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Making Tax Abatements More Effective

by

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My name is Wayne Wendling. I am a senior economist with the W. E. Upjohn Institute for Employment Research in Kalamazoo, Michigan. The presentation which I am about to give is based on research that I conducted several years ago on the relationship between tax abatements and the financing of public education, and also on the general effectiveness of tax abatements at inducing industrial and commercial development. Furthermore, I have had the opportunity to apply the research findings to the practical problems facing a community since I also have served on a special study committee for the city of Kalamazoo that examined the use of tax abatements. Thank you for the opportunity to make this presentation.

The recessionary conditions from 1980 to 1982 put economic development and job creation at the forefront of the policy debate. However, since we are in the second year of the recovery, it may be time to reevaluate what has been done and to see if changes can be made that will not impede the competitive position of this state and its communities, and at the same time enhance the revenue positions of its local taxing units.

Economic development is an extremely competitive activity. States attempt to extol their advantages and differentiate themselves from their neighbors. One dimension along which states cannot afford to be too different is tax policy. For example, a state may not want to use industrial development bonds, but it needs to keep the enabling legislation on the books. To repeal it would make the state notorious. Likewise to propose that the state of Michigan repeal Public Acts 198 and 255 would put the state at a significant competitive disadvantage. But it is possible to make tax abatements work more effectively for this state and its communities.

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Michigan must be cognizant of what the tax abatement legislation is in neighboring states. I will briefly review them here.

Indiana: Tax abatements are limited to urban development areas. That is, to areas within cities that have become undesirable due to the cessation of growth, deterioration or other factors that hinder the use of the property. Abatements are limited to 10 years, but the percentage of the property abated is set according to a sliding schedule established in the statute; 100 percent in the first year, 95 percent in year 2, 80 percent in the third year and 5 percent in the final year.

Illinois: The tax abatement statute was adopted in 1982 in Illinois. Any local taxing district may abate any portion of the district's taxes applying to newly located industrial firms. The maximum length of the abatement is 10 years, but no more than \$1 million worth of taxes can be abated for any facility.

Ohio: Tax abatements in Ohio are limited to community reinvestment areas. According to the definition, community reinvestment areas must have existing older housing or structures of historical significance. A 15 year abatement can then be granted for newly constructed dwellings, commercial and industrial structures. The percentage abatement is not listed.

Wisconsin: Does not grant tax abatements.

Thus, as we can see, most other Midwest states have legislation that allow the granting of tax abatements, but they differ in what is eligible, how long and how much can be abated. It does appear, however, that Michigan statutes are the most flexible.

THE INCONCLUSIVENESS OF THE RESEARCH EVIDENCE

Frequently, the issue of tax abatements is put in terms of a full loaf versus a half loaf versus no loaf at all. Granting a tax abatement when it's not necessary will result in half of a loaf, that is, you are giving up half the tax revenues. Conversely, there is the potential that if you don't grant the tax abatement, there will be no loaf at all and the firm will decide to locate its plant elsewhere or to expand its operations elsewhere. This difficulty is mirrored by the fact that some research results show that tax costs are not really an important element in the decision to locate a plant or to expand the plant, whereas other studies show that the tax structure can be a significant determinant.

Roger Schmenner's evaluation of relocations and new plant locations of Fortune 500 firms determined the following features as "musts" for the state/region, in the order they are listed.

- * favorable labor climate
- * near market
- * attractive place for engineers/managers to live
- * near supplies, resources
- * low labor rates
- * near existing facilities of division/company
- * environmental permits

Schmenner also was able to evaluate the "must" factors for the final site selection. That is, the site within the region. The "must" factors are listed in order below:

- * rail service
- * on expressway
- * special provision of utilities
- * rural area
- * environmental permits

Low taxes was listed as a "desirable" factor, but only in 35 percent of the plant openings.

But there is other evidence that indicates the state and/or local government tax structure is a significant factor. A survey of high technology firms was conducted by the Joint Economic Committee of the Congress of the United States. One question that was asked of the high technology firms was the significance of various factors influencing the location choice of those firms. The most important factor was the availability of workers, particularly technical, skilled and professional workers. The second most important factor was the state and/or local government tax structure and the third most important determinant was the community's attitude toward business.

