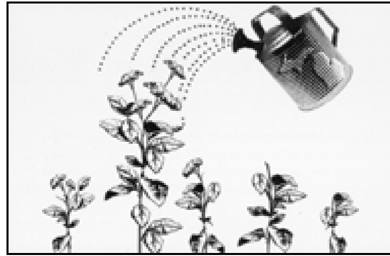

MEGA Industrial Policy: An Analysis of the Proposed Michigan Economic Growth Authority

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7/26/96

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I Introduction

Attracting, retaining, and expanding private sector firms--and the jobs that come with them--has in the last fifteen years become a major competitive enterprise for every state in the nation. Economic development programs at the state and local level have sprouted quickly, and job creation has become a central theme of nearly every political campaign. Plant expansions, relocations and closures are the stuff of headline news, and can have a stunning impact on a community, either positive or negative.

In the course of the debate over what role Michigan state government should play in economic development, two distinct philosophies have emerged. The first, a free market approach, recognizes that the costs imposed on commercial enterprise by government policies such as taxation, regulation, and legal liability act to discourage economic activity. Political leaders guided by this principle emphasize restructuring government to impose fewer costs by downsizing, privatizing, reforming tort law, streamlining or eliminating regulatory procedures, eliminating barriers to capital formation, and lowering overall tax burdens.

The free market approach holds that the purpose of government is to provide the legal and protective functions necessary for the economy to operate efficiently. This philosophy recognizes that true wealth is created only by increasing the amount of valued goods and services, not by simply "creating jobs." It focuses on reducing the government-created disincentives to productivity, and seeks to provide equal treatment for all commercial enterprises.

The second philosophy views government as an active player in the economy, often referred to as "industrial policy." In this view, it is the role of government to decide what types of business are needed, what type of training programs are necessary, and where these businesses should be located; to create strategic investment pools to assist businesses that fail to acquire funding in the private market; to subsidize losses, and so forth. It trusts the judgments of state bureaucrats more than those of the individual consumers, workers, bankers, insurers, investors, and managers whose collective decisions form the market economy. It takes tax dollars from citizens and businesses and redistributes them to certain projects or companies that find favor with state officials and their economic development planners. It abandons nondiscriminatory tax policy in favor of selective tax policy that lowers operating costs for certain preferred businesses or investments, often at the expense of others.

One industrial policy tool widely used in Michigan and elsewhere to help attract business to the state or a particular area is the selective tax exemption, usually in the form of a tax abatement or tax credit. Another tool is the direct subsidy--in the form of loans or direct payments--for capital, job training, research and development, or a variety of other purposes. As a 1988 report commissioned by then Senate Majority Leader John Engler declared,

> The use of such incentives has now proliferated to the degree that the process of business location in America has devolved into an intense interstate cold war competition--with each state having far more weapons in its arsenal than it needs, but no state willing to unilaterally disarm for fear of losing parity in the battle for business migrants. From a business management standpoint, so many state and local governments now offer discretionary

> inducements that they have often come to be a prerequisite to, rather than a determinant of, new investment.(1)

During the 1990 gubernatorial campaign, challenger John Engler criticized incumbent Governor James Blanchard for pursuing the latter agenda, a government directed industrial policy, and with good reason. In the 1980s Governor Blanchard presided over a string of failures with state investment in commercial enterprise. The state-subsidized AutoWorld theme park in Flint went bankrupt; the Michigan Strategic Fund found two-thirds of its direct loans and grants were either delinquent or in deep trouble; the Urban Land Assembly Fund wrote off 38 percent of its economic development as in default or verging on default.

After winning a narrow victory, Governor Engler, despite some notable exceptions, pursued a free-market economic development strategy designed to reduce the costs of Michigan state government for all citizens and businesses. National attention focused on Michigan as the state restructured school financing, cut property taxes, privatized state functions, and streamlined departments. Michigan became a model for dealing with fiscal challenges without raising taxes.

Defining Economic Development

Much of Michigan's recent acclaim is due to the state's dramatic turnaround. But even with unemployment at an astonishing low of 4.1 percent, economic development is still at the forefront of policy discussions. In the last decade the focus of attention has become jobs-and lots of them. Lost in the debate is the true foundation of prosperity. Perhaps the notion of economic development needs a closer look.

