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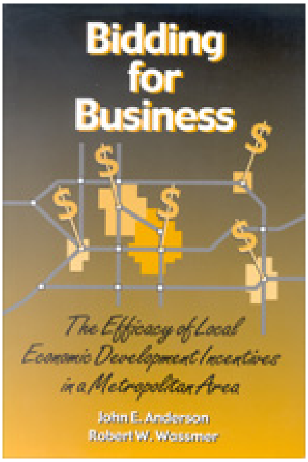
Local Economic Development Incentives in the United States



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1 Local Economic Development Incentives in the United States

The jury is still out on whether economic development policies have any effect at all.

—Therese J. McGuire (1992)

One of the most important policy issues facing major metropolitan areas in the United States now—and for at least the past three decades—is economic development. The overall distribution of business activity within a metropolitan area, the retention of existing economic activity, and the attraction of new economic activity to central cities and inner suburbs are all of concern. The concern stems from the relationships that exist between many of the most pressing urban problems, such as crime, poverty, unemployment, blight, deteriorating infrastructure, and fiscal stress and from the continued redistribution of employment and residence from central cities and inner suburbs to outer suburbs and rural areas.[1] Redistribution of economic activity within most metropolitan areas has also created the labor market issue of a spatial mismatch between low-skilled employees residing in central cities and inner suburbs and potential employers located increasingly farther out in urban areas.

Policymakers of affected cities have not been content to let this shift in economic activity go uncontested and have responded with a host of incentives designed to alter location decisions. Local business incentives have taken a number of forms: tax forgiveness, tax increment finance authorities (TIFAs), industrial development bonds (IDBs), municipal land acquisition, establishment of development authorities and zones, and other related activities.[2] Since the 1970s, the use of such locally initiated incentives has increased dramatically throughout the United States. While most of these incentives are aimed at lowering the cost of business capital within a specific jurisdiction, they are also offered in a desire to increase employment opportunities for city residents. After all, who has not heard the three reasons most often cited by politicians to justify a local economic development incentive program: jobs, jobs, and jobs.

Bartik (1991a and 1994) has offered an equity- and efficiency-based argument in favor of local incentives to business. The equity side concerns business location responses to intrametropolitan tax differentials that impose greater costs on some communities. Due to high property taxation and inadequate business services, many firms choose not to locate in a community that is also likely to have a greater number of poor people within its boundaries. The result is a higher level of local taxes paid by the poor, a lower level of local public services provided to them, and reduced employment opportunities for those most in need. An offering of local development incentives may counteract this regressive chain of events.

The efficiency side of Bartik's argument is the use of local economic incentives to correct the market failure of the mispricing of the value of an additional local job in a city experiencing high unemployment. In a perfectly efficient world, workers in any city are paid a wage equal to the value they place on alternative uses of their time. In this efficient world, an additional job generates local tax revenue equivalent to the increase in local public services that accompany the new job. Bartik argues that, in the real world, cities that have high unemployment may enjoy greater social benefits from an additional local job than cities with low unemployment. High unemployment cities are also more likely to have underused public infrastructure (streets and parks) and services (police and firefighters). An additional job poses little additional public cost to such a city. Bartik argues that a local incentive that redirects a job from a low unemployment city to a high unemployment city is efficient in the sense of correcting the mispriced market signal that exists without it.

As states have provided their local governments with the ability to grant economic development incentives, local tax revenue has been foregone in an effort to attract business capital and employment. Success in the use of development incentives could be defined as directing economic development to areas where it would not otherwise have occurred. If local incentives achieve this goal, the foregone revenue may well be justified. If not, communities have simply given away tax revenue to the benefit of the business recipients' bottom line. Furthermore, if such inducements have become the primary way that communities compete with one another to attract capital and employment—as is more likely to be the case within a metropolitan area—it is appropriate to ask whether such competition is good public policy. It may be quite reasonable from the point of view of policymakers in one community to grant a tax incentive in hopes of attracting productive capital and employment within its boundaries. However, if all other communities in the region grant the same identical incentive, there is no redirection of business activity.

This book is a detailed examination of the use and effectiveness of local economic development incentives within a region or metropolitan area. Our analysis focuses on an important and large U.S. metropolitan area, that of Detroit. We have made this choice because, for over 20 years, the Detroit area has grappled with the use of a wide array of local economic development incentives. Metropolitan Detroit provides a rich laboratory in which to investigate the adoption, use, and effectiveness of such incentives. Our experience in conducting research on urban fiscal issues leads us to believe that our methodology, findings, and policy suggestions are relevant to other U.S. metropolitan areas as well.

Our goal is to enrich the public policy debate on the degree to which local economic development incentives have helped to create economic opportunities in cities. We are also interested in revealing the factors that drive one city to offer more of a particular form of a local economic development incentive than what another city is offering. Our intended audience is educated laypersons, policymakers, and researchers. We employ the appropriate economic theory and statistical methods but place particularly technical procedures in appendixes so that the body of the monograph is accessible to the nontechnician. We have structured this study to emphasize clear policy appraisals and recommendations. If one is not particularly interested in a detailed account of earlier research on local economic development incentives and spatial mismatch, we recommend that Chapter 2 be skipped or just briefly reviewed.

