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Increasing the Equity and Efficiency of Tax Abatement Programs

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Introduction

The state role in economic development policy has increased as the federal government has devolved selected programs to balance growth and incomes among different part of the country. Rapid growth in coastal states and the suburban areas around many cities, and stagnation or decline in areas that have remained rural has intensified economic development debate. Within the broad spectrum of economic development policy, significant resources are focused on state industrial recruitment through tax abatements. This article uses the Michigan experience to illustrate how current application of tax abatements may increase geographic income inequality, and that some adjustment in the policy would be needed if policy makers want to rectify the unequal distribution of tax expenditure. We also argue that localities have few incentives to reject or limit, which can lead to overuse of the tool. Relatively straightforward countervailing measures such as a cap on per capita use of abatements, together with payments to localities that do not use their quota of abatements, could improve the effectiveness of overall state economic development policy by increasing the level of local public debate about the use of abatements and making funds available for alternatives to tax abatements.

A Brief History of Tax Abatements as an Economic Development Policy

Tax abatements have their roots in the 1930s as southern states began to look for ways to diversify their economies. Cheap land, cheap labor, and an unorganized workforce made the southern region attrac-

tive to northern manufacturing firms. Tax abatements served as the inducement to offset costs of making the move. Encouraged by the success of early leaders, other states emulated the policy; now most states offer some kind of abatement program. The policy also cascaded from states to localities.¹

Initially focused on manufacturing, use of abatements expanded to other types of economic activity, most notably data processing, warehousing/distribution, and sports facilities. It also extended to expansion, and, to a lesser extent, retention, of existing business. But recruitment of manufacturing is still a major focus of abatements.

Abatement Pros and Cons

Economists are overwhelmingly against tax abatements as incentives for investment. In the mid 1990s, over 100 Midwestern economists signed a petition asking states to abolish their tax abatement-based recruitment programs (Reed, 1996). A decade later, industrial location incentives are in full force despite recent legal challenges in federal court (Mazerov, 2005). Why do most economists frown on the abatements, and why do incentives continue to be popular? Clearly there must be compelling arguments on both sides. We start with the main arguments against.

High Costs. Because so many governments are trying to recruit a very limited number of "footloose" firms, managers are able to extract big concessions in their location decisions. For example, Kentucky once offered \$350,000 in aids per job for a 400 employee steel mill (LeRoy, 1997). Gabe and Kraybill (2002) found that firms receiving incentives often did not live

¹ This paragraph summarizes a history presented in Ross and Friedman, 1990.

up to job creation promises, increasing final costs per job well beyond announced costs. Costs may also be imposed as owners game the system to get incentives for investments they would anyway make (Wolcott, 1992; Oechssler, 1994). Furthermore, manufacturing is subject to a profit cycle during which the optimal manufacturing location may shift (Markusen, 1985), so recruited firms may move to lower labor cost sites (e.g., offshore) when the abatements expire. Communities may recruit a firm thinking it will remain for twenty years and compute their willingness to pay accordingly; with a profit-cycle driven shorter time span, costs per year of benefit go up.

Zero Sum Game. Abatements merely move economic activity from one place to another without affecting growth at the national scale.

Market Distortion. Sectors favored by abatement programs grow at the expense of other sectors that may be more efficient given local market conditions. The result is market inefficiencies and lower overall productivity of the local economy.

So why do we still engage in industrial recruitment? Some of the main arguments:

Time Preferences. Industrial recruitment seems to offer some chance of jump-starting a stalled economy. Prior work (Loveridge and Loy, 1998, Loveridge, Bokemeier, and Kakela, 2005) has shown that people tend to prefer their economic development now rather than later, even if it costs jobs in the not-too-distant future. This time preference effect is intensified at the level of decision-makers, as officials are anxious to publicly display results before the next budget cycle (for agencies) or election, even when the costs of the program exceed the benefits (Dewar, 1998). Economic development choices such as training or investments in scientific research that will pay off further in the future have little value for officials dealing with political realities. Academics have a tendency to criticize officials for the scale of abatements, but research by Loveridge *et al.* (*op. cit.*) indicates officials are reflecting the preferences of the electorate.

