collected on residential versus commercial property. The problem that now exists emanates from the fact the residential property values have risen far more rapidly than commercial real estate values so that at the present time residential values constitute more than 75% of the total, placing what most businesses feel is an unfair burden upon them.

Amendment 23 was passed to counteract a decline in per pupil spending on K-12 education in Colorado when compared to other states. Passed in the year 2000, it mandated increases of 1% per pupil each year plus the rate of inflation through 2010.

Unfortunately, the three amendments conflict in a way that significantly reduces state services to business, a fact that may actually dissuade businesses from locating or re-locating within Colorado. In an effort to resolve Colorado’s current budget crisis, legislators have been attempting to reform the conflicting measures that TABOR and Amendment 23 mandate, but as recently as May 4, 2004 “the state Senate killed the last legislative chance at changing the amendments before the session [ended] at midnight [May 5th].”¹⁴ Obviously, it appears that Colorado legislators have a tough road ahead of them if they want to alter these significant amendments.

Business Community Sentiment

The following segment will highlight some of the key findings pertaining to the primary research we conducted in an effort to understand firsthand how the issue of economic development incentives affects Colorado businesses. Figure 1 provides an industry breakdown of the respondents we personally interviewed. Note that the results of our study will understandably be skewed in accordance with the higher percentage of respondents occurring in the Government, Research & Policy Institutes and Services sectors.

¹⁴ “Changes to TABOR and Amendment 23 Voted Down”, by Chris Frates. The Denver Post, May 5, 2004.

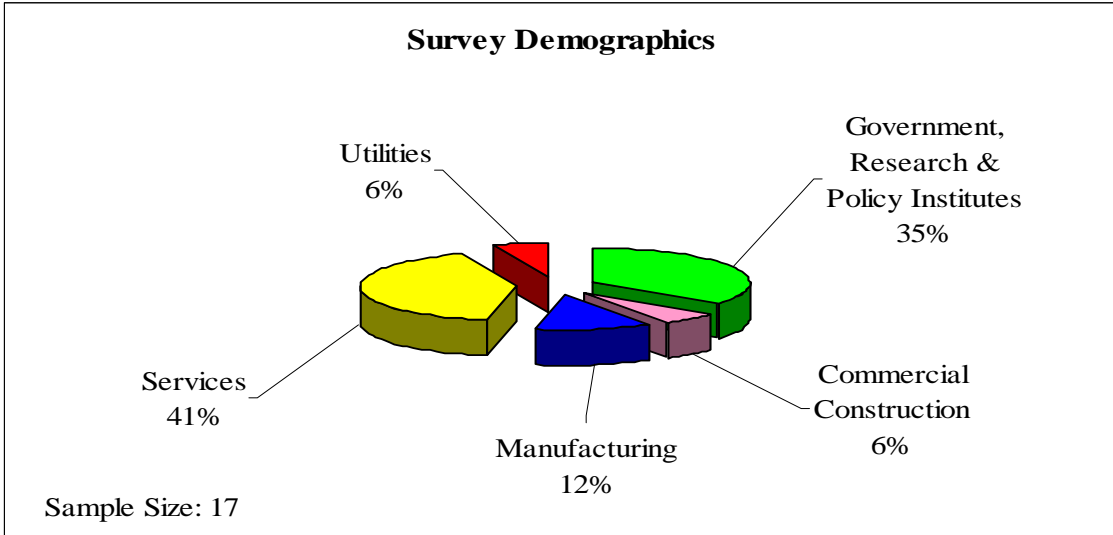


Figure 1

Key Results of the Study

In order to determine which Colorado business attributes were most important to businesses choosing to operate in Colorado, we asked our respondents to rank, in order of importance, which of eight factors did or would play a significant role in the site selection process. Figure 2 is a weighted average of their responses, with 8 points rewarded for a first place response and 1 point rewarded for a last place response. Interestingly, as the figure demonstrates, tax incentives were ranked 6th in order of importance.