Economic growth refers to an increase in real output of goods and services per capita. Economic development describes a broader phenomenon of increasing standards of living and improved quality of life. Obviously, productive employment contributes to economic wellbeing and thus fosters economic development. Economic growth, productive employment, and economic development are the natural consequences of private enterprise in the free market economy. Free individuals and enterprises, acting to maximize their own self-interest, generate employment, development, and improved standards of living. It doesn't require intrusive governmental intervention or exotic policy schemes, only unexciting, mundane protection of private property and free exchange.

Now in his second term, Governor Engler is beginning to advocate selective industrial policy as an economic development strategy in addition to continuing efforts to reduce the general costs of state government. In his State of the State address, Governor Engler proposed creating a new state agency, the Michigan Economic Growth Authority (MEGA), that would grant selective tax credits as a means of defense against other states that attempt to lure away Michigan jobs, and as an incentive for certain out-of-state businesses to expand or relocate in Michigan.

This report examines the MEGA proposal and discusses the merits and problems with such an approach. The report concludes that MEGA is a severely flawed proposal that would not only fail to achieve its goal, but also discriminate against small businesses and retail businesses, increase the costs of state government, hinder further across-the-board tax reform, and set a dangerous precedent for discretionary state-level tax policy.

II What is MEGA?

As proposed by the Michigan Jobs Commission, the Michigan Economic Growth Authority would be a 7-member state board chaired by the chief executive officer of the Michigan Jobs Commission, and include the state treasurer, the director of the Department of Transportation, the director of the Department of Management and Budget and three other individuals appointed by the Governor with the advice and consent of the Senate.

The MEGA board would administer a "Job Expansion Incentive Program." This program would provide refundable single business tax (SBT) credits for up to 20 years for selected Michigan firms whose business investments create over seventy-five "high-paying" jobs in Michigan. Out-of-state firms must create one hundred fifty such jobs in Michigan to be considered for the credits. The credits would equal up to the amount of state income tax paid by the new employees plus an amount equal to the company's increased SBT liability. The incentive is capped at, and could be used by the company to offset, the planned capital investment, related infrastructure, employee training costs and relocation costs of the project.

To understand how the credit would work, assume a Michigan manufacturing firm is selected to receive a MEGA tax credit for a $10 million expansion that creates 100 new jobs. Assume further that the new expansion generates income which creates $50,000 per year in additional SBT liability. If the average state income tax paid by these employees is $1,500, the company would receive a $200,000 (100 x $1,500 + $50,000) SBT credit each year for up to 20 years, for a total credit of $4 million.

State officials are cautious about estimating the impact on the state budget, but first year revenue reductions in the range of $7-$10 million have been proposed. A mid-range figure of $8 million in first year reductions, assuming a 20 year credit period, would mean that the board is expected to authorize approximately $160 million (current year dollars) in SBT credits for the first year of the project. Although new credits would not be authorized after December 31, 1998, those authorized before that time would continue for up to 20 years. Over its 4-year life span, the proposal would allow the MEGA board to authorize approximately $640 million in single business tax credits. If the Legislature extends the program, the credits could increase indefinitely, and the proposed legislation sets no limit on the amount of credits that can be granted.

Program Details

Any business seeking a MEGA tax credit must qualify using the following process set forth in the proposed legislation, and subject to amendment:

First, the business must be an "eligible business," which means that it creates new jobs in Michigan after the effective date of the MEGA act, in manufacturing, research and development, wholesale and trade, or office operations. Retail businesses--including department stores, restaurants and hotels--are not eligible businesses and may not receive a MEGA credit.

Next, an "eligible business," must meet another set of criteria in order to apply for designation as an "authorized business."

1. The business must create a minimum of 75 "qualified new jobs" if expanding in Michigan, or 150 qualified new jobs if locating in Michigan, within 12 months of opening the facility. A "qualified new job" means a full time job in excess of the number of jobs existing in the year before the new facility opens.

2. The business must agree to maintain the 75 (or 150) new jobs each year that a credit is received.

3. The business must agree to maintain a number of employees greater than the number employed in the year before the new facility is opened.

4. The average wage paid for the new jobs must be greater than the average wage paid by private sector firms in that county.

5. The business must certify that the expansion or location would not have occurred in Michigan without the tax credit.

6. Local government must make a financial or economic commitment to the business for the facility.

7. The business must not have begun construction or announced the specific location of the facility.

In the third step, the MEGA board determines if the business meets the criteria above, and whether:

1. The expansion or location will "benefit the people of this state by increasing opportunities for employment and by strengthening the economy of this state."

