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Preface

The Guarini Institute for Government and Leadership White Paper Series (GWPS) is designed to stimulate timely and relevant discussion around key public policy topics germane to New Jersey. The series will provide contributors a unique opportunity to share their opinions related to critical public policy issues. This is the third paper in a series of white papers sponsored by the Guarini Institute. On behalf of the institute, we thank Dr. Rafferty for his contribution.

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Property Tax Abatements: Trickle Down Economics Du Jour

Abstract: This policy note examines the recent debate concerning property tax abatements. In doing so, it highlights two distinction approaches to economic development and identifies that this policy measure belongs to the neoliberal, trickle-down tradition of economic thought. Thus, the main argument advanced is that property tax abatements are counterproductive to economic development. To support this, we demonstrate its negative impact on local budgetary dynamics, unemployment, poverty, and inequality.

Introduction

It has become an increasing trend among urban political circles to offer property tax abatements to real estate developers, the rationale behind this policy being that these credits will spur economic development and so-called revitalization efforts in blighted communities. However, there is wide disagreement on the merits of this concept. On the one hand, proponents argue it will bring much needed resources to areas believed to be lacking these components. On the other hand, critics point out that, generally speaking, property tax abatements heavily contribute to unsustainable budget dynamics- which in and of themselves introduce a whole host of negative issues as well as increasing poverty and unemployment with growing inequality. This policy brief supports the latter view; namely, that property tax abatements should be avoided by governing officials in favor of other, more inclusive, sustainable pro-middle class development strategies.

The structure of this note is as follows. First, we highlight two differing views on the problem of development and how each results in a radically different set of policy prescriptions. In turn, this allows us to reveal the rationale behind property tax abatements and why they are presupposed to create positive outcomes. Second, we analyze the effects property tax abatements are likely to have on governing budgets. Third, we identify how proponents of property tax abatements commonly ignore the concept of opportunity cost when evaluating the policy's outcomes. Fourth, we discuss the impact that they are likely to have on unemployment, poverty, and inequality. Finally, we make some closing remarks and, in doing so, place the issue of property tax abatements into an historical context of American economic development. Such an exercise reveals that they irrelevant to creating the conditions for sustained, inclusive development.

I-Two Ways of Thinking about Economic Development

There are two differing approaches to envisioning the problem of economic development. The first views areas in need of development as lacking the resources necessary for wealth creation; that is, they are believed to be resource scarce.¹ Accordingly, the frequent recommendation for this situation is to design policies that will allow it to attract additional resources from outside. Thus, policymakers subsequently devise a whole host of measures they believe will make their

¹ Though in the literature the term 'resources' has referred to a host of items, it typically is used as shorthand for capital and entrepreneurial talent.

economies appear more 'market conforming' and thereby attractive to individuals and companies already possessing large stocks of resources-with the goal being that these entities will invest in and transfer production to the area(s) in need of development. From among the more popular measures, local officials have typically selected property tax credits and exemptions, subsidies, loosened regulations (especially surrounding labor rights and wages), and the like. To follow the 1989 classic *Field of Dreams*, the general idea behind this is 'if you build it, they will come'. It should be clear how property tax abatements follow this strand of reasoning. Since the motivation behind them is to attract outside resources (and hence spur development), policymakers believe it is necessary to offer potential investors additional incentives (besides the investment income) to entice them to choose the area in need of development over other alternative investments. Hence, they frequently pass legislation stating that if an entrepreneur invests in the area(s), no tax will be collected on the property for a certain duration. In doing so, both the local officials and the outside investor are appeased: for the former, capital and entrepreneurship are brought to an area thought to be lacking it while for the latter, a tax free investment producing above average returns is made.

From the above it is easy to see that property tax abatements are yet another form of the neoliberal, trickle-down approach to macroeconomics that has dominated American economic ideology over the last thirty years. Indeed, it is this ideology that, over the timeframe, has reduced trend growth rates, increased their volatility, increased income and wealth inequality, produced higher unemployment and poverty, and, in 2008, directly caused the single largest global economic disruption since the Great Depression. However, it is not hard to see why property tax abatements are currently enjoying such popularity: *both* major political parties-particularly the Clintonian New Democrats and the GOP's Establishment and Tea Party wings-espouse and practice neoliberal, trickle-down economic policy.

Briefly, there is an alternative view of the problem of economic development. In this second view, the issue is not a lack of resources, but instead an inability to fully utilize existing resources owing to structural constraints- such as non-fully developed capital and/or occupational markets as well as typically a lack of the informational, personal, and communicative networks that are the backbone of entrepreneurial ability. Thus, here the problem is not that the prerequisites for development do not exist. Instead, the issue is that they are scattered, hidden, and underutilized. Hence, the primary challenge is not to attract additional outside resources, but instead to devise policies that mobilize current resources in such a way that they are used more efficiently and entrepreneurial talents are 'discovered'. Accordingly, this perspective advocates targeted spending and lending by the policymaking body to produce direct job creation and cause local investment inducements to emerge. As opposed to importing resources, here the objective is to ignite an endogenous process that will ultimately overcome the aforementioned structural obstacles through a 'snowballing' effect.

