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TACIR STAFF RESEARCH BRIEF

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Summary

A February 2004 report by the Tennessee Advisory Commission on Intergovernmental Relations, required by the Tennessee General Assembly, found that there was inadequate data to assess whether enhanced economic development offsets the overall effect on local public education when property taxes or payments in lieu of taxes earmarked for education are abated or reduced.

In 2007, the General Assembly required the state's method for equalizing education funding across Tennessee's 95 counties to include the value of payments in lieu of taxes. This is an important step forward, but getting it right is going to be a challenge and may require further legislative action to ensure accuracy and consistency across the state.

Getting It Right

The Effect on the Property Tax Base of Economic Development Agreements and Property Tax Incentives for Businesses

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Like many states, Tennessee has made provision for special tax incentives to attract businesses and encourage them to expand here. One incentive used to varying degrees by cities and counties across the state is lease agreements that work to abate property taxes for new and expanding businesses. The effect is to reduce the property tax burden on the business, which may or may not mean less revenue for the city or county depending on whether the business makes direct payments in lieu of taxes (PILOTs) or whether the increase in business activity generates more tax revenue in other ways such as through increased taxable sales. It must be assumed that the value to the city or county offering the incentive involves a net increase in local revenue or the offer would not be made. And it may be presumed that the underlying property, therefore, continues to have value to the local government and effectively generates revenue for it as though the business owned it and paid property taxes.

The problem arises when the value of the property tax base is used to "equalize" state funding to local governments. While the property that is subject to the lease generates revenue for the local government, in recent times, the value of that property has not been included in estimates of local governments' ability to generate revenue from their own sources.* The result is that, relative to cities and counties

*The fiscal capacity formula used to equalize state education funding from 1992 through 2007, which is produced by TACIR staff, includes estimates of the value of property subject to these agreements for fiscal years 1993 through 1995, the last three years for which estimates are available. Tennessee's Comptroller is in the process of updating those estimates and making them available for use in fiscal capacity calculations for fiscal year 2007-08 and beyond.

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that make little or no use of these agreements, cities and counties that use them more often appear to have smaller tax bases and less tax capacity than they otherwise would. If tax base calculations do not adjust for this, then it is impossible to produce fair and accurate estimates of each city or county's ability to generate revenue.

- A number of steps could be taken to ensure that these calculations are based on comparable information
- reporting should be improved,
- accountability for cost/benefit analyses should be increased, and
- up-to-date data should be maintained and made a routine part of tax base analysis.

Why Getting the Property Tax Base Right Matters

An education equity model must be

- understandable,
- accurate, and
- fair.

Tennessee has long sought an education equity model that is understandable, accurate, and fair. For most of the latter half of the 20th Century, the model was based solely on the local property tax base, and it affected only 7.5% of the state's main education funding formula. That formula, originally called the Minimum Foundation Program and later evolving into the Tennessee Foundation Program or TFP, was declared unconstitutional in 1993. Most school systems received about the same amount of funding per student, and those in tax-base poor areas could not raise enough local revenue to provide their students with an education that was "substantially equal" to that offered by wealthier school systems. The replacement formula, the Basic Education Program (BEP), was equalized using a much more complex fiscal capacity formula with a broader base and elements of taxpayer equity. The state dollars per student distributed by this formula vary greatly, largely because of the combined effects of a much larger formula and a much larger local match.

The equalization method was changed yet again in 2007. The method is being phased in, but when fully implemented, it will be based solely on the local property tax base and local taxable sales. As a result, the property tax base will be a much more important element of the equalization formula, representing about 60% of the average county's tax capacity. With that change, a problem that has plagued the capacity calculation for years immediately becomes more significant. That problem is the lack of current, accurate assessments of the value of property associated with local economic development agreements (EDAs) authorized by Tennessee Code Annotated § 4-17-301 *et seq.*

While all counties presumably start on a level playing field when it comes time to calculate their ability to raise revenue for education, for some the field is more level than it is for others. This happens because various cities and counties use EDAs to different degrees and these EDAs are not properly accounted for. Consequently, the tax bases of those that use them to greater degrees appear less robust than they really are. Often referred to as tax abatements, these tax incentives are more properly described as lease agreements for the use of public lands or buildings by private entities. Technically, tax abatements are not legal in Tennessee, but these agreements can have much the same effect in that public property is tax exempt, and thus the private party leasing it has no property tax liability. They may or may not be accompanied by PILOTs that would likely have been collected had the property remained in private hands and been similarly used.