2. The tax credit is needed due to a significant cost disparity--including economic incentives offered by a competing state--between this state, and the competing state.

3. The business has a sound financial record based on the financial statements of the last 3 years.

The final step is for the MEGA board and the business to execute a written agreement that officially makes the business an "authorized business," able to receive an SBT credit. The MEGA board determines the length of the credits (not to exceed 20 years) and the percentage of the credits (up to 100 percent of the income tax paid by the new employees). This agreement must provide that a misrepresentation in the application or a violation of the agreement may result in revocation of the "authorized business" status and loss of the tax credit.

If a business is denied a MEGA credit, it may appeal the decision, first before an administrative law judge, and then in circuit court.

Once the business is authorized to receive a credit, its SBT liability is reduced each year the credit is applicable by the total amount of state income tax paid by the new employees, plus the amount of any increase in SBT liability due to the new investment. The MEGA board must submit an annual report to the Legislature.

III MEGA Promises

The Governor is under pressure from certain Michigan businesses and economic development professionals to respond to the incentives for business expansion and relocation offered by other states. Michigan employers receive targeted appeals from other states touting a business-friendly environment, often in terms of right-to-work laws, low unemployment insurance and workers' compensation rates, a reasonably priced skilled labor force, and a lower overall tax level.

MEGA is intended to make Michigan a better competitor against other states using strategic industrial subsidization. The Jobs Commission, based on a PHH Fantus Consulting report, has identified seven primary competitors for new job expansion: Alabama, Indiana, Kentucky, North Carolina, Ohio, South Carolina and Wisconsin. These states offer some of the most substantial economic development incentives in the nation. MEGA provides Michigan with a strategic tool to compete in incentive contests with other states, and purportedly supplements Michigan's improved overall business climate as an attraction to investors.

MEGA incentives are also supposed to protect existing jobs against predation by other states, symbolize a favorable attitude toward business activity, and encourage plant expansions that create new jobs in Michigan.

The proposal issued by the Jobs Commission claims the following benefits of MEGA:

1. It is revenue-neutral, funded with future revenue growth from investments that would not have occurred in Michigan, and actually generates more state and local revenue than is forgone.

2. It emphasizes expansion of Michigan-based firms.

3. It encourages business diversification by providing benefits to manufacturing and non-manufacturing firms of all sectors, except retail.

4. It levels the playing field between Michigan and other states and provides the ability for all Michigan communities to compete for investments.

5. It creates no new bureaucracy.

This report takes issue with several of these claims.

IV MEGA Problems

While MEGA might create the illusion that state government is "doing something" about economic development, in reality there is little evidence that this type of program will accomplish its stated objective. There are also many ways that such a program would actually harm the Michigan economy and hinder further tax reform. The following concerns highlight the problems that characterize MEGA.

1. The empirical evidence shows that targeted tax credits have no significant impact on job creation or economic performance.

A 1988 report commissioned by then Senate Majority Leader John Engler evaluated the performance of Michigan's economic development strategies and programs in the course of the 1979-1986 business cycle. Addressing the use of financial and tax incentives, the study described the increasing competition between the states:

> The arguments against the conventional incentives approach to business development are overwhelming. Practically every major analysis conducted in the past decade has concluded that standard business incentives packages neither substantially encourage investment, nor boost output or create jobs, yet the revenue losses to the jurisdictions offering the incentives can be substantial.
>
> These studies present compelling arguments that financial and tax incentives of the types now employed in Michigan to attract investment really are not very meaningful--typically accounting for less than one-tenth of the value in a weighted spectrum of Vocational factors. A mounting body of evidence suggests that while such incentives can reinforce other locational determinants, and be the deciding factor in marginal cases where all other costs are identical, such considerations as overall tax levels, a reasonably priced skilled labor force, the relative cost of bureaucratic compliance, efficient transportation facilities, and even lifestyle ambience, can weigh more heavily than capital incentives in investment decisions.(2)

The report went on to suggest that the key to successful economic growth in Michigan is to focus on economic incentives for research and development.

Other states have already deployed programs similar to MEGA, and the results of these programs have usually been disappointing. Despite headline-making subsidy deals, the empirical evidence suggests that strategic incentives have no impact on either industrial location or overall economic performance across states. The Council of State Governments states:

> [A] comprehensive review of past studies reveals no statistical evidence that business incentives actually create jobs… They are not the primary or sole influence on business location decision-making and… they do not have a primary effect on state employment growth… (3)

In fact, the most successful states in terms of new and expanded industrial facilities offer the fewest number of incentives.(4) Despite the political appeal, the overwhelming evidence shows that MEGA will fail to improve overall employment or economic performance.