Economic Diversification. Recruitment offers a way to seed industries that may not be present or ever arise in the local economy. The problem comes with deciding what qualifies as an infant industry. For example, LeRoy (2004) documents a Minnesota case where a \$275,000 tax increment financing subsidy was approved for a firm that was creating one (possibly seasonal) minimum wage fast-food restaurant job.²

² A kind of indirect abatement where property taxes the business pays are diverted from the general fund to pay off public debt incurred to finance improvements on that tax payer's property. In effect, the owner pays taxes instead of taking out a loan, thereby avoiding the loan payments.

Additional Benefits. We can go beyond the main arguments for industrial recruitment when policies targeting rural and economically distressed areas are considered. First, stabilizing small towns or core cities can make more complete use of existing infrastructure. Directing growth towards areas with underutilized infrastructure reduces the need to develop costly new suburban infrastructure and reduces pressure on the natural environment. This argument is particularly relevant where large facilities are vacant due to manufacturing, military base, or prison closings, but may also apply to roads, sewers, and schools. Second, many rural and central city areas have high poverty rates, so business subsidies in these areas may be justifiable on equity grounds.

The Michigan Experience

The Michigan experience with abatements is instructive. Initially against incentives, Governor Engler in 1995 inaugurated the Michigan Economic Growth Authority (MEGA), a tax abatement program aimed at attracting business investments (Reed, 1996) that would otherwise not occur (CRC 2001).³ The only geographic targeting was a lower eligibility threshold in federally designated distressed zones. By the end of 2003 there were 173 active MEGAs that benefited 36 of 83 Michigan counties (see Figure 1). A total of \$1.4B in abatements was granted (about \$145 per capita).

Michigan's national ranking in *Site Selection's* major business investment database rose sharply during the same period. It increased from 22nd in 1994 to 7th place in 1995 and 6th in 1996 (Nizalov and Loveridge, 2005). From 1997 through 2000, Michigan took first place, and remained in the top five from 2001 through 2003⁴ (*op. cit.*). This ranking is based on the number of projects meeting the magazine's job creation or dollar investment thresholds. While the association does not prove causation, implementation of the MEGA policy clearly coincided with increases in the type of investments that count in the magazine's contest. Even if one accepts *a priori* the strong assumption that MEGA caused all the investments, it should be noted that prosperity did not rise: Michigan's income per capita relative to the US declined over the same period, reversing an earlier period of modest improvement.⁵

³ "... applicants must certify that the project would not occur absent the MEGA grant." (CRC 2001, p. 20).

⁴ The ranking does not account for population. The US Census ranks Michigan as the eighth largest in population.

⁵ Author calculations based on Bureau of Economic Analysis data. From 1984 to 1988, the Michigan/US per capita income ratio hovered between .97 and .98; from 1989 to 1994 it gradually increased to 1.02, after MEGA was implemented, it declined from 1.01 in 1995 to .96 in 2002.

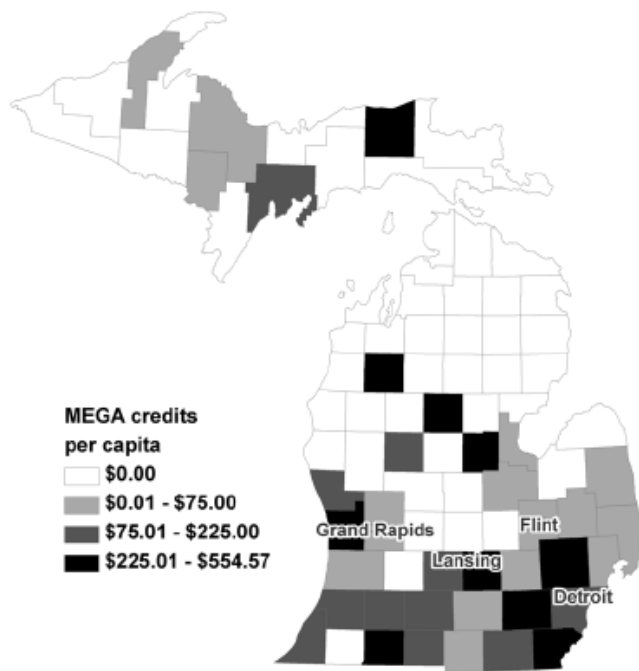


Figure 1. Michigan Economic Growth Authorities – 2003 (data from Michigan Economic Development Corporation).

