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Projected Fiscal Costs

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Impact of Business Incentives on General Revenue: Projected Fiscal Costs

This report examines the impact of business development incentive programs on revenues in South Carolina's general fund and on property tax revenues collected by local governments. It is an update to our 1997 report, *Business Incentives: Projected Fiscal Costs*,[1] which was prepared as part of that year's Fiscal Sustainability Project. Since the 1997 report, modifications have been made to several incentive programs. Certain adjustments have also been made in some of the earlier assumptions.

This report is organized as follows. First, major changes to the state's incentive programs in 1998 are summarized. Then, the various incentive programs and their impacts on revenue collections are discussed. The major business incentives offered in the state impact both corporate and individual income tax revenue and local property tax revenue. Annual revenue impacts are estimated for the 12-year period from fiscal year 1998-99 through fiscal year 2009-10.

A comparison of the projections for fiscal year 1996-97 from last year's report with figures released by state agencies indicates the estimates were fairly conservative. For the fee-in-lieu-of-tax program, the Department of Revenue indicated companies were scheduled to pay $47.3 million in calendar year 1997 with the establishments generally receiving a six-percent assessment. These amounts imply that these firms received property tax reductions of about $35.5 million in 1997. Figures for calendar year 1996 were not available, but the reduction for that year was estimated at $25 million for this analysis. These numbers imply that the 1996-97 fiscal year impact of this program was approximately $30 million,[2] which was considerably above the $20 million estimated in last year's study. Similar figures were not available for comparison of the actual jobs tax credit with last year's predictions. The job development programs were projected to reduce individual income tax receipts by $8 million in 1996-97 and by $18.8 million in 1997-98. These projections were a little lower than the South Carolina State Budget and Control Board's Board of Economic Advisors' (BEA) forecasts of $10 million and $20 million.[3] The other projections presented last year (AFDC and economic impact zone credit) were extrapolations of the BEA forecasts of these categories.

The subsequent analyses are not meant as arguments either for or against current policies. This study focuses only on the projected fiscal impact of the state's business incentive programs. No judgement is made about the net economic benefit of these incentive programs to the state. Nevertheless, we believe that our analyses represent an important part of the story—one that must be considered if serious discussions on the future of these programs are to take place.

Major Changes to Business Incentive Programs in 1998

Three major changes to the state's package of business incentives were made in 1998.[4] They are as follows:

1. A moratorium on corporate income taxes was added for companies that invest in SC counties with unemployment rates that are twice the state average (the county must have a minimum

unemployment rate of 10%). The company must have at least 90% of its total investment in one of these counties. If the company creates at least 100 jobs, the moratorium will last for 10 years. For companies that create at least 200 jobs, the moratorium will last for 15 years.

Four counties (Georgetown, Marion, Marlboro, and Williamsburg) currently qualify for the moratorium on corporate income taxes. This new incentive program is intended to make these counties more attractive as potential industrial sites. However, because of the low population bases, human capital statistics, and other demographic information, it was assumed that the level of new investment would not increase drastically as a result of the incentive. Hence, no special effort was made to estimate the revenue impact of this incentive.

2. "Qualified Service Facility" legislation was amended to make the state more attractive to higher paying service establishments. The old legislation required these companies to create at least 250 new jobs. The new legislation states if the company: a) hires 125 employees and pays 1.5 times the average county wage, or b) hires 75 employees and pays twice the average wage, or c) hires 30 employees and pays 2.5 times the average wage, it can qualify for the jobs tax credit. The change to the qualified service facility incentive program is intended to make the state more attractive to high technology industries.

   A service facility is any facility that obtains over 50 percent of its gross receipts from the provision of services. In general, the demand for service activity is dependent upon income and economic activity. Unfortunately, there are no data readily available pertaining to the number of service facilities locating in South Carolina and paying these wages. For this reason, it is impossible to comment on the exact fiscal impact of this program alone. Therefore, the revenue impact of this program change was calculated within the estimation of all job tax credits.

3. The investment tax credit was changed from a flat five percent of capital investment (real and personal) to a graduated scale based on the useful life of the property. Property with a three-year tax life will receive a one-percent credit; the credit increases by one percent for each change in classification and is capped at five percent for property with a tax life of 15 years or more.