II-The Effects of Property Tax Abatements on Governing Budgets

Once it is established that property tax abatements belong to the family of trickle-down economics, it is fairly easy to ascertain the outcomes of such a policy. In what follows, we highlight its effects on the local governing body's budget dynamics as well as the broad macroeconomic indicators of unemployment, poverty, and inequality.

To put it as succinctly as possible, a strategy of development centered on property tax abatements is likely to produce enormous, unsustainable disruptions to the governing budget, for the simple reason that spending allocations and priorities are formulated years in advance and tend to be non-discretionary while revenues depend on the state of current income and the tax rate. To be

sure, a certain quantity of spending will always be required- there is a need to have an excellent staff of first responders, competent teachers and schools, a viable infrastructure, and sufficient savings in a 'rainy day' fund for disaster prevention and relief most recently exemplified by Hurricane Sandy.

On the other hand, revenues are dependent upon whether the economy is booming as well as what the tax rate and tax base is.² For example, if the economy is slumping and total income is \$100 dollars and the tax rate is 20% with everyone in the tax base, revenue will be \$20. However, if the economy turns around and begins booming with total income rising to \$200, the same 20% tax rate and an unchanged tax base will produce revenue of \$40. Finally, if policymakers decide certain members of the tax base are exempt from paying taxes, this means the tax base will be smaller and therefore even with a total income of \$200 and an unchanged tax rate of 20% total revenue will be lower, say, \$175.

The key to understanding the likely outcome of property tax abatements on budget dynamics lies in its effects on spending allocations, the tax base, and subsequent tax rates. Once policy makers decide that outside investors are exempt from the tax base, many negative, unsustainable forces work themselves into the budget dynamics.

First, since a certain group of individuals become exempt from paying tax, initially the total tax revenue collected diminishes. In turn, there are fewer funds for the provision of governmental services- meaning spending cuts will have to be made at some future point to cover the shortfall. In practice, this means, at a minimum, there will be fewer firemen, police, EMT's, teachers, crossing guards, and the like; as well as a deteriorating infrastructure; and fewer safeguards for the 'rainy day' fund. To compensate, the governing body will frequently issue bonds to cover the shortfall, which it will have to pay back at interest- a scenario that can quickly dissolve into a Ponzi scheme as Orange County, CA and notably the states of Indiana, Mississippi, Utah, Kansas, Kentucky, New Jersey, and many others discovered in 2008.³

Second, the tax burden and the need to raise funds for the provision of services falls further on those who are not investors- lower and middle class citizens. Indeed, to address the budgetary shortfall, policymakers are frequently forced to raise taxes on the remaining base- instead of, say, 20%, the rate increases to 25% or 30%. Unfortunately, as Keynes pointed out exactly eighty years ago, this only serves to crush consumption demand, which is the most essential component of an economy's health and stability.

A popular rebuttal made by proponents of property tax abatements to these arguments is that the above analysis is static; that is, it is only analyzing the impacts of the policy at a point in time. Instead, they argue, what really happens once the property tax abatement is granted and outside investment begins to pour in is that jobs will be locally created and thus total income will rise. In turn, this will result in the higher level of consumption demand stressed by Keynes while allowing the government to increase its revenues since the tax rate will be applied to a higher total income level (\$100 to \$200). However, this is wishful thinking- most of the jobs created by this policy are typically low skill, low wage service-sector jobs (also frequently temporary) that ultimately have a negligible impact on both the level of consumption demand and taxable income (\$200 to \$175) (Cherry, 1998). Thus, what ends up happening is that the governing body's revenue shortfall persists and subsequently translates into either the de facto spending cuts for services, infrastructure, and safeguards discussed above or the need for external borrowing (usually both). Moreover, (and this point is vitally important) the profits that emerge from the

² The tax base concerns who gets taxed and who does not.

³ In all, there have been thirty-one U.S. states that have directly experienced budget difficulties from financial volatility associated with the Great Recession.

development project are rarely, if ever, reinvested locally; instead, they are almost always repatriated to an outside area where the parent company is headquartered- further contributing to a negligible income gain.

III-Placing Property Tax Abatements in Context: Opportunity Cost Anyone?