The Deceptive Claim of "Creating Jobs"

Credibility of the MEGA proposal hinges on the question of whether MEGA would actually create jobs in Michigan that would not have been created here otherwise. MEGA proponents argue that the incentives would be budget neutral, since tax credits would be offset by taxes paid by the holders of the newly created jobs.

This claim, however, is dubious for two reasons. First, how can the MEGA board know if the investments would have been made even without the tax subsidies? Despite the most thorough site location analysis, it will still be easy for a firm to claim that the MEGA credit is the decisive factor. Development professionals know that companies often make their location decisions, and then negotiate incentive packages after the fact. It is simple for a firm to obtain a competing subsidy offer from another state, even if they have no intention of relocating, in order to receive MEGA tax credits. In this case, Say's law surely holds: supply creates its own demand.

Second, how can the Michigan Jobs Commission know whether the new workers employed by a MEGA qualified investment would not have found work elsewhere in the same community or another part of the state? Any claim that MEGA incentives create jobs must demonstrate that the new employees would have remained unemployed but for the MEGA incentive.

Determinants of Industrial Location and Expansion

The reason targeted subsidies and tax credits fail to improve overall economic performance can be understood by examining the process firms use to determine site location. Firms locate in particular states or regions in order to maximize profits. Various market factors determine the profitability of any location. These include general factors such as access to markets, quality of life, executive convenience, and state and local attitude toward business. Also crucial are costs of production, including the overall tax level, labor costs and productivity, capital costs and availability, the legal and regulatory climate, transportation costs and proximity to suppliers, unionization and right-to-work status, informational spillovers, and public and private infrastructure.

Targeted industrial subsidies are only one of many factors in the industrial location choice; traditional market factors dominate the decision. Incentives matter only marginally when all else is equal; they are at best tie-breakers. State government's job is to make all else unequal by improving infrastructure and the business climate in Michigan so that firms will not be enticed by other states' subsidies.

Perhaps the best illustration of why the value of an incentive pales when compared to intrinsic locational factors is the effect of right-to-work laws. According to an executive from Fantus Consulting, a leading site selection firm,

> Approximately 50 percent of our clients indicate during the preliminary stages of the site selection process that they do not want to consider locations unless they are in right-to-work states. We have every reason to believe that this is typical of corporate site selectors in

> general. As a result, states that are not right-to-work states, and the communities in them, are eliminated from consideration in the initial phase of the site selection process, no matter how strong their other advantages for a facility might be. Rarely, if ever, will an area that has been eliminated in the early stages of a site selection be brought back into contention later in the process.(5)

Many of the states Michigan competes against are among the 21 right-to-work states. For nearly half of all companies, the absence of a right-to-work law is something even the most ambitious tax credit will fail to overcome.

The Importance of Core Competencies

Although we do not always know why particular industries started in Michigan, we do know why they expanded here once established. A specialized private and public infrastructure provided increasing economies of scale to expanding firms, lowering their cost of production. Once minimum efficient scale was reached, the development of the state's industrial clusters in automobiles, chemicals, and office furniture became path dependent. The state developed core competencies, and firms expanded here because they were established here in the first place.

Targeted incentives do not contribute to the development of core competencies, they only partially offset diseconomies and disadvantages of operating in this state. MEGA tax breaks do nothing to augment the specialized infrastructure necessary to develop or retain genuine core competencies. Since targeted subsidies are now commodities, all states can offer them; they do nothing to differentiate Michigan or enhance our distinctive competitive advantage. Moreover, when a firm chooses a site on the basis of an incentive package rather than on the existence of a core competency, it can quickly leave the state when a more attractive handout comes along. Core competencies require a symbiosis between public and private sectors. Targeted tax incentives distract state government's attention from its functions that build authentic core competencies, and are destined to fail at creating sustained economic growth.

2. MEGA would discriminate against small businesses, retail businesses, and capital-intensive businesses. MEGA would result in these employers paying a greater percentage of total single business tax revenue, and cause inefficient use of economic resources.