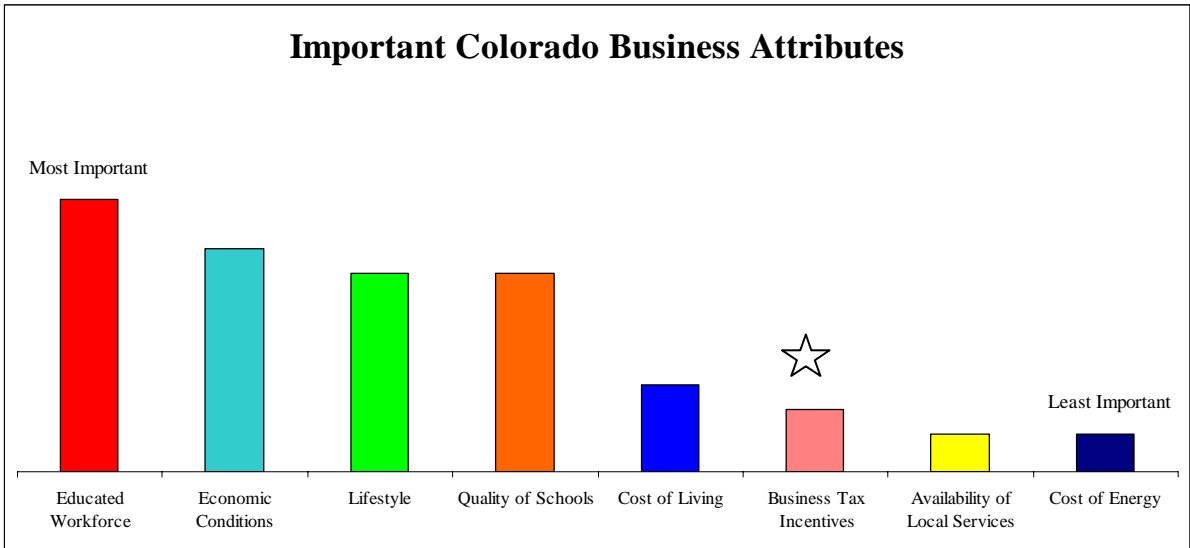


Figure 2

As the literature suggests, and our study indicates, factors such as an educated workforce, economic conditions - including such items as state budgetary issues,

tax policies and competition – lifestyle, and quality of schools played a more significant role in the minds of our respondents.

When a business makes the decision to expand or relocate there are many factors that must be considered, such as the particular business attributes listed above. Economic development incentives may certainly play a significant role in determining the final location and in an effort to ascertain when exactly tax incentives entered the picture, we posed the question, “At what point, if any, did tax incentives become an important factor in the site selection process?”

- 15% responded that they become important at the beginning of the process,
- 15% responded that they become important at the end of the process, and
- 70% responded that they aren’t important at all in the site selection process.

This data serves to further substantiate the previous finding that tax incentives are not nearly the most significant factor influencing site selection decisions by businesses. The sentiment expressed time and again by our respondents was that tax incentives only became important as a tool of negotiation after one or two sites had been chosen as the most likely locations.

Business Expenses

Economic development tools entice businesses by offering cost saving benefits that help offset large operational expenses. Therefore, in order to ascertain precisely which expenses most significantly affect businesses, hence allowing for the creation of more accurate economic development tools, we asked our respondents to rank the following operational expenses as they related to the overall cost of doing business:

- Labor Costs
- Taxes
- Raw Materials
- Energy Costs
- Building and Equipment
- Office Space
- Land

Of the respondents, 80% indicated that labor costs were the single most expensive operational factor, 13% indicated that taxes were the single most expensive operational factor and 7% indicated that raw materials were the most expensive operational factor in their business. The data again is somewhat distorted by the fact that over three quarters of our respondents are in industry segments, such as service, that undeniably are comprised of large labor forces.

There are a number of factors unique to Colorado's business climate, namely the access to an educated workforce and exemplary living conditions, but there is one unique feature within Colorado's taxation system that most significantly captures the attention of many business leaders and that is the existence of a Business Personal Property Tax (BPPT). We asked our respondents to "Rate the following taxes in relation to their importance to your business: Sales Tax, Property Tax and Corporate Income Tax." Figure 3 highlights the responses to this question, which clearly indicate the importance of property taxes, and most specifically, the BPPT. In subsequent conversations with business leaders, it was apparent that the BPPT generated the most complaints among businesses because in effect it places a disproportionate amount of burden on businesses, which are required to pay more in property taxes than homeowners, even though commercial property values have not increased as rapidly as residential property values. The manufacturing sector in particular is heavily affected by the BPPT, as they maintain higher levels of equipment that are subject to the tax year after year. Clearly, the BPTT acts as a disincentive to attracting capital-intensive businesses.

