Economic development has evolved into an important activity for state and local governments. Understanding the various methods of financing these efforts can help governments maximize private investment in their communities.

Financing Economic Development: A Survey of Techniques

By Peter Eisinger

Economic development as a government activity may be defined as the effort to encourage private investment in a particular jurisdiction for the purposes of generating or retaining jobs, expanding the tax base, and increasing the general level of economic well-being. Although such efforts are not unusual today, it is important to note that government initiatives designed to shape or influence capital allocation once represented a challenge to the American vision of a free market economy. Only under the duress of rampant unemployment, industrial flight, export competition, reduced federal intergovernmental revenues, and the decline of manufacturing did governments come to acknowledge that they might have a legitimate economic role to play in a capitalist economy.

Prior to 1970, only a handful of pioneering states and cities had ventured to take any serious responsibility for encouraging private investment and job creation within their jurisdictions. But well before the century's end, such economic development activities had become a virtually universal and unremarkable function of subnational governments in the United States. Although some states and local jurisdictions see this relatively new responsibility as chiefly requiring inexpensive loans, lower business taxes, and more forgiving regulation, others have fashioned more aggressive approaches to fostering growth that involve everything from targeting grants to assuming equity positions in fledgling private firms. In virtually every case along the continuum of government involvement, however, states and cities see it as their proper role to spend (or forego) some public revenues, directly or indirectly, for the purpose of inducing private firms or entrepreneurs to invest in business undertakings.

A major characteristic of this domain of public expenditures is the great variety of instruments and techniques used for raising or allocating funds for economic development purposes. Few other activities of state and local governments are sustained by so many different methods of financing. These methods range from tapping general tax revenues to providing favorable tax treatment to businesses and from extracting various sorts of nuisance taxes earmarked for development purposes to issuing a variety of debt instruments. Even this range scarcely covers all the means by which states and local governments find the funds to spend on development. Other means include spending intergovernmental revenues, earmarking lottery proceeds, and tapping public employee pension funds. In most cases, public monies are designed to leverage private investments, creating public/private partnerships in the pursuit of development projects deemed to accomplish public as well as private ends. The purpose of this article is to survey and describe the most common techniques by which states and localities raise funds to carry out their economic development objectives.

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Tax Incentives

States and local governments provide economic development assistance either through their tax codes or by actually raising revenues in any number of different ways. Tax incentives, or "tax breaks," include various sorts of abatements, credits, and exemptions. These incentives may be available to all businesses as a matter of right or they may be negotiated on a case-by-case basis. One of the most notable features of tax incentives is that no one—not legislatures, not revenue departments, not scholars—really knows how much these breaks cost states and localities in lost taxes. Certain of these are now virtually universal among the states.

Tax Abatements

A tax abatement may be defined as a partial reduction of the property tax liability of a given piece of real estate for a specified number of years. Occasionally, the abatement is complete rather than partial, in which case it may be called a property tax exemption. However, the two terms often are used interchangeably. In 1998, 38 states permitted some form of real property tax abatement for economic development purposes. In those states, eligible local governments may offer tax abatements, depending on the state enabling legislation, to developers of new or rehabilitated industrial or commercial property, or multi-unit housing. In some states, abatements may be offered only in so-called "blighted" areas or in designated development zones. Depending on the state, abatements may last anywhere from five to 32 years. At the end of the abatement period, the property in question is assessed at its full taxable value.

A good example of an active abatement program is Michigan's Industrial Property Tax Abatement, authorized in 1974. Local units of government may apply to the State Tax Commission to provide abatements that can last up to a dozen years for new or rehabilitated industrial properties. The state considers more than 800 applications a year. In 1998, the total investment approved for abatement in Michigan amounted to more than $5 billion. However, the amount of property tax revenues foregone by local governments is not known. Michigan's lack of information in this regard is not unusual. States simply do not expend the resources to keep track of the sum total of local tax abatements.

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Tax Exemptions

States offer a variety of tax exemptions to businesses and entrepreneurs for purchases, investments, and activities other than real estate development. In addition, states may exempt businesses, investors, and employees located within state enterprise zones or their equivalent from corporate and personal income taxes. The purpose of these incentives is in every case to reduce the cost of doing business in the state or in particular locales within the state or, in the parlance of economic development, to create a favorable "business climate."

The most common of these tax exemptions is for the purchase of raw materials, machinery, and equipment. Every state exempts businesses from paying sales taxes on raw materials, and 47 states exempt the purchase of new equipment from sales or use taxes. Nearly every state exempts businesses from paying inventory taxes on goods in transit, a tax break designed to protect employment in warehousing, shipping, and transportation.