It should be noted that there is some disagreement about what the state and/or local government tax structure means. Some suggest that it refers primarily to local taxes which the business bears directly. Others suggest that it refers to sales, income and residential property taxes which are borne by workers. Furthermore, some suggest that the tax structure does not

necessarily mean low taxes, but it refers to stable taxes that businesses can plan on, rather than surprise or special taxes.

FUNDING PUBLIC EDUCATION

The Michigan State method of funding public education is based on a district power equalizing formula. This formula equalizes the return that each school district gets from each mill of tax that it levies. However, because the state contribution has not kept pace with the increases in the general cost of education, and due to declining enrollments, more and more school districts have moved out-of-formula. That is, they are no longer receiving aid from the state of Michigan for general operating purposes; all revenues for general operating purposes are raised locally.

The implication of being out-of-formula is that the school district is directly impacted by the granting of a tax abatement to a firm that would not have necessarily required one to expand in the area. This is the rub. It appears to be the general feeling that tax abatements are frequently granted in situations in which the firm is already committed to the area, its expansion plans are well under way, and the abatement really does nothing more than reduce the firm's obligation. It is not the critical element in inducing the decision to expand or relocate.

This moves us to the question of whether tax abatements impair the financing of public education. The answer to this could be a "no" very quickly if the level of state funding was sufficient so that no school districts are out-of-formula. Then, any granting of an abatement which potentially would result in a half of a loaf as opposed to a full loaf will not result in lost potential revenues because the district is limited to what it can spend by the tax rate that it is willing to levy. But almost 200 districts within the state are out-of-formula. Therefore, if an abatement is granted to a firm in which the abatement is not a critical factor, we have the situation in which potential revenues are being lost. There is never the situation in which revenues are being taken away. But if potential revenues are being lost, it may not be possible to provide the level of public services that the community desires.

This suggests that we should find more effective ways of determining when to grant tax abatements. It is easy for us to say that local units of government should be more critical in their evaluation of tax abatement applications, but there are a number of forces at work on that local unit of government which we really cannot appreciate. The firm applying for the abatement will indicate that it is necessary for their expansion. The cost associated with making a mistake, i.e., not granting the abatement that is crucial to the decision, is much greater than the cost associated with granting an abatement in a situation in which it is not needed. Everybody remembers the one that got away. Furthermore, our understanding of the location decision or expansion decision, as should be evident from the findings provided earlier, is not sophisticated enough to state with 95 percent certainty when the tax abatement is the critical factor for undertaking the project. Therefore, the tendency is to err on the side of being more generous.

This brings us to the point that is often overlooked: public services are necessary to produce goods and services. Taxes are one cost of doing business, but that cost is indistinguishable to the firm from the cost arising from increased maintenance costs on a fleet of trucks due to inadequately maintained roads. The public services are inputs into the production process. We know a firm cannot produce goods and services unless it has water; it cannot get goods to market unless it has roads and it needs skilled workers to make the product. These are legitimate inputs to their production process. What is needed is a balance between the granting of tax abatements to insure that economic development takes place and having sufficient revenues so that the public services so critical to the production of these goods and services can be provided.

Several other issues are related to this. First of all, there is the question of the redistribution of the tax burden within the community. As abatements are granted to industrial and commercial firms, and the same level of public services are expected, there will be a shift of the tax burden from the firms to the residents. Is this a shift that we desire to see? Second, if there is a difference in the propensity of communities to grant tax abatements, then there can be a shifting of funds from one part of the state to a different part of the state. For example, if a community that tends to grant tax abatements has a school district that is in-formula, the granting of the tax

abatement will lead to more state aid flowing into that district, whereas the granting of the tax abatement in the community in which the school district is out-of-formula will have no such effect.