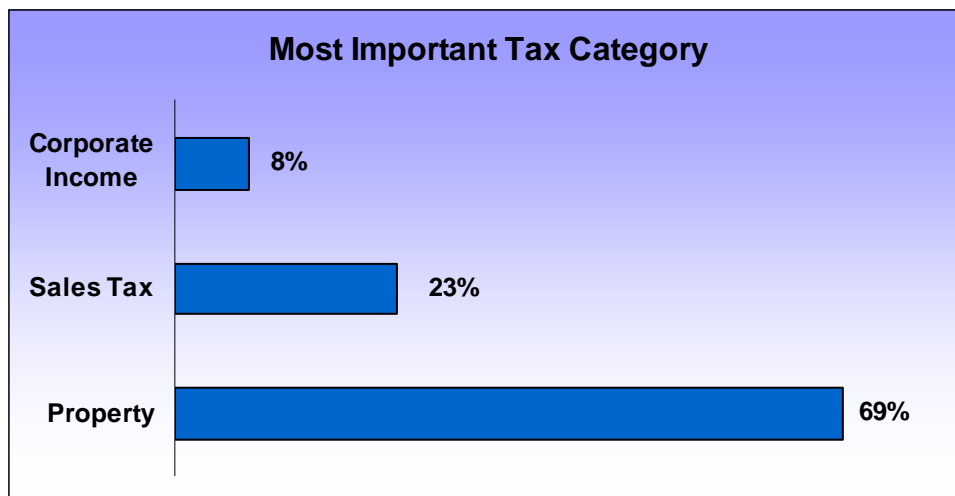


Figure 3

In order to understand how the current state of Colorado's tax structure affects businesses, we asked our respondents to provide us with feedback on the amendment which seems to generate the most concern, and that is the Taxpayers Bill of Rights.

What are your feelings on TABOR?

- 35% had unfavorable comments
 - “It is a living hell to state and local governments.”
 - “A nightmare that almost all taxpayers do not understand, including its supporters.”
- 24% had favorable comments

“Good job for economic development because companies can be assured of the absence of random tax increases.”

- 41% had neutral comments
“TABOR’s core principle-voter approval of taxes-isn’t bad, but TABOR contains a number of flawed provisions: the lack of emergency reserve requirements, special interest prohibitions, and limits on spending.”

Suggestions by Respondents for Economic Development Incentives

The following segment includes suggestions made by our respondents in regard to what they perceive as opportunities for improving economic development initiatives in the state of Colorado.

- A number of respondents indicated that a priority should be the reform or elimination of the Business Personal Property Tax,
- Others felt that adjusting the Gallagher Amendment’s 55/45 split would be a step in the right direction in terms of more appropriately allocating the tax burden associated with property taxes,
- A few indicated that addressing the imbalance caused by the conflicting measures within TABOR and Amendment 23 would help Colorado’s budgetary issues
- Some advocated pro-rated tax incentives or deferrals as a means of attracting business, and
- Finally, a number of respondents indicated that larger workforce training incentives might be an appropriate means of encouraging economic development in Colorado.

Concluding Remarks

So what exactly has our study and the available literature indicated in regard to economic development? To begin with, conventional wisdom concerning the importance of tax incentives as an economic development tool appears to be incorrect. Current economic studies indicate that “tax increases used to enhance public services can be the best way to spur the economy. By stimulating growth, generating jobs, and providing direct benefits to residents, improvements in state and local public services can be one of the most effective strategies to advance the quality of life of citizens.”¹⁵

Secondly, factors such as an educated workforce, the availability of public services, and labor costs are much more important in terms of providing incentives to stimulate business development. Many surveys have been conducted to determine what factors determine location decisions, and the prevailing findings suggest that “while market factors and quality-of-life factors were important determinants of investment decisions, taxes and financial incentives had little effect on location decisions.”¹⁶

¹⁵ Lynch, Robert G., *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*. Economic Policy Institute, Washington, D.C., 2004.

¹⁶ Ibid.

“Factors, such as the cost and quality of labor, the quantity and quality of public services (such as schools, roads and highways, sewer systems, recreational facilities, higher education, and health services), the proximity to business markets, and the access to raw materials and supplies tend to be more important than taxes in business location decisions.

- In addition, there is little evidence that state and local tax cuts, when paid for by reducing public services, stimulate economic activity or create jobs.
- On the other hand, there is evidence that reductions in public services due to state and local tax cuts and incentives cause job loss and economic slowdown because public services can have positive effects on economic development.”¹⁷

Finally, there is enormous potential for improvement in terms of providing potential businesses with the information necessary to make informed decisions of whether or not to locate in Colorado. Similarly, legislative policies remain an area of contention, suggesting that reform and better education on the key issues concerning economic development are possible and indeed necessary to promote economic success.

¹⁷ Ibid.