Tax Credits

Exemptions free the taxpayer from the obligation to pay a particular tax. In contrast, credits are reductions in the tax bill. Tax credits most commonly are used by states to encourage research and development activities, job creation, and investment. For example, states may offer eligible firms a one-time credit for each new job created or a credit for every $100,000 of investment in depreciable capital stock. In some states, firms receive a tax credit for installing pollution control equipment. About half of the state enterprise zone programs offer employers a tax credit for each new job or each new employee who lives in the zone.

Exhibit 1

INCIDENCE OF STATE METHODS OF ECONOMIC DEVELOPMENT FINANCING (1998)

Property tax abatement enabling legislation	76%
Machinery and equipment tax exemptions	84%
Raw material tax exemptions	100%
Job creation tax credits	86%
Below-market rate loans	84%
Industrial Revenue Bond enabling legislation	90%
Tax Increment Financing enabling legislation	88%

Source: Site Selection, *October-November 1998*

Exhibit 2

INCIDENCE OF MUNICIPAL METHODS OF ECONOMIC DEVELOPMENT FINANCING (1989)

(101 Cities > 100,000 Population)

Industrial Revenue Bonds	79%
Tax Increment Financing	56%
Below-market rate loans	67%
Revolving loan funds	73%

Source: Susan Clarke and Gary Gaile, "The Next Wave: Postfederal Local Economic Development Strategies," Economic Development Quarterly *6 (1992): 187-198.*

Revenue Devices

Public Borrowing

Every state and most general-purpose local governments lend money to private business firms at below-market rates to induce investment. At the local level, this lending function is often the responsibility of special authorities rather than municipalities themselves. Debt financing may take the form of direct loans for construction or expansion of industrial plants or the purchase of machinery and equipment. In other cases, the state or local government guarantees loans. Recipients generally are expected to seek financing on the private market first, but the creditworthiness of the firm rarely has been a barrier to access to publicly subsidized lending programs. States capitalize these lending programs both by issuing bonds and through legislative appropriations.

Many of these debt subsidy programs are fairly small, but one debt instrument—the industrial revenue bond (or industrial development bond)—played a major role in the emergence of states and local governments as economic development players. The IRB, which traces its origins to the Depression-era South, came into almost universal use in the 1970s. IRBs are instruments issued by a public authority that thus qualifies them for the federal tax exemption. The proceeds of the bond issue are either used to finance a private industrial facility, which is then leased to the private beneficiary, or they are loaned at favorable rates. The private beneficiary bears full liability for repayment or default. Taxpayers are not implicated in the arrangement. The advantage for the private beneficiary is the low interest rate.

As foregone federal revenues grew with the proliferation of IRB financing, Congress became concerned about the costs of the program. The Revenue Adjustment Act of 1968 delineated the uses for which IRB financing could be employed, and capped single bond issues at $1 million. This cap was steadily increased to $10 million over the ensuing decade. In 1984, Congress set a sunset date of 1986 for all industrial revenue bonds. However, intensive lobbying by state and local officials succeeded in persuading Congress to delay the sunset date until 1992 when the sunset provision was eliminated altogether, saving IRBs from extinction. In the meantime, Congress imposed caps on the amount of tax-exempt debt that could be issued by the states. This was a pooled cap, which applied not only to IRBs for small manufacturing projects, but also to other publicly issued private activity bonds, such as mortgage revenue bonds. Since 1988, the amount of tax-exempt private bonding has been limited to $150 million per state per year, or $50 per capita. The result has been a sharp decline in the use of IRBs for industrial financing.[1]

At the local level, another means of using public debt to support economic development—tax increment financing, or TIF—has emerged as one of the most important development tools at the disposal of local governments.[2] Growth of this device stalled in the early 1990s, when excess downtown development created a drag on the real estate market, but since then its use has boomed, both as a replacement source of funding for diminishing federal monies and in response to the restrictions placed on industrial revenue bonds. Tax increment financing involves the use of municipal bonds backed by anticipated increases in property tax revenues that occurs with new development to finance economic development projects. These revenues are typically not used to make direct loans to developers.

Although municipalities regard TIF as a boon in an era of disappearing federal economic development aid, there are several problems involved in its use. One is the possibility that increased development within the district will fail to generate sufficient revenues to retire the bonds, leaving the government with the responsibility of servicing the debt from the general fund. In a period of booming real estate development, this is not likely to be an issue. But if a glut in commercial property were to develop, a city like Chicago, which relies heavily on TIF arrangements, could be in trouble.