As mentioned previously, MEGA credits are available only to selected Michigan firms that employ at least 75 new employees, and to out-of-state firms that employ at least 150 new workers. MEGA is clearly aimed at large firms, since only the largest employers can consider projects that create at least 75 new jobs. But big businesses are not generating Michigan's new jobs. Small firms have been and will likely continue to be the engine of new employment in this state. Subsidizing employment in big businesses discriminates against small firms, and forces small business to bear more of the tax burden.

Not even all big businesses can benefit from MEGA. If Grand Rapids-based Meijer Corporation opens a new store and hires 150 new employees, it will not receive MEGA tax treatment because of its retail status. Even if Meijer is contemplating a choice of opening a new store in Clio, Michigan or Mishawaka, Indiana, MEGA benefits cannot influence its decision. MEGA establishes a policy

that retail jobs are not as valuable as manufacturing jobs, an economic decision that is best left to sovereign consumers operating in a market economy, not state bureaucrats.

Capital-intensive manufacturers, who use a high proportion of capital in relation to labor, may also create too few jobs to benefit from MEGA tax credits. For example, Dow Chemical may invest $50 million in a new production process, but create only ten jobs due to its capital-intensive, highly automated production technology. Furniture maker Herman Miller, on the other hand, may invest the same $50 million, employ 150 workers, and qualify for MEGA tax credits because of its labor-intensive manufacturing process. Dow has invested the same amount in the state, but would not be granted SBT tax relief under MEGA. Subsidizing labor and taxing capital artificially changes the relative prices of capital and labor, encouraging firms to use combinations of capital and labor that are not efficient, which wastes society's scarce resources. Selective incentives distort price signals, encourage economic inefficiency, and politicize commercial exchange.

3. The selective nature of MEGA tax incentives would allow certain firms to be favored over their in-state competitors, a situation that would be fundamentally unfair.

Given the fact that many Michigan firms have in-state competitors, such as the major automobile and furniture manufacturers and their numerous suppliers, it is very unlikely that a system of selective tax credits would be applied equally to each firm. As noted above, the broad discretion given to the MEGA board in granting tax incentives will create situations where one company receives a tax advantage over its in-state competitor.

Such a policy violates a fundamental principle of treating each person equally before the law, a principle that is as important for respecting the rule of law as it is for its economic consequences.

4. Michigan's strong economic performance indicates that general tax and regulatory reforms are already working, and that specific incentives are unnecessary for continued economic growth. Furthermore, MEGA would provide no incentive for many of Michigan's leading employers.

A review of Michigan business activity in the last several years demonstrates that MEGA ignores some of the fundamental characteristics of job growth in Michigan.

Thanks to a robust national economy and Governor Engler's economic policies, Michigan has done well on the employment front. Michigan's 1994 total employment of 4,491,000 and a labor force of 4,773,000 yielded an average unemployment rate of 5.9%, lower than the national average. Today the unemployment rate is 4.1 %, the lowest rate in at least 25 years, and a level that most economists would consider full employment.

Table1 Michigan's Top Ten Private Industry Employers

*SIC**	*Industry*	*Number*	*Percent*
80	Medical, Other Health	314,393	9.6
37	Transportation Equipment	279,555	8.5
58	Eating and Drinking Places	262,006	8.0
73	Business Services	177,236	5.4
50	Wholesale Trade	128,158	3.9
35	Industrial Machinery	119,055	3.6
53	Gereral Merchandise Stores	114,541	3.5
34	Fabricated Metal Products	113,322	3.5
54	Food and Dairy Stores	104,271	3.2
17	Special Trade Contractors	94,755	2.9

*Standard Industrial Classification

Source: MESC Annual Planning Information Report, 1993

Table 1 shows Michigan's top ten private employers, with health care as the leading industry statewide. Michigan's employment exhibits greater diversity, and depends less on the automotive industry than it once did, although the transportation equipment industry remains an important employer. A glance at industry classifications shows that many of the largest employer groups would be ineligible for MEGA incentives, such as health care providers, eating and drinking places, general merchandise stores, and food and dairy stores. As discussed below, these employers would be left to carry an ever-increasing share of the single business tax as a few large manufacturers receive MEGA exemptions and further across-the-board tax reduction is stifled.

