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Michigan's Economic Development Policies

Testimony of

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Thank you, Mr. Chairman, and members of the Joint Committee on Business Competitiveness, for the opportunity to testify before you today on Michigan's business climate and what the state government can do to promote job creation.

Our remarks today are inspired in part by our experience over many years providing economic analysis to local economic development groups in Kalamazoo, Battle Creek, Grand Rapids, Benton Harbor and several rural areas in the state. It is also based on our research on economic development policies in various states and communities throughout the nation. But our remarks today are primarily based on our work last year, together with Peter Eisinger of Wayne State University, in writing the chapter on state economic development policies for the "Michigan at the Millennium" project sponsored by Michigan State University, the University of Michigan, and Wayne State University. This project is producing a book on Michigan's economy and fiscal policies that will be published in June 2003 by Michigan State University Press.

In sum, our research suggests that this state has fundamentally sound economic development policies that need modest reforms and enhancements, not repeals and cuts. Michigan's tax structure for business is surprisingly competitive. Michigan's economic development agency, the Michigan Economic Development Corporation (MEDC), does an excellent job of providing needed economic development services to existing businesses. The Michigan Economic Growth Alliance tax credit program (MEGA) provides assistance that is highly targeted and probably cost-effective. The major gap in Michigan's economic development portfolio is that the state currently offers few programs to encourage and enhance small business growth. The remainder of our remarks will amplify this summary and provide evidence.

While some in the Michigan's business community argue that state taxes should be lower, our research shows that Michigan's effective state and local business tax rates are already at or lower than most

of our nearby competitor states. We have attached a table from our “Michigan at the Millennium” chapter that compares state and local business tax rates for the average manufacturing firm in Michigan to state and local business tax rates of similar firms in Indiana, Ohio, Illinois, and Wisconsin. These rates are calculated using a “hypothetical firm” model which tries to simulate all state and local business taxes for a typical firm with a typical balance sheet. This table shows that even without considering economic development incentives, such as property tax abatements, Michigan’s average business tax rates are lower than those in Indiana and Ohio. Moreover, Michigan has more extensive economic development incentives than our nearby competitors. With “normal” incentives, such as the property tax abatements provided to virtually every new or expanding manufacturing plant in Michigan, average Michigan business tax rates are about the same as effective tax rates in Illinois and lower than all the other nearby competitor states. With Michigan’s more “selective” incentives, such as MEGA or Renaissance Zones, Michigan’s effective business tax rates are clearly lower than all these nearby states.

At the same time, state policymakers should also recognize that higher business tax rates that finance public services valued by businesses may enhance a state’s economic development. Of 26 studies that have examined the effects of public services on state and local development, 15 studies found positive and significant effects of higher levels of public services on state growth.¹ Three of these studies allowed a comparison of the positive effects of public services with the negative effects of taxes on economic development, and all three of these studies found at least one public service for which a business tax

¹Timothy J. Bartik, *Who Benefits From State and Local Economic Development Policies?* (Kalamazoo: Upjohn Institute, 1991)

increase, if used to finance that public service, would enhance the state's economic growth. Services that were frequently found to enhance economic development include education and infrastructure spending.

Michigan's main economic development organization, the Michigan Economic Development Corporation or MEDC, has generally received high ratings for performance from both outside observers and the MEDC's "stakeholders," the businesses and economic development organizations that the MEDC works with. MEDC has been judged to be one of the top ten state or local economic development organizations in the U.S. for four years in a row (1997–2001) by *Site Selection* magazine. In a survey by Public Sector Consultants (PSC), 77 percent of surveyed stakeholders having experience with MEDC report that they were very satisfied, and 16 percent report that they were somewhat satisfied. Public Sector Consultants points out that "in general, customer satisfaction surveys of government and member organizations yield 50–60 percent satisfaction ratings. Just once in PSC's experience of administering customer satisfaction surveys have we encountered satisfaction numbers in the high nineties."