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Another problem involves the inability of overlying jurisdictions, particularly school districts, to share in the fruits of development until the TIF bonds are retired. Several states, including California, Wisconsin, and Illinois, compensate schools for this loss of access to the tax increment, essentially making state taxpayers subsidize local development. However, these "hold harmless" provisions are not universal and generally do not apply to counties or other jurisdictions that rely on property taxes. These governments chafe at bearing an interlocal subsidy for development whose fruits they must wait to share. TIF also freezes a significant portion of a city's tax base, making it difficult to finance the increased service demands that the new development necessitates.[3]

Federal Intergovernmental Revenues

At least since the postwar urban renewal program, Washington has used various federal grant programs to support subnational economic development, working through governments or quasi-public authorities at the local level. Although federal funding for this purpose has declined since its peak in the pre-Reagan era, there is still an array of programs that state and local governments can use to fund development. These fall into three broad categories: support for business attraction and expansion, support for investment in high-risk locations, and manufacturing modernization.

Business Attraction and Expansion. At least since urban renewal, local governments have sought to attract business investments by using federal funds to acquire developable land from private owners, prepare it for construction, and support it with infrastructure. Today, a major source of funding for this sort of effort is the Community Development Block Grant, passed in 1974. This is a broad block grant that is used by localities for a variety of community development activities, including housing rehabilitation, public works, and planning. Historically, only 8 to 15 percent of CDBG funds are used for economic development purposes. Metropolitan cities and urban counties are eligible for entitlement grants, while smaller communities can seek CDBG funds in a competition administered by their state.

One of the more innovative uses of CDBG grants is the capitalization of revolving loan funds, which are used to make low-interest loans to businesses. As the loans are paid back, the funds are loaned out to other firms. However, these funds tend to be fairly small. For example, in Wisconsin the average business loan is only $53,000. Cities also may borrow against future CDBG grants through the Section 108 program, using the federal dollars as loan guarantees. Eligible cities may apply for up to five times their CDBG entitlement to finance brownfield reclamation, public infrastructure, and private investment.

Another program that provides modest funding for business attraction is the Public Works and Development Facilities Program administered by the Economic Development Administration. Funded at less than $200 million annually, this program may be used by communities experiencing industrial shutdowns or departures to fund business incubators, access roads to industrial parks, port improvements, and brownfield development projects. Though relatively small, these grants significantly affect employment at the county level. It is estimated that an average of 11 new jobs are created by every $100,000 of EDA money (which must be matched by local sources).[4]

Investment in High-Risk Locations. The most notable Clinton administration efforts to support local economic development were not in the funding or invention of conventional business attraction programs, but rather in the effort to encourage investment in high-risk locations. The best known of these programs is the Empowerment Zone and Enterprise Community Initiative passed in 1993. Since then, two rounds of competition have produced 23 urban empowerment zone communities, a smaller number of rural empowerment zones, and nearly 100 enterprise communities.

The urban empowerment zone designees are the biggest winners in the competition for these funds. Each receives $100 million in federal funds for a wide variety of locally designed job creation and job training purposes. Employers in the zones are eligible for federal wage credits equal to $3,000 for each employee who lives in the zone. In addition, zone administrators may issue tax-exempt bonds to underwrite development within the zone. According to the Department of Housing and Urban Development, the initial round of these grants leveraged an estimated $4 billion in public and private investment.

Whether or not this program is making a difference in the designated cities is a matter of debate. In Detroit, for example, zone administrators have been unable to spend all of the funds at their disposal because grassroots organizations have failed to meet planning requirements or hire qualified personnel to implement the programs. Much investment in the zone would probably have occurred without federal incentives, raising the age-old question of whether or not public subsidies actually induce development that would not have occurred otherwise.[5]

The Community Development Financial Institutions program became part of the effort to implement the Clinton administration's New Markets Initiative. This initiative was based on the notion that poverty-stricken areas possess some degree of buying power, entrepreneurial energy, and labor potential. One of several programs designed to create what the administration called "conditions of economic success," the CDFI fund seeks to channel investment dollars into distressed communities by providing federal dollars in the form of equity, loans, grants, and deposits to some 270 community development corporations, banks, and credit unions. These institutions are used for housing and some business development. The consensus is that these public-private investments have been successful in developing low-income housing. Business development activities have been less successful.

Manufacturing and Modernization. A third set of federal incentives that support regional economic development falls under the rubric of manufacturing modernization. This effort, modeled on the agricultural extension program, is led by the Department of Commerce's National Institute of Standards and Technology. Fearing that many American manufacturing firms were falling behind their foreign counterparts in global competition, Congress in 1988 directed NIST to assist small- and medium-sized companies in adopting advanced technologies and production processes. These efforts are pursued by manufacturing extension partnerships in every state. Operated by universities, state governments, and nonprofit entities, these partnerships bring together federal, state, university, and industrial resources to improve the performance of manufacturing companies. Some partnerships are associated with well-known state technology programs such as Ohio's Thomas Edison Program, while others stand alone. Aggregate spending by federal, state, and local governments on these programs amounted to about $200 million in 1995.