   The investment tax credit was changed due to large increases in the amount of credits claimed. The incorporation of these changes on projected revenue impacts are presented in the discussion related to the investment tax credit program.

Corporate Income Tax Incentive Programs

The job tax credit, investment tax credit, EIZ credit, and AFDC credit programs all reduce gross corporate income tax receipts. In 1998-99, adjustments to gross corporate income tax receipts are estimated to be $42.2 million. By 2009-10, corporate income tax adjustments due to these four business incentive programs are projected to be $104.0 million. These impacts are summarized in Table 1.

[1] Daniel V. Rainey, *Business Incentives: Projected Fiscal Costs* (Clemson, S.C.: Strom Thurmond Institute, October 23, 1997).

[2]The tax returns (and therefore credit information) are reported on a calendar year basis. Thus, the projections of the

impacts on a fiscal year basis will always be slightly different from the actual figures, due to the different time periods. A rough estimate of the fiscal year values can be obtained by taking half of the values for the two calendar years and summing them together; i.e., adding half of the 1995 and half of the 1996 calendar year values will approximate the 1995-96 fiscal year value.

[3] S.C., State Budget and Control Board, Board of Economic Advisors, *Long Range General Fund Revenue Plan*, February 10, 1997.

[4] A brief description of these changes can be found in: S.C., Department of Revenue, *Economic Development Incentives Update*, letters dated July 8, 1998 and October 19, 1998.

Table 1
Corporate Income Tax Incentive Programs
Projected Fiscal Costs, 1998-99 and 2009-10
(in millions)

Program	*1998-99*	*2009-10*
Job Tax Credit	$12.2	$44.9
Investment Tax Credit	21.5	34.9
EIZ Credit	2.7	7.6
AFDC Credit	5.8	16.6
Total	**$42.2**	**$104.0**

JOB TAX CREDIT

A job tax credit is allowed for each employee hired as long as the company maintains a minimum level of employment. Manufacturing firms must create or add at least 10 new employees to qualify for the incentive. The employment base for non-manufacturing establishments depends on their industrial classification, the wages they pay, and their location within the state. However, the majority of the firms receiving the credit are in the manufacturing sector.

In projecting the amount of credits taken against future corporate income tax receipts, the following assumptions are made. New employment estimates for 1998-99 and beyond are projected from announced employment during the 11-year period 1987-88 through 1997-98. The allocation of employment between the four county classifications in the Rural Development Act of 1996 (RDA) is based on the average for the years 1995, 1996, and 1997.

A major change from last year’s analysis is the assumption that establishments, on average, only use eight percent of the credit earned each year. Last year’s study assumed that 16 percent of the credits earned were used in the same period. That assumption was based on data from 1988–90, which indicated that 16 percent was the actual amount used by firms during that period.[1] However, the dollar range for the credit firms can earn per employee each year has increased significantly since 1990—300 percent or more, depending on the RDA classification of the county. Therefore, the utilization rate underlying this year’s projections was reduced to better reflect what firms could realistically receive. The reductions in corporate income taxes as a result of the job tax credit program are estimated at $12.2 million in 1998-99. This amount is projected to grow to $44.9 million in 2009-10.

Investment Tax Credit

The investment tax credit allows firms to reduce their corporate income tax liability by a percentage of their actual investment. This credit is only available in the 27 counties classified as economic impact zones. The percentage that firms can earn depends on the expected life of the property and ranges from one percent for three-year property to five percent for property with a tax life of 15 years or longer. Because the BEA's forecast did not include any impact from this program last year, the revenue impact of the investment tax credit was not estimated in last year's report.

The projected revenue adjustment resulting from the investment tax credit in 1998-99 is $21.5 million. This figure is based on the assumption that this credit reduced corporate income tax revenue by $33.8 million in 1997-98.[2] However, in 1997-98 there was also a flat credit of five percent for all property that qualified for this credit. This credit was changed to a tiered credit for 1998-99 and future years.

In this analysis, the average property qualifying for the credit is assumed to be seven-year property, which qualifies for a credit of three percent. The credit estimated for 1998-99 assumes an increase in the 1997-98 credit of 6.4 percent, which is then reduced by 40 percent due to the lower credit (three percent versus five percent). Projections for this credit in future years assumed the 1998-99 credit would grow at the rate of investment growth. The revenue adjustment due to the investment tax credit is projected to be $34.9 million in 2009-10.