One reason that MEDC deservedly receives high ratings is that unlike many economic development organizations in other states, the MEDC devotes the majority of its staff resources to helping existing businesses resolve problems or barriers to growth. Extra attention to existing businesses is appropriate because such businesses create many more jobs than attracting new firms to a state or local area. Of the jobs added by plant openings and expansions during a one-year period, about 85 percent are due to existing firms expanding, versus only 15 percent for new firm openings.² Clearly, state and local economic development efforts must pay a lot of attention to encouraging expansions. The MEDC has 23 "account

²Stephen Davis, John Haltiwanger, and Scott Schuh, *Job Creation and Destruction* (Cambridge, MA: The MIT Press, 1996).

managers” working on retention compared with only eight staff persons working on attracting new companies. Many other states have a majority of their staff working on attraction rather than retention, which we would argue is a mistake. According to one outside observer we interviewed for our “Michigan at the Millennium” study, Michigan “has been a trend setter [among states in industrial retention]...Industrial retention is one of the best things they have done.”

It is important to understand that the retention services provided to existing businesses by account managers represents a legitimate public service that could not be adequately provided by the private sector. These account managers help businesses learn about new sites, understand and resolve problems with regulatory agencies and the permitting process, and learn about how to access training services provided by community colleges. A publicly supported economic development agency that helps resolve these problems makes sense because the public sector has an obligation to help make its regulations and services understandable and accessible by all constituents, including the business sector. Such services, while helping in retention, may also be highly effective in attracting new businesses. Whether a business is trying to expand an existing site, or locate at a new site, time is frequently of the essence, and services that save time are enormously valuable in increasing favorable location decisions. In addition, many rural areas of the state lack adequate expertise in economic development, and the MEDC’s account managers are particularly needed in helping these areas. Finally, the account managers help coordinate local efforts and discourage in-state “raiding” of business projects.

One of the larger state-financed incentive programs is the Michigan Economic Growth Alliance tax credit program, or MEGA. Under this program, the state provides a limited number of job-creating business projects with sizable tax credits. We found that MEGA could frequently have significant effects

on the profitability of a project, reducing average state and local business taxes for a project by 36 percent. The state tries to target MEGA tax credits only on projects where the project would have been located outside of Michigan “but for” the MEGA credit, and where the project will result in a net fiscal gain for the state treasury. Although the gross costs of MEGA (the tax credit actually paid) are now about \$50 million a year, we found the true costs of MEGA may be considerably less, and in fact the program may even raise money for the state. By statute, MEGA is supposed to be decisive in 100 percent of its projects, an unrealistic standard. Our research suggests that the MEGA program will break even from a state budget perspective if MEGA is decisive in 28 percent of its projects, which we think is quite possible.

In our view, one area where the state could enhance its economic development policies is by expanding its support of small business services. MEDC has tried to minimize state involvement in small business promotion in recent years because of fears of being overwhelmed by dealing with huge numbers of small businesses, many of which are not part of Michigan’s economic base and are unlikely to play a catalytic role in promoting a strong Michigan economy. However, we believe that MEDC could play a useful role by providing financial support to local intermediary organizations that assist small businesses. This MEDC financial support should be targeted at small businesses that are part of the state’s export base, which are businesses whose growth enhances the state’s economy by selling goods or services outside the state or substituting for goods or services that are imported into the state. In contrast, assisting Michigan small businesses that simply compete with other small businesses in Michigan is likely to substitute greater growth in the assisted firm for less growth in unassisted firms, with little net effect on the state economy.

Possible initiatives to improve Michigan’s small business growth include:

- **Make state investments in intermediary programs or organizations that would increase the supply of capital to new small businesses that are part of the state’s export base.** This could include state grants to local revolving loan funds that provide small business loans, state investments in seed capital and venture capital funds, state grants or investments in local business development financial institutions, and renewed state support for the Capital Access Program. (The Capital Access Program, terminated as of September 2002, is a program that was originated in Michigan, and then spread to 19 other states, under which state government provides partial support for loan loss reserves that encourage banks to provide somewhat riskier than normal loans to small businesses.) Evaluations of such capital market programs suggest that they can be successful in encouraging loans and investments that would not normally be made by the private market, and yet are of acceptable risk given the potential social benefits of successful economic development.³
- **Provide state support for the 12 regional Small Business Development Centers in Michigan that provide information and counseling to potential start-up small businesses and existing small businesses.** Unlike other states, Michigan’s SBDCs are totally supported by federal and local funds and receive no state support. State support should be targeted on helping business ventures that either export from the state or replace imports to the state. Evaluations suggest that information and training for entrepreneurs can significantly increase small business success. For example, one study suggested that of potential entrepreneurs provided with