A study conducted about 15 years ago documented the experience of a major aluminum company. The company conducted an intensive study as to the least-cost location to construct a new plant. They decided upon a community in West Virginia in which the supply of labor was plentiful and the wage level was low. On completing the construction of the plant and opening up of the personnel office to hire the individuals, they discovered that the quality of public education was so low in that community that the individuals did not have the requisite skills to be employed. They had to recruit individuals from outside the community in order to staff that facility. In fact, they had a difficult time recruiting the managerial staff to that location because they were reluctant to move there due to the inferior level of public services. Therefore, what turned out to be a low-cost location was actually not because the firm had services to compensate for them.

ADMINISTERING TAX ABATEMENTS

Given the difficulty in deciding beforehand whether an abatement is necessary, the question we should be asking is: How do we make the use of tax abatements more efficient so that the local community is not giving up more potential revenues than necessary?

Using tax abatements more efficiently and effectively gets us into the area of administering tax abatements once they have been granted and/or varying the length of the abatement according to certain criteria. Currently, most abatements are granted for 12 years. This occurs if the investment represents either a minor addition or a major expansion. Perhaps one of the things we could do with abatements is to use them to encourage greater investment. That could be done by varying the length of the abatement according to the value added to the existing investment. Another approach would be to limit the length of the abatement, particularly on equipment, to four or six years. Still another approach would be to decrease the percentage abatement over time, similar to the Indiana formula. Looking at the schedule of the value to the

firm of an abatement, it becomes obvious that the later years add relatively little to the present value of the abatement. Furthermore, we know that firms tend to have relatively quick payoff schedules; i.e., they will not make the investment unless the equipment pays for itself within four to five years. Why subsidize the firm for a longer period of time than it would be willing to assume the risk?

Another approach is to limit the percentage of revenues that a community can abate. For example, you can estimate or calculate what the total revenues would be from your tax base given your existing tax levies and then recalculate it with the revenues you are actually receiving after deducting the revenues foregone due to tax abatements. If the revenues foregone exceed 5 percent or 7.5 percent of the potential revenue and given the overall tax levy of the community, one may be dangerously close to having exceeded what we tend to call the community's fiscal capacity. That is, the community is approaching the point that any increase in the tax levy will lead to an exit of firms and individuals from the community. Overburden arises when the public service requirements exceed the level that can be provided with the revenues generated. This is potentially a very severe problem and it goes back to the point that public services also are inputs into the production of private goods and services.

Perhaps the most difficult issue concerning the granting of tax abatements is the equity issue. If you grant an abatement to one firm, can you deny another? What if you grant an abatement to a firm that is a competitor of an existing firm? That existing firm is not going to be coming before you for an abatement because they are not planning any plants and equipment expenditure. Is this an equitable situation? We have moved to that point in which the abatement is viewed as a right. Part of this is the result that they have been granted so indiscriminately that any decision not to is viewed as a discriminatory act. Therefore, as we consider the whole tax abatement issue, we need to keep this equity concept in mind.

Finally, there is the issue of whether a tax abatement is an efficient subsidy from the community to the firm. This is a question of the bang for the buck. Local property taxes are deductible for a federal income tax purposes. Suppose we abate \$500,000 worth of property taxes for a firm. If that firm is

already paying corporate income taxes at a 46 percent rate, the actual value of that abatement to the firm is just a little more than \$270,000. The community has given up \$500,000 in tax revenues but the abatement is only worth around \$270,000 to the firm. That is a pretty inefficient subsidy to give up \$2.00 in exchange for \$1.00 in benefit.

This suggests that we must look at the whole coordination of local tax policies. One other tax policy that is very much in demand these days is tax incremental financing (TIF) in which an upfront subsidy is given to a firm as opposed to subsidy over time. In some instances, that type of a subsidy is much more effective because its value is not being stretched out over time and secondly, you don't have the federal income tax deductability question there. So there is the need to look at coordinating these policies rather viewing them separately.

In conclusion, the State of Michigan is constrained about what it can do regarding tax abatements. Competition from other states requires that the state continue to allow local taxing units to grant them. Furthermore, in some instances, an abatement may be the critical determinant in an investment decision. The avenue that seems most fruitful is to (a) reduce their length, (b) make the length a function of the value added, (c) introduce a sliding scale of percentage abated each year, and (d) place an upper bound on the revenue that a community can forego.