EIZ Credit

The economic impact zone (EIZ) credit program allows companies that hire workers who became unemployed due to the closure or downsizing of certain federal facilities to take a credit against their corporate income tax liability. The credit is equal to 10 percent of the first $10,000 paid to the employee.

In 1997, the BEA projected the impact of this program to the year 2004-05. For years beyond 2004-05, this study extends the BEA projections by assuming the impact will increase at the rate of inflation. The projected revenue loss from this program is projected to be $2.7 million in 1998-99 and $7.6 million in 2009-10.

AFDC Credit

The AFDC credit program allows corporations to reduce their corporate income tax liability when they hire individuals who were formerly on the Aid to Families with Dependent Children rolls. Firms must retain these employees for three years to earn the credit. In 1997, the BEA forecast the impact of this program on corporate income tax receipts through 2004-05; the 1998-99 revenue impact was forecast to be $5.8 million. In this report, those annual forecasts are extended to 2009-10 by assuming the credit's revenue impact will grow 2.5 percent each year—the rate of inflation. The projected revenue cost in 2009-10 is $16.6 million.

INDIVIDUAL INCOME TAX INCENTIVE PROGRAMS

The job development credit and retraining agreements programs reduce gross individual income tax receipts. Adjustments to gross individual income tax receipts due to these two business incentive programs are estimated to be $29.3 million in 1998-99 and $190.7 million in 2009-10. These revenue adjustments are summarized in Table 2.

[1]This figure is due to statutory limits that prohibit firms from reducing their tax liability by more than 50 percent.

[2]The Department of Revenue indicated that $30 million in credits were claimed under this program in 1996. Although no figures were released, DOR staff indicated there has not been a significant increase since that time.

Table 2
Individual Income Tax Incentive Programs
Projected Fiscal Costs, 1998-99 and 2009-10
(in millions)

Program	*1998-99*	*2009-10*
Job Development Credit	$9.5	152.5
Retraining Agreements	19.8	38.1
Total	**$29.3**	**$190.7**

Note: Detail may not sum to totals due to rounding.

JOB DEVELOPMENT CREDITS

Job development credits allow corporations to obtain refunds from their withholdings of employee state income tax payments. Firms may use this credit for reimbursement of expenses incurred on infrastructure improvements, employee training, pollution control equipment, and purchases of real property. The amount of the credit is determined by the wages paid by the firm. In addition, only firms in the state's least developed counties are allowed to keep 100 percent of the credit. For establishments in the other counties, a fraction of the credit is deposited in the Rural Infrastructure Bank. These funds are used to assist distressed areas with infrastructure improvements in order to make them more competitive for new investment.

The impact of this program on individual income tax receipts is estimated to be $9.5 million in 1998-99. This figure is based on 44,000 employees enrolled in the program through December 1997.[1] However, establishments cannot begin to earn the credits until they meet all of the requirements of the revitalization agreement, which they must sign with the Coordinating Council for Economic Development at the Department of Commerce. Therefore, the number of employees earning a credit is estimated by assuming firms employing 30 percent of the employees enrolled will fulfill their agreement in the first year. Twenty percent of the remaining employees are assumed to become eligible in years two, three, and four and 10 percent in year five. The average wage paid to employees enrolled at this time is $13.22 per hour, which qualifies for a four-percent credit.

In this analysis, it is assumed that wages will grow at the rate of inflation until the year 2009-10 and that the number of new employees enrolled will grow by three percent from the previous year's level (roughly the rate of projected growth in announced employment). The revenue impact of this program is projected to be $152.5 million in 2009-10.

Retraining Agreements

Retraining agreements are intended to reduce the cost of keeping employees productive. This program allows firms to receive a refund on individual income tax withholdings as reimbursement for training expenses incurred. The firm can be reimbursed for only half of the expenses incurred, and the training must take place at one of the state's technical colleges.

This program is projected to reduce individual income tax receipts by $19.8 million in 1998-99. This projection is based on 66,000 employees enrolled in the program at the start of 1998, with an average credit per employee of $311. [2] Enrollment in this program is assumed to grow by roughly 16,000 employees per year, with each employee's eligibility terminating after five years in the program. The average credit per employee is assumed to increase at the rate of inflation (2.5% per year) for future estimates. The impact in 2009-10 is projected to be $38.1 million.