Earmarked Taxes

Municipal governments and special authorities are increasingly financing economic development through taxes and surcharges specifically established for a particular project. These levies often include a sunset data, which is normally when the related bonds are retired. Oftentimes, these taxes are designed to shift the burden of development from residents to visitors. Just as often, a local sales tax is piggybacked on the state sales tax, dividing the burden between residents and visitors. Although communities in North and South Dakota can levy a 1 percent sales tax for the purpose of raising funds for economic development, this sort of earmarking is unusual for municipalities. However, a number of special sports authorities, such as those in Denver and Milwaukee, back their bonds for stadium construction and maintenance with sales tax surcharges, typically one-tenth of 1 percent.

For some projects, local governments simply impose a variety of sin or nuisance taxes. These sort of custom-designed levies are used most often to finance public and quasi-public works such as convention centers, sports stadiums, and arts complexes. These are assumed to stimulate spending and employment, thus qualifying as economic development initiatives—at least in the minds of public officials. Boston imposed a surcharge on automobile rentals to finance the construction of its convention center. The Ohio State Legislature passed enabling legislation in 1990 to permit counties to finance debt for stadium and sports arena construction by levying a new tax on liquor sales. Voters in Cuyahoga County then passed a referendum imposing a new tax of $3 a gallon of liquor and 4.5 cents per pack of cigarettes to generate revenues to retire the bonds for the construction of Jacobs Field in Cleveland. Similarly, Chicago's Comiskey Park was financed in part by a combination of state and local hotel room tax revenues.

Development Financing in the New Century

For a brief period in the 1980s, the state of Oregon earmarked lottery revenues for economic development. Other states began to tap their public employee pension funds, especially to establish small public venture capital programs. One survey from this period found that 24 states invested some small portion of their public employee pension funds in limited partnerships with private venture capital firms, and at least two of the states—Ohio and Michigan—also made direct venture investments.[6] It appeared at the time that the states were moving more aggressively and more imaginatively in the search for alternative funding sources.

By the late 1990s, however, the state of Oregon decided that other needs, particularly public education, were more compelling, and their unique way of funding economic development activities fell by the wayside. In other states, high-risk activities, such as venture investing with pension funds, grew during the decade. However, instead of earmarking these investments for economic development purposes, the funds sought instead to maximize returns to principal, which dictated that investments be made without regard for state borders.[7]

In general, state and local governments began to revert to the more traditional methods of financing economic development: bonding, particularly tax increment financing, and tax breaks. Industrial recruitment experienced a renaissance, even though a raft of studies by government policy analysts and academics has indicated that such efforts rarely produced net economic gains. Nevertheless, the programs that emerged in the 1980s—venture capital, small business development, technology transfer, export market development—seemed too slow and too small to offer the immediate payoffs that politicians desired. Economic development, politicians discovered, is just as much a political activity as an economic one. For political purposes, it is more valuable for a governor or mayor to announce that he or she has lured a plan from another state or from a foreign country than it is to make a grant to a research consortium that might someday develop a marketable product. And for the former purpose, traditional tax breaks and low-interest loans are the incentives of choice. There is no sign that they will be replaced soon.

NOTES

1. Alberta Sbragia, *Debt Wish: Entrepreneurial Cities, U.S. Federalism, and Economic Development* (Pittsburgh: University of Pittsburgh Press, 1996).
2. Eli Lehrer, "The Town that Loves TIF," *Governing* 12 (1999): 44, 46.
3. Roland Calia, *Assessing the Impact of Tax Increment Financing in Northeastern Illinois* (The Civic Federation, 1997).
4. Andrew Haughwout, "New Estimates of the Impact of EDA Public Works Program Investments on County Labor Markets," *Economic Development Quarterly* 13 (1999): 371-382.
5. Joseph Persky et. al., "How do we Know that 'But for the Incentives' the Development Would Not Have Occurred?" in Richard Bingham and Robert Mier, eds., *Dilemmas of Urban Economic Development* (Thousand Oaks, California: Sage, 1997), 28-45.
6. Peter Eisinger, "The State of Economic Development in the 1990s: Politics and Policy Learning," *Economic Development Quarterly* 5 (1991): 64-76.
7. Venture Economics, interview by author, December 8, 1999.

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