The MEGAs were concentrated mainly in metro areas, with large stretches of Michigan’s rural areas, including Michigan’s highest poverty rural region, the northeastern part of the lower peninsula, failing to make any use of the policy tool (see Figure 1). Table 1 summarizes the rural-urban MEGA divide in per capita terms. Out of total of 173 MEGA, 153 (88 percent) are located in metro counties.⁶ The amount of tax credit per capita was \$168 in metro counties, but only about \$40 in non-metro counties. The MEGA program was used by 96 percent of metro counties but only by 21 percent of non-metro counties. Because the metro awards also tended to be larger than non-metro awards, 95 percent of the tax credits were awarded in metro counties. Comparing the distribution of the tax credits per capita (Figure 1), we can see that the difference in use of abatements between rural and metropolitan counties shrinks if there is at least one MEGA in a county. Thus much, but not all, of the bias in the policy application exists along the with/without lines, not with how much is granted. The metro bias in MEGA awards may have widened the income gap between metro and non-metro residents. At the begin-

ning of the MEGA program, personal income per capita in non-metro areas was 73 percent of metro per capita income, but by 2003 the gap had increased to 71 percent. Nationally, metro per capita income grew by 1.3 percent more quickly than non-metro income, but in Michigan, the gap in growth between non-metro and metro areas was 3 percent.⁷

In 2003, the legislature overwhelmingly voted to re-authorize MEGA. One modification to the 1994 law was lower employment eligibility threshold for up to five “rural” businesses per year. Significant impact on rural areas will take a long time at the rate of five (smaller) deals per year.⁸ In practice, even these small threshold awards seem to be biased towards higher population areas. In 2004 and 2005 five of the six “rural” MEGAs went to counties the USDA classifies as metropolitan adjacent.

Even within the metropolitan areas the policy tends to benefit more suburban communities. For example, Detroit Primary Metropolitan Statistical Area (PMSA), which consists of six counties, had 74 active MEGAs in 2003. Only four of them (5.4 percent) went to the distressed central city area (cities of Detroit, Highland Park and Hamtramack in Wayne County). The central city area received about \$34.6M in tax credits - \$180 per capita (only 4 percent of the total granted to Detroit PMSA). Meanwhile, suburban Oakland County, Michigan’s wealthiest county⁹, had one of the state’s highest per capita MEGA use, accounting for nearly 29 percent of total credits awarded state-wide. On balance, the MEGA program seems to be associated with an increase in state-sponsored deal making, but most of the activity seems to occur in well-off suburban areas in a limited number of counties. Because sprawl-type growth patterns in suburban areas frequently require additional state-subsidized infrastructure investments, the state may pay twice for growth in these regions and also increase the long-term costs of government services as it is forced to maintain infrastructure in depopulating rural towns and central cities (Hemlich and Anderson, 2001). There is some evidence that the geographic pattern of abatements observed in Michigan is not unique (Schweke, 2004).

⁶ Identified as those with Beale Codes 0-3.

⁷ Based on Bureau of Economic Analysis income data, 1995-2003.

⁸ “Rural” was defined as counties with less than 75,000 people, which includes 59 of Michigan’s 83 counties.

⁹ According to the US Census.

Table 1. MEGA awards in metropolitan and non-metropolitan Michigan, 1995-2003 (data: Michigan Economic Development Corporation)

	Number of MEGA	MEGA per 100,000 county residents	Total Amount of Tax Credit	Tax Credit Per Capita	Counties with MEGA / all counties
Total:	173	1.72	\$1,466M	\$145	36/83=43%
Metro:	153	1.85	\$1,393M	\$168	24/25=96%
Non-Metro:	20	1.11	\$73M	\$40	12/58=21%