With a model that sums to 100%, if one county's capacity is understated, then all other counties' capacities will be overstated.

If tax exempt properties leased to private companies are not properly accounted for in the calculation of cities' and counties' ability to raise revenue, then the fiscal capacity of those cities and counties that make heavy use of them will be understated. Because fiscal capacity in the equalization of Tennessee's education funding formula takes the form of a set of percentages that sum to 100% for the 95 counties, if one county's capacity is understated, then all other counties' capacity will be overstated. The effect on equalization formulas used in other programs may not be as direct, but it should not be ignored.

Getting the Tax Base Calculation Right

Any tax or fiscal capacity model must take into account more than just the actual revenue-producing bases. The total value of the bases must also be considered. The total value of the property tax base would theoretically include properties owned by governmental entities and exempt religious, educational, charitable, and other non-profit organizations. It would also include the market value of property subject to special statutory assessments, such as "greenbelt" property. Likewise, total value should include properties whose tax revenues are diverted (such as parcels for which tax increment financing (TIF) is used to fund development), as well as public properties leased to private entities whose taxes are thus "abated."

Values that have been removed from the taxable base by constitutional provisions or state law are rightly omitted from calculations of local fiscal capacity. These provisions apply equally to all local governments and cannot be overridden by local action; they are beyond the control of local officials. The same is not true for the property subject to TIF and lease agreements. **Discretionary actions of local governments should not be treated the same as**

constitutional provisions or statutory exemptions. There are some very good reasons why the values of properties that have been abated or whose revenues have been diverted *by local agreements* should be included in the property tax base when making fiscal capacity calculations.

How EDAs Distort Tax Base Calculations

Putting property under public ownership so that a private entity can use it via a lease agreement without any property tax liability distorts the actual value of the property tax base to the government that owns it—*it is reasonable to assume that the local government doing this expects to gain financially from the transaction or it would not enter into it.* Local governments always expect commensurate collateral benefits from the granting of abatements. These may or may not be realized, but regardless, the abatements do not justify the resulting distortion of the value of the property tax base. Removal of abated parcels from the property tax base not only distorts any calculations based on it, but it may do so for up to 20 years, depending upon the term of the agreement.

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1. If the tax capacity of cities and counties that employ tax abatements as economic development devices is based solely on the value of properties actually on the tax rolls, then the capacity of those cities and counties will be understated by some unknown, and until recently, completely unknowable amount. When tax capacity is a relative measure, as it is in the allocation of local responsibility for the BEP formula, then cities and counties with these agreements have a distinct financial advantage over those that do not have them or that use them to a lesser degree. Because the ability of those who use EDAs to generate local revenue is understated based on recorded taxable property values, they receive relatively more funding from the state than they otherwise would and more than similar cities and counties that do not use them.
2. Consider two cities (or two counties) with the same taxable property values and the same tax rates so that they are generating the same amount of revenue. One grants an abatement through a leaseback, removing a revenue producing parcel from the tax base. The abatement is granted in return for development of the parcel and some amount of increase in revenue—other than from the property, which is now tax exempt because it is in government ownership. The other makes no such agreement; its property tax base remains the same as does its property tax revenue. In the first case, revenue increases, but the apparent tax base is now smaller.

In the second, both stay the same. Neither changes its tax rate, but the tax *effort* of the first now appears to be greater than that of the second.

3. To compound the problem, it is unlikely that the true taxable value of these properties would be reported. The lessee—the private sector entity that is party to the agreement—establishes the value for reporting purposes, not the local property assessor. The value reported may be market value, replacement value, depreciated value, or something else, since the statute does not define "value". The lessee probably should not be expected to know what the taxable value is and has no incentive to look into the issue.

4. Moreover, the current reporting system itself is problematic. Some local governments rely on private lessees to report their annual job creation, wages, and capital investment and have no method for verifying the lessee's compliance with the EDA. Claw-back provisions that require repayment of incentives if the lessee fails to meet specified objectives are sometimes overlooked because of inefficiencies in record-keeping and because no one has been assigned responsibility for enforcing them.

5. And even if the property assessor were required to set the value, because no revenue is generated by the property, there would be no incentive to carefully estimate its value. In any case, it is highly unlikely that the values reported for properties subject to these agreements, to the extent that they are reported, are comparable to the values of similar properties in the same area.