Table 2 Employment Growth, 1988-1991

Industry	*Job Growth*	*Percent*
Health Services	31,826	11.1
Eating and Drinking Places	12,643	5.2
Social Services	8,287	14.9
Department Stores	6,185	5.7
Amusement and Recreation	5,073	15.9
Educational Services	3,329	9.6
Real Estate	3,174	10.3
Wholesale-Durables	2,863	4.2
Agricultural Services	2,540	17.9
Membership Organizations	2,412	3.9

Source: MESC Annual Planning Information Report, 1993

Michigan's economy generated 127,900 new jobs between 1993 and 1994. Table 2 shows that between 1988 and 1991 (the latest years for which disaggregated data is available) service industries created the most new employment. Eight of ten industries with the biggest employment growth were in retail or services, not manufacturing.

Table 3 Employment Growth, 1988-1991

Employment	**% Manufacturing Firms**	**%Service Firms**
1-9	3.1	16.6
10-19	4.3	10.2
20-49	9.1	13.3
50-99	9.5	10.6
100-249	15.6	15.5
250-499	12.4	9.2
500-999	10.4	7.7
1000+	35.5	16.9

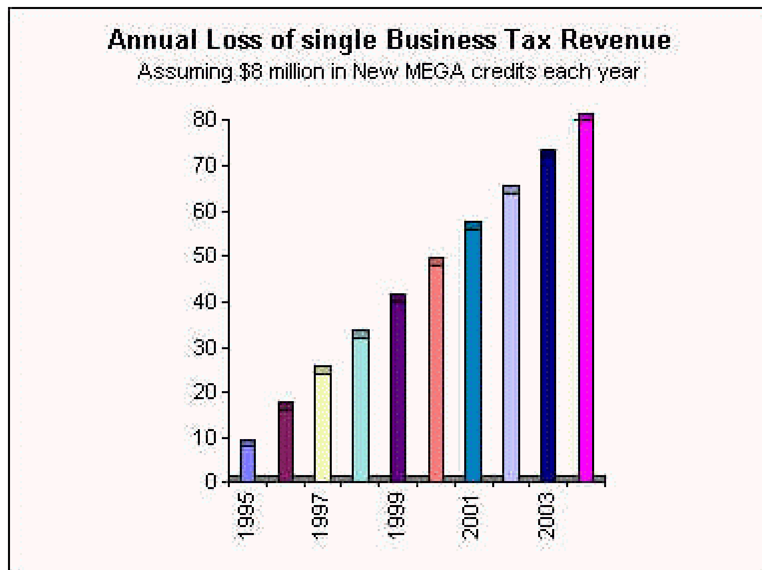
Source: MESC Annual Planning Information Report, 1993

Employment has shifted from big firms to small firms as well as from manufacturing to service industries. As Table 3 demonstrates, over the past decade, most jobs grew within firms with less than 500 workers rather than in the industrial behemoths of the past. Even in manufacturing, the share of employment concentrated in large firms fell from 59% in 1980 to 46% in 1994.(6) Michigan's envious employment performance has been accompanied by a diversification of the state's employment structure and a transfer of employment to smaller, more numerous firms. And this has been accomplished without state subsidies for employment expansion.

In short, Michigan has performed extremely well in the last several years, and further employment growth can be expected without MEGA incentives. More high-paying manufacturing jobs would certainly be desirable, but the current employment structure poses no threat to Michigan's economic vitality. As mentioned previously, sustained growth in the manufacturing sector will result only from further reduction in such costs of production as labor, unemployment insurance, workers' compensation, overall tax levels and the cost of bureaucratic compliance.

5. MEGA would be a massive realignment of Michigan tax policy, with total projected SBT revenue reductions of $640 million even if the program is sunset in 4 years.

The costs of the MEGA plan in terms of lost SBT revenue are deceptive. Proponents of the plan frequently speak in terms of "initial year SBT revenue reductions of $7-10 million." However, if one assumes a credit authorization that would result in a mid-range estimate of $8 million in initial year credits, and that it applies for the full 20 year term, the total revenue lost by that single year's authorization is $160 million. The total credits authorized in the next four years alone would amount to $640 million.



The actual progressive impact on annual SBT revenues can be seen in Figure 1. Again assuming that credits are authorized each year to create an $8 million initial year credit, the total SBT revenue forgone in the second year would be $16 million, $24 million in the third year, $32 million in the fourth, and so on until the credit is terminated. After termination the amount of revenue forgone would either stabilize and later decline, or decline immediately, depending on the number of creditable years remaining.

6. MEGA would set a precedent for discretionary state-level tax policy and allow a small group of political appointees to determine tax policy for some of Michigan's largest corporations.

