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Impacts of Tax Exemptions:

An Overview

EXECUTIVE SUMMARY

Tax Exemptions

Identifying and measuring tax exemptions originated with the federal government in the 1960s. The idea was to provide cost estimates for tax subsidies and preferences that favored particular taxpayer groups in much the same way that budget documents displayed information on government spending. Besides the federal government, 33 states, including Washington, provide estimates of tax exemptions.

Tax exemptions are measured relative to a “normal” level of taxation. Differing views on what constitutes a “normal” tax system lead to differing estimates of tax exemption costs.

Tax Exemptions and Economic Development

Policies that encourage businesses to increase employment and investment through tax subsidies, credits, or other preferential treatment constitute a major category of tax exemptions. A substantial quantity of research has investigated whether state taxes and tax incentives influence business location decisions and state economic activity. Summarizing the conclusions from three different analytic approaches to this issue suggests that taxes have a relatively small impact on economic activity and business location decisions.

- **Statewide** studies use state-level measures of economic activity (such as employment) to find a relationship between various state tax indicators and overall state economic activity. The weakness of this approach is that summary measures of state tax systems (such as average taxes per capita) rarely represent the tax impacts faced by individual businesses when deciding where (or whether) to expand operations.

- **Hypothetical firm** studies create hypothetical businesses and attempt to measure the state taxes that would be paid by these “representative firms” in various states. Although more accurately representing the tax liabilities faced by individual businesses, hypothetical firm studies cannot provide an estimated relationship between taxation and economic activity.

- **Specific tax exemption** studies examine specific tax exemptions or incentive packages and attempt to determine their impact on economic activity in a particular state or metropolitan area. Such studies directly address the effectiveness of economic development tax exemptions. It is difficult, however, to separate the economic impact of exemptions from other variables.

Findings. Each approach to measuring the impact of tax exemptions on economic activity has advantages and disadvantages. However, taken as a whole, the research suggests that state taxes and tax incentives can have an impact on economic activity. This impact may be weakened or strengthened by the design of tax incentive programs or a state's business tax burden relative to other states, but the economic impact of tax exemptions is likely to be small and less important than other factors, such as labor costs and productivity.

Other Tax Exemptions

In addition to economic development, tax exemptions are enacted to meet other policy goals, such as assisting nonprofit organizations or reducing the tax system's administrative burdens. Because outcomes associated with these desired goals are often hard to measure, the data needed for analysis purposes are often lacking, and little research exists to guide policy in this area.

Findings. In attempting to assess the value or usefulness of non-economic development exemptions, it is important to consider two points.

- As noted above, data to measure or analyze the desired goals of these exemptions are often difficult to obtain or, in some cases, completely unavailable. Therefore, any assessment of tax exemptions needs to consider all possible sources of information, both qualitative and quantitative.

- The potential unintended consequences of tax exemptions are important considerations. For example, research suggests that the combination of tax exemptions for nonprofit organizations and high tax rates encourages nonprofits to engage in commercial activities. In turn, this provides nonprofits with a competitive advantage over for-profit businesses. The possible negative effects on existing firms should be considered, as well as the expected benefits to be provided, when analyzing tax exemptions for nonprofit organizations.