It should be noted that, although this program is paid for with individual income tax receipts, the funds are used to compensate the state's technical colleges for training they provide. Thus, this program also serves to benefit the technical colleges.

Local Government Property Tax Revenue

The fee-in-lieu-of-taxes (FILOT) program reduces the local property tax burden on qualifying businesses. The FILOT program allows companies investing more than $5 million in property and equipment to reduce their property tax assessment ratio from 10.5 percent to six percent. Companies making very large investments may be able to further reduce their assessment ratio to four percent. These incentives are not automatic; rather, the county council negotiates FILOT agreements on a firm-by-firm basis.

The revenue impact of the FILOT program is determined by three components: 1) the value of property entering the program, 2) the assessment ratio negotiated, and 3) the appropriate millage rate. Most FILOT agreements state that the value of real property will remain at its initial level. However, personal property must be depreciated. This study assumes that personal property used in the facilities will be classified as seven-year property on average and depreciated using the double-declining-balance method. The state average of all county and school taxes is used as the millage.

The impact of this program on local property tax revenue collections is projected to be $34.5 million in 1998-99 and $58.7 million in 2009-10. The 1998-99 estimate assumes that 20 percent of the announced investment since 1990 (roughly $3.2 billion, allowing for depreciation) will be entered in the FILOT program in 1998. Investment projections to 2009-10 are based on the previous 11 years of investment activity. It is also assumed that 20 percent of projected investment will obtain a FILOT agreement, and that these agreements will be at the six-percent assessment ratio.

Conclusion

This study presents projections of the adjustments to gross state and local tax revenue related to the major economic development incentives offered to companies in South Carolina. In 1998-99, it is estimated that the state's business incentive programs will cost state and local governments a total of $106.0 million in foregone revenue. By 2009-10, these programs are projected to cost $353.4 million in foregone revenue. These projections are detailed in Table 3.

Readers are again reminded that these projected revenue adjustments represent only the projected fiscal costs of these programs; they do not represent the net economic benefits of these programs to the state. The purpose of this study is to shed light on the possible fiscal outcomes that may occur if the programs remain in place, and unchanged, over the course of the next decade. It is believed that this information will prove useful in discussions about the direction of future policy in this important area.

[1]S.C. Department of Commerce, personal communication.

[2]S.C. Department of Commerce, personal communication.

Table 3.

Projected Fiscal Cost of South Carolina's Business Incentive Programs, 1998-99 to 2009-10 (in millions)

FISCAL YEAR	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Corporate Income Tax Programs	$42.2	$46.8	$51.5	$56.5	$61.6	$67.0	$72.5	$78.3	$84.4	$90.6	$97.2	$104.0
Job Tax Credit	12.2	14.7	17.3	20.1	22.8	25.7	28.7	31.8	34.9	38.2	41.5	44.9
Investment Tax Credit	21.5	22.7	23.9	25.2	26.4	27.6	28.8	30.1	31.3	32.5	33.7	34.9
Economic Impact Zones	2.7	2.9	3.2	3.5	3.9	4.3	4.7	5.2	5.7	6.3	6.9	7.6
AFDC	5.8	6.4	7.0	7.7	8.5	9.4	10.3	11.3	12.5	13.7	15.1	16.6
Individual Income Tax Programs	$29.3	$44.3	$57.5	$70.4	$83.3	$95.7	$109.0	$123.2	$138.4	$154.7	$172.1	$190.7
Job Development Credit	9.5	23.4	35.3	46.8	58.2	69.0	80.7	93.1	106.5	120.8	136.1	152.5
Retraining Agreements	19.8	20.9	22.2	23.6	25.1	26.7	28.3	30.1	31.9	33.9	36.0	38.1
Total, Corp. and Ind. Income Tax	$71.4	$91.1	$109.0	$126.9	$144.9	$162.7	$181.5	$201.5	$222.8	$245.3	$269.3	$294.7
Local Property Tax Incentives (FILOT)	$34.5	$36.7	$38.9	$41.2	$43.4	$45.5	$47.7	$49.9	$52.1	$54.3	$56.5	$58.7
TOTAL, ALL PROGRAMS	$106.0	$127.8	$147.9	$168.0	$188.3	$208.2	$229.3	$251.5	$274.9	$299.6	$325.8	$353.4

Note: Detail may not sum to totals due to rounding.