³Evaluations include: Alan Berube, “Capital Access Programs”, January 2001 report by U.S. Department of the Treasury; Andrea Levere and David Wingate, “Counting on Local Capital: Evolution of the Revolving Loan Fund Industry,” 1999 report in *Community Investments*, a publication of the Federal Reserve Bank of San Francisco.

training, 60 percent successfully started a business, compared to 44 percent in a control group that did not receive such training.⁴

- **Increase state support for the network of six regional centers that are part of the Michigan Manufacturing Technology Center, which provide technical assistance to help small and medium-sized Michigan manufacturers improve their productivity.** Studies suggest that such “industrial extension” programs can increase the productivity of assisted businesses, compared to otherwise similar businesses, by 3 to 5 percent per year.⁵

Ultimately, the case for state government support for economic development programs depends on two assertions: (1) such programs can increase state economic growth; and (2) state economic growth provides social benefits to the public, which justifies public support. As we have already pointed out in this testimony, there are a number of studies that suggest that economic development programs can increase state economic growth. There also are a number of studies that suggest that stronger economic growth can reduce poverty, increase employment rates, and increase occupational upgrading.⁶ However, we suspect that any person who has had trouble finding a job, or has suffered through major plant closings or downsizings, would find no trouble believing that there are social benefits from creating jobs for persons who need them. We suspect the case for the social benefits of employment growth would be obvious in many communities in Michigan that have gone through economic turmoil: Flint, Battle Creek, Detroit, the

⁴Jacob Benus et al., *Final Impact Analysis of the Washington and Massachusetts Self-Employment Demonstrations*, report to U.S. Department of Labor, December 1994.

⁵Eric Oldsman and Jack Russell, “The Industrial Resource Center Program: Assessing the Record and Charting the Future,” 1999 report prepared for State of Pennsylvania.

⁶These studies are reviewed in a book by Timothy Bartik, *Jobs for the Poor* (New York, Russell Sage Foundation, 2001).

Upper Peninsula, and Kalamazoo. Well-targeted and operated economic development programs are a legitimate government activity that can increase the ability of the private sector to provide the jobs, earnings, and stability that our citizens and communities need. As we have argued in this testimony, this state has good programs in place to pursue these goals. We urge the legislature to support these programs by enhancements and careful reforms.

**Effects of Economic Development Incentives
on Effective State and Local Business Tax Rates,
Michigan and Nearby States**

State	Effective State and Local Business Tax Rate without Incentives (% reduction in rate of return)	% Reduction in State and Local Taxes Due to Normal Incentives	% Reduction after Discretionary Incentives Such as MEGA	% Reduction after State and Local Enterprise Zone Incentives
Michigan	11.3	27.7	63.6	85.0
Indiana	20.5	20.0		57.1
Ohio	15.0	22.6	28.1	48.8
Illinois	8.6	6.8		25.6
Wisconsin	9.3	0		31.7

NOTES: This table is derived by simulations of the Tax and Incentive Model (TAIM) developed and maintained by Peter Fisher and Alan Peters of the University of Iowa. Fisher and Peters (1998) describe the model in detail. The model is a hypothetical firm model. State and local taxes and incentives are defined as of 1998 in the current version of the model. The results here are based on results for 16 manufacturing industries at the two-digit level (SICs 20, 23–28, 30–38). The average results reported here are aggregated using GDP shares of each industry in Michigan in 1999. The effective state and local business tax rate is defined as the percentage reduction in the internal rate of return in a project located in the state, compared to locating the same project in a hypothetical state that has no state or local taxes. For example, a reduction from a 10% return to an 8% return is a 20% effective tax rate. The percentage reduction in state and local taxes is simply the reduction in taxes with the incentive in question, compared to if there were no incentives, divided by the taxes if there were no incentives, and multiplied by 100. Both the discretionary calculations and the enterprise zone calculations also assume all the normal incentives are applied, but the enterprise zone calculations assume that discretionary incentives such as MEGA are not also applied. Michigan and Ohio are the only ones of these states that have truly discretionary incentives.