As discussed in Part II, once a business has established that it meets the minimum criteria, the MEGA board has broad discretion to determine whether the proposed investment will "benefit the people of this state" and is "needed due to a significant cost disparity" between Michigan and the competing state.

MEGA is simply unsound tax policy. It allows a small political board to grant an unlimited total amount of Single Business Tax credits to large firms based on very subjective criteria. It is hard to imagine a program more open to abuse.

While guidelines would most likely be adopted by the MEGA board to further implement a more rigorous cost/benefit analysis, none exist in the legislation; it is meant to be highly discretionary. Controls on MEGA dollars require only that subsidized investments create at least 75 new jobs (150 for out-of-state firms), and that these jobs pay higher than average wages, and so forth. Bureaucratic discretion and bidding wars, and the absence of efficiency guidelines, create an environment in which public dollars might not be allocated to provide the highest return.

Other states have established objective, detailed criteria to determine eligibility for incentives. For example, Wisconsin examines ten criteria when considering preferential state aid for a firm or industry:

1) state cost per job created;

2) ratio of wages to state cost;

3) ratio of capital investment to state cost;

4) extent to which business increases state wealth;

5) community distress;

6) cost/benefit ratio;

7) ratio of state to private dollars;

8) state linkages and multiplier effect;

9) protection of state interests; and

10) extent to which the project builds on existing strengths and weaknesses.

Public subsidies, indeed all public sector activities, should weigh costs and benefits. But the costs and benefits of industrial incentive programs are extremely difficult to measure, so the programs are usually established and administered according to political, not economic, criteria.

7. MEGA incentives would have to continually increase to be competitive. The cost of winning a subsidy contest with other states escalates sharply, and would require ever-increasing tax incentives.

The costs of "winning" an industrial subsidization contest have risen sharply. Michigan is a latecomer to the state-level strategic incentive competition, having chosen not to compete aggressively during the 1980's, when the competition intensified. In other states, the subsidy cost per job has increased dramatically, culminating in Alabama's expense of $400 million, or

approximately $270,000 per job, needed to attract the Mercedes-Benz assembly facility in 1994. The city of St. Louis will spend approximately $720 million to entice the Los Angeles Rams to relocate, after all construction, concessions, and debt service costs are considered.

With MEGA, Michigan appears to be entering the contest a day late and a dollar short. Even if selective incentives were effective in achieving net job growth, nothing would prevent a competing state from simply increasing its own incentive to exceed the value of the MEGA credit. Selective incentives will fail to make any appreciable difference, as long as Michigan is competing from the position of having fundamental locational disincentives such as high unemployment insurance and workers' compensation rates, non-right-to-work status, and high tax and regulatory costs.

8. MEGA would make it more difficult to lower overall tax levels.

One of the certain but unintended consequences of the MEGA program would be increased difficulty in achieving across-the-board tax reform. When tax revenues are used in some way, alternative uses are forgone. When taxes are credited back to employers, the alternative uses of those tax revenues are given up.

Crediting tax revenues to selected large corporations does two things. First, it lowers the amount of revenue that could be used to fund an overall reduction in the SBT rate, thereby preventing a lower tax burden for all businesses subject to the SBT. Second, such credits diminish the incentive for those firms lucky enough to receive the credit to lobby for further reform. Those states that aggressively pursue selective tax credit schemes to lure away business are actually reducing their ability to produce an overall, competitive business climate with each arbitrary subsidy or rebate contrivance they create. Michigan can foster superior and sustainable growth, as it is already proving, if it spends less energy on a few trees and cares instead for the forest as a whole.

9. MEGA would be difficult to terminate once established due to constituent pressures, political benefit, and the difficulty of measuring program success.

If enacted, MEGA is unlikely to end at its December 31, 1998 sunset date. Many of the firms that would gain from the MEGA credits employ lobbyists in the state capital who will work to renew the program. And future governors will have their own reasons to support it. While net new jobs are dubious, MEGA is certain to create excellent photo opportunities for the Governor and other state officials at the ground-breaking ceremonies for the new "job creating" projects.

Difficulty in determining the efficiency and effectiveness of the program will prevent it from being judged unsuccessful and terminated. Businesses will claim their need for the tax credits whether or not they are actually the deciding factor in the location decision, and the businesses lost due to the failure to obtain further lowering of overall tax levels will go unseen and unmeasured.