Recommendations for Change

The example shows that using abatements to attract investment may produce perverse outcomes: poor communities subsidizing the rich and increasing overall costs of government. But with increasing global competition, industrial incentives are probably here to stay. Rather than eliminating this economic development option, a more reasoned and politically feasible approach might be to increase the competition for abatements and to put into place methods to assure a more equitable geographic distribution of tax credits. Schweke (2004) proposes a) recession-triggered state-wide job creation tax credits or b) geographically targeted wage subsidies for companies hiring unemployed workers as an alternative to tax abatements. LeRoy (2004) suggests “sunshine” as a way of limiting tax abatements. He provides a number of examples of state policies to increase awareness of the level of tax abatements and other incentives given to relocating companies. His suggestion is that reporting of subsidies will cause individuals to object to egregious use of incentives, thereby curtailing officials’ willingness to apply them. While LeRoy’s approaches have some merit, our observation is that the states from which he draws his examples do not seem to have reduced their overall levels of incentives; indeed, the \$275K tax increment financing story he documents from Minnesota was fully subject to “sunshine” through a public web site. So sunshine is good but not enough. Communities must feel there is some cost of using abatements, even if state government is paying.

Communities could be made to feel some cost if a per capita cap on the amount of tax credits awarded within a county per five-year reauthorization cycle were set. For example, as shown in Table 1, Michigan awarded tax credits of \$145 per person between 1995 and 2003. If we assume the same rate of tax expenditure in future years, this works out to about \$16 per person per year, or \$80 per person for five years. Tax credits could be capped at \$80 per person during each five year reauthorization cycle. So a county with 100,000 people would have a cap of \$8M in tax credits

to be used during the five years. So an \$8 million tax abatement in year 1 of the cycle would mean that no new abatements could be awarded in that county. If existing local businesses know that abatements for a new company may cost them tax credits on their future expansion, they will have incentives to closely examine any local deals. This, together with LeRoy’s “sunshine” policies, would establish a countervailing pressure to offset power that is currently concentrated in the hands of footloose businesses.

Motivation to critically scrutinize abatements could be further increased if the State were to award localities funds for alternative economic development programs (e.g. basic infrastructure development and repair, business counseling, revolving loan funds, worker training, tourism promotion, or value-added agriculture) based on the number of unused tax credits at the end of the abatement’s authorization cycle. To continue our example, suppose the county with a population of 100,000 were to award only \$4M in tax credits during the five year reauthorization cycle. A portion (say 50 percent) the remaining tax credits could be given to the county to support entrepreneurial training, workforce development, revolving loan funds, amenity development, or a temporary county-wide reduction in state business taxes. Groups likely to benefit from these alternative economic development programs would then have an interest in serving as watchdogs of local dealmaking. A two week comment period followed by a public vote by the local elected body would assure open debate without unduly delaying the firm’s investment decision. Such a program would help local groups internalize the real tradeoffs involved with tax abatements without shutting the door on this important but controversial economic development tool. Alternatively, one could decouple the payments from the per capita cap and simply make an allocation to areas that don’t make use of abatements. This is justifiable on pure equity grounds, and could still help local areas resist bad deals, increasing the efficiency of state tax incentives.

Geographic targeting of economically distressed and rural and core urban areas might further increase

efficiency of tax abatement policies, as long as the number of eligible zones is sufficiently restrained. For example, areas with poverty rates in the top ten percent could be made eligible for a slightly larger per person allocation, while wealthy areas where sprawl is an issue could receive proportionately less. In highly urbanized areas, city boundaries might be used to determine eligible poverty rates rather than county boundaries. Borders could be used to increase regional collaboration in economic development. For example, localities could be allowed to give a portion their allocation of state tax abatements to a bordering community in exchange for a portion of the resulting tax base. This might ultimately serve to reduce the multiplicity of local industrial recruitment offices present in the current system as neighboring communities with common goals discover the benefits of working together rather than competing.

Implementing the suggested per capita caps and refunding a portion of the unused abatement allocation to the locality are not without some potential costs, and these should be discussed. First, some will claim that it will impose excess processing costs on the system. The information management abilities of both firms and government have increased substantially since the 1930s, so implementing the changes should not be beyond their capacities. If government could track a temporary tax abatement in the 1930s, it can probably track a cap on abatements now! Second, the policy will inevitably be blamed for lost prospects. These costs must be balanced against the cost of providing subsidies for low quality jobs, for firms that would locate within the area without the abatements, or for firms whose other attributes (pollution, reputation for socially unacceptable management practices) make them undesirable to the local community.

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