These dynamics get at the heart of what the debate over property tax abatements is all about. This also represents a microcosm of its total effect. Proponents of the policy commonly cite any job and income gains resulting from such a policy as a sign of success and thus claim it should be expanded. However, that is hardly the entire story. This perspective fails to take into account what economists call opportunity cost- basically what could have been done had resources been placed elsewhere.⁴

This concept's applicability to the debate on property tax abatements is as follows: while it is true such a policy might create additional jobs and income, it is probable that existing funds could be put to a more productive, sustainable use elsewhere which would subsequently result in a greater increase in jobs and income. In this second scenario the contribution to development would be larger than that of granting the property tax abatements.⁵

This is why it is crucial to properly envision economic development: on the one hand, property tax abatement supporters believe a scarcity of resources mandates the need to attract outside investors and thus any positive development, even minimal, is interpreted as a success. Conversely, a more grounded approach recognizes that the real issue involves utilizing existing resources more efficiently and thus public expenditure should reflect this by targeting the maximization of productivity gains.

This is not all. Unfortunately, the detrimental impact of property tax abatements goes further than the public coffers. To be sure, they also tend to have large negative effects on unemployment, poverty, and inequality. This is the direction to which we now turn.

IV-The Effects of Property Tax Abatements on Unemployment, Poverty, and Inequality

As mentioned above, the type of jobs typically resulting from property tax abatements are low skill, low wage service-sector occupations (and frequently temporary) (Cherry, 1998). Thus, while initially unemployment may drop (though its frequently a negligible impact), the question is not whether jobs are created but instead what *types* of jobs are created. In other words, the issue is whether property tax abatements are likely to lead to the emergence of a sustainable increase of income and consumption- typically what is known as a growing middle class. Most often, the answer to this question is no (Fischer et al, 2015). Thus, at best, the likely impact on unemployment is negligible and frequently it increases because of reasons relating to inequality, which will be discussed below.

The effects on poverty typically follow those of unemployment. Since the jobs created are low wage, low skill service-sector occupations, they tend to reinforce poverty (Cherry, 1998, Fischer, et al, 2015). Moreover, the individuals occupying these positions already tend to be low skill,

⁴ The textbook example of opportunity cost is how a college student is likely forgoing earning, say, \$10/hour working at a pizzeria by attending class. While the student could be earning \$10/hour by placing his or her resources at the disposal of the pizzeria, it is likely far more profitable in the long run for the student to gain an education which enables him or her to earn a larger lifetime income.

⁵ In a related point, it is notoriously hard to isolate and differentiate between economic activity that was newly created by the property tax abatement and activity that would have occurred anyway.

low wage workers- which simply increases the rate of turnover. After all, who has ever heard of a software engineer leaving his or her occupation to become a bricklayer? Finally, since a significant share of the jobs only exist as long as the project is being implemented, any corresponding reduction in poverty from hiring previously unemployed workers is temporary as well- hardly a sustainable development strategy.

Property tax abatements do, however, tend to have a large impact on one significant variable- inequality. Indeed, while at best they have little to no impact on the level of income, unemployment, and poverty experienced by the lower and middle classes and at worst they have deleterious effects, they do greatly benefit the upper class initiating the capital development projects. To be sure, while depressing the economic situation of the lower and middle classes, property tax abatements greatly improve the circumstances facing the upper class since their investments will now be tax free- leaving them with a higher rate of return and windfall investment income. Consequently, this increases income inequality, which inherently translates into increased wealth and opportunity inequality- all three of which have been shown to have enormous impacts on future generations' economic potential (Fischer, 2014).

That is not all. As James K. Galbraith has prominently argued and to which we alluded to above, increasing inequality tends to concomitantly increase unemployment. This is because in a society in which there are only a few high paying jobs, there is an incentive to hold out for one of the higher paying positions rather than immediately secure a lower paying position. Thus, since property tax abatements increase inequality, they actually tend to increase unemployment (Galbraith, 2012).

V-Concluding Thoughts

In closing, this policy brief presented the argument in favor of property tax abatements and what the logic is behind them. In doing so, we demonstrated that their popularity results from a mis-characterization of the problem of economic development. Thus, any success these policies have is spurious at best. Furthermore, in the bulk of the analysis, we pointed out that they are likely to have many negative, unsustainable impacts on a wide range of economic variables- from the local governing body's budget to unemployment, poverty, and inequality. Hence, property tax abatements should not be considered as a viable component of any serious, sustainable economic development strategy.

It should be noted that it is curious why property tax abatements have rapidly become a prominent development strategy on both sides of the aisle. After all, historically speaking, America was able to develop the vast markets, infrastructure, and governmental services that formed the backbone of the most powerful economic nation in history without any need for property tax abatements. Why are they now suddenly seen as an indispensable tool of economic development when they were not necessary then? Indeed, given the above analysis, they appear to be a solution in search of a problem.

Works Cited

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