It is unlikely that the true value of properties that are the basis of economic development agreements will be accurately reported.

How EDAs Affect the Ability to Fund Public Schools

1. When a local government earmarks local sales tax revenues for a sports facility, for example, it has *voluntarily* diverted school revenues to another purpose. A TIF is a *voluntary* diversion of property tax revenues to a development project. A property tax abatement results when a public entity *voluntarily* grants a private entity the use of publicly-owned tax-exempt property.

2. When property is removed from the county and municipal tax rolls, this diminishes the property tax base, lowers tax capacity, and, in effect, rewards local governments that have *voluntarily* relinquished revenues that would have gone to public schools had the abatement not been granted. While abatements effected through leases are legal under Tennessee law, officials in counties that have utilized (or over-utilized) them should not be subsidized by excluding the values of abated parcels from their property tax bases.

3. In 2002, tax abatements were estimated to have cost counties and municipalities approximately $104.3 million in forgone revenues. The loss to county school systems was at least $33 million. The actual total revenue loss was undoubtedly much higher because of under-reporting. The fact is that no one knows the total amount of school revenues that are diverted or abated, and no one knows to what extent the economic benefits of abatements compensate for those losses.

4. Some states (Kansas, Minnesota) give school boards a role in abatement decisions. Others (Texas, South Carolina) give them control over the abatement of the school portion of property taxes. Florida prohibits the abatement of property taxes for schools. None of these provisions applies in Tennessee.

In summary, there is no meaningful oversight of tax abatements, no performance reviews of the entities that grant them, and no mechanism for evaluating the efficacy of abatements in creating jobs and promoting economic development. The revenue expenditures of public entities are audited, but there is no similar accountability for their tax expenditures, as granted through diversions or abatements.

If the granting of property tax abatements were more transparent and accountable, if their effectiveness could be documented, and if the impact on public education could be factored into every abatement decision, there would perhaps be justification for excluding abated parcels from a fiscal capacity model. Since none of these is the case, abatements, as a matter of equity, should be included in each county's property tax base. It is simply unfair to treat a county that has granted hundreds of abatements totaling millions of dollars in forgone tax revenues the same as a poor, rural county that has granted no abatements or even a wealthier county that has not granted abatements.

The value of abatements, as a matter of equity, should be included in each county's property tax base.

How Property Tax Base Data for Capacity Calculations Could be Improved*

1. ***Ensure that all EDAs are filed with the Comptroller of the Treasury.*** It is not legal to abate taxes in Tennessee without an EDA, but many have never been filed with the comptroller's office as required by statute. As recently as 2004, when TACIR last reported on the subject, there were 22 counties that had never filed an EDA since reporting started on January 1, 1993. The fact that lessees had filed annual reports in some of those counties indicates that there must have been some EDAs there.

2. ***Ensure that annual reports by lessees are made and properly filed.*** Private lessees of public property are required by law to file annual reports disclosing the value of their leases, but many do not. In 2002, there were 51 counties from which no reports were filed. Information gathered for a February 2004 TACIR report on the subject indicated that many of these counties had EDAs in effect, but no annual lessee reports were filed.

3. ***Extend the same reporting requirements to all entities that grant tax abatements.*** Some entities that grant tax abatements (public building authorities, sports authorities, and enterprise zone development authorities) are not subject to any reporting requirements.

4. ***Improve cost-benefit accountability.*** Economic development agreements (when filed) must be accompanied by a cost-benefit analysis (CBA), but based on a review of the forms and calculation methodologies, that analysis is only for the first year of the agreement, is skewed toward the benefit side, and does not provide for the calculation of any ancillary costs of the development project. CBAs, as a matter of course, are usually completed after the EDA has already been executed by the parties. Some that are currently in effect show a negative cost-benefit ratio.

5. ***Extend to all counties the requirement that county governments be parties to the negotiation of EDAs that provide for taxes, or PILOTs, that are less than the amount of county property taxes.*** Currently this applies only in Shelby County. Municipal and other entities in the other 94 counties are free to grant abatements as they please.

6. ***Increase the use of "claw back" provisions.*** Most EDAs in Tennessee do not contain claw back provisions, which protect taxpayers in case the private entity fails to meet the objectives and promises set forth in the agreement.

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*For more information about these issues, see *Property Tax Abatements and Payments in Lieu of Taxes: Impact on Public Education* (TACIR 2004).

TACIR Publication Policy

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