10. MEGA would increase the cost of state government and further subject the state to litigation, something an across-the-board tax cut would not do.

Unlike a general tax rate reduction, the MEGA proposal would require state employees to administer. The proposal authorizes staffing the Michigan Jobs Commission to handle the administrative work required to promulgate MEGA guidelines and rules, evaluate company applications, publish an annual report, monitor continued compliance, and conduct other program

oversight. In addition, the legislation would allow any company denied a tax credit to appeal the ruling, first before an administrative judge and then in circuit court.

11. MEGA would require companies to spend thousands of dollars in the application process with no guarantee that they will be selected for an incentive. In addition, MEGA would actually *require* a company to evaluate the advantages of locating in competing states.

The process of applying for a MEGA credit would be expensive. Without knowing whether or not it will receive a credit, the company must

1) solicit the participation of local units of government and receive a commitment of financial or economic participation;

2) delay construction and public announcement of the facility location;

3) calculate average wages for the county of location and make sure the proposed wages exceed them;

4) certify that the tax credit is the deciding factor in its location decision;

5) commit to retain all other employees, whether or not they are performing needed functions;

6) provide proof that it has a sound financial record;

7) convince the MEGA board that the credit is needed due to a significant cost disparity between Michigan and a competing state;

8) convince the MEGA board that the relocation will "benefit the people of this state";

9) have its lawyers draft and/or review the written agreement; and

10) provide proof of its continuing compliance.

It should be clear that this process would be extremely time consuming, and a complete waste if the credit is not approved. A general tax rate reduction, on the other hand, requires no time or expense on the part of the businesses.

A perverse result of the MEGA proposal is that companies seeking the tax credit will be required to evaluate locating in, and perhaps even solicit bids from, competing states. Encouraging Michigan businesses to explore expansion opportunities in other states weakens the state's ability to retain jobs. What these businesses seek, they may very well find.

V Conclusion

Governor Engler has led Michigan to stellar economic success in the first four years of his administration, a feat accomplished by pursuing an ambitious policy of government streamlining and downsizing aimed at lowering the overall costs of doing business in Michigan. MEGA is a departure from this proven free-market economic development approach toward an industrial policy model of government economic planning, with political appointees picking the winners and losers. If passed, MEGA would not only fail to achieve its primary objective, but also increase the size and cost of state government, subject the state to litigation, discriminate against certain types of business, hinder future efforts to reduce the overall tax burden, cause economic dislocation and inefficiency, and set a poor precedent of state-level discretionary tax policy.

In order to attract and retain industry, state government should concentrate on creating an environment that produces the specialized infrastructure and human capital that will make it unreasonable for firms to even think about locating in another state. Good infrastructure, a highly skilled labor force, and a reasonable business climate will retain high-wage, high-skill jobs in this state and countervail lowball subsidy packages from states that have to buy jobs. Other states' project-specific incentives will not overcome the disincentives associated with a poor business climate or an unstable tax environment; nor will they do so in Michigan.(7)

Politicians don't create jobs, and they shouldn't count them either. The objective of economic activity is the accumulation of wealth and an improved standard of living, not just jobs. Everybody in the Soviet Union worked: unemployment was a crime. It is not enough to have jobs as the objective of a development strategy.

The State of Michigan does not have to micromanage economic development through legislative committees or economic development agencies. Government should create an economic policy environment that fosters overall productivity growth, technical change, and high quality private capital accumulation rather than subsidize particular labor-intensive ventures. Government also supports private enterprise by supplying long-term public goods. The free-market economy has built-in incentives for job creation and wealth accumulation, and doesn't require government meddling. Economic prosperity depends on a free economy, not on government industrial policy.

Today, with Michigan unemployment at a 25-year low of 4.1 percent and a track record of sound and courageous fiscal management, Michigan is heading in the right direction. The 1988 Engler report properly noted, "Incentives are ephemeral. Efforts to improve business climate, and tax climate in particular, on the other hand, are more intrinsic and tend to work."

MEGA is not "state of the art" economic development strategy as its proponents claim. It is a giant step backward on Michigan's road to a world competitive free-market economy. Making Michigan more competitive by reducing the business tax burden is a laudable goal, but we don't need a new state bureaucracy to do it.

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VII Endnotes

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3. Council of State Governments, "State Business Incentives and Economic Growth: Are They Effective? A Review of the Literature", p. 2.

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6. MESC Annual Planning Information Report, 1993, p. 29.

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