As readers of policy tracts ourselves, we have always found it enticing to sample major results without having to plow through an entire book. For the Detroit metropolitan area, we find that the offering of most local economic development incentives (holding all else constant) has increased over time. A city providing more of one type of such incentives is also more likely to offer more of other types of local incentives. We find little to support the notion that increased manufacturing or commercial property value in a city in a metropolitan area (holding all else constant) raises the employment rate of residents in a city. However, we do see evidence that increased manufacturing or commercial property value in a city decreases the percentage of the city's residents that live in poverty. If increased manufacturing or commercial property value reduces a city's poverty rate, then perhaps a local economic development incentive that increases nonresidential property value can be used to counteract spatial mismatch and to decrease local poverty. We do in fact find that the establishment of a TIFA or a downtown development authority (DDA) district in the average city in the Detroit area in any of the observed years increased the commercial value of property in the city. In addition, the granting of property tax abatements to manufacturing property prior to 1977 exerted a positive influence on local manufacturing property value. The use of manufacturing property tax abatements in other years, and of IDBs and commercial property tax abatements in any year, exerted no positive influence on local nonresidential property values. The remainder of this book is about the details and policy implications associated with these broad findings.

The next section of this introductory chapter contains a brief background on economic development incentives in the United States. We review only local incentives that are designed to reduce the cost of doing business in a city. We do not consider local activities to increase the human capital of a city's residents, regenerate mature industries, and/or apply new technology. These tools of economic development are not the focus of the book.[3] This chapter also contains a discussion of why intraregional local incentive offers merit independent study, evidence on the intraregional use of incentives in the United States and metropolitan Detroit, and an outline of the contents of remaining chapters.

U.S. ECONOMIC DEVELOPMENT INCENTIVES

> *The widespread use of direct financial incentives by the states demonstrates the degree to which they have become partners with private business in the development process.*
>
> —National Association of State Development Agencies (1991)

Although the active use of state-sanctioned incentives to attract economic development began in the mid 1970s, local governments have always devoted a portion of their borrowing ability and infrastructure expenditure to activities that benefit business.[4] Early initiatives of this type were primarily directed to accommodating the growth of population into undeveloped areas and facilitating the commerce that followed.

By creating the Balance Agriculture with Industry Program in 1936, Mississippi was the first state to actively encourage private industrial development through publicly sanctioned activity. The incentive employed was the issuance of industrial development bonds. A state or local government issues the IDBs, but the revenue stream of the private project backs the bonds. This arrangement takes advantage of the tax-exempt status granted municipal debt. Although initially challenged in courts, IDBs have been upheld as constitutionally appropriate. By the 1960s, most states had authorized the use of IDBs in some form to attract business investment. Since 1968, Congress has increasingly placed restrictions on the ability of state and local governments to issue private purpose IDBs. In response, a few states in the late 1980s allowed the state issue of taxable IDBs.[5] In 1991, Mississippi and South Carolina were the only states that recognized the local issue of a taxable bond backed by the assets of a private endeavor.

By 1991, the options available to states for the inducement of economic development had grown to the list provided in Table 1.1. In addition to allowing IDBs, three states (Louisiana, North Dakota, and Tennessee) permitted the use of general obligation bonds by local governments to finance private industrial development. The full faith and credit of the issuing government back general obligation bonds. In Michigan, this form of municipal bond can only be used for state-sanctioned private projects. General obligation bonds issued by governments for private purposes have primarily been used by communities desiring to establish a labor-intensive manufacturing base, or, as in the case of Michigan, to retain large manufacturers.

To facilitate the attraction and retention of small businesses, in 1991 nine states used an *umbrella*, or composite, issue of one industrial development bond. The proceeds of such an issue are used by the state to meet the financing needs of more than one enterprise. Another bond innovation was the guarantee by six states to pay outstanding principal and interest on bond issues in case of default. To address constitutional questions raised by this backing, the full faith and credit of the state are not committed to the guarantee. A separate reserve account is instead established.

According to the National Association of State Development Agencies (NASDA 1991), second to IDBs, in terms of the number of states that allow them, are direct loans or grants by a state or local government. Similar to the criteria for a private loan, an application and

Table 1.1 Economic Development Incentives Offered within the United States

Manufacturing revenue bonds (tax exempt)
Manufacturing revenue bonds (taxable)
General obligation bonds
Umbrella bonds
Manufacturing revenue bond guarantees
Direct state loans
Loan guarantees
State-funded interest subsidies
State-funded equity/venture capital corporations
Privately sponsored development credit corporations
Customized manufacturing training
Tax incentives
Enterprise zones

SOURCE: NASDA (1983 and 1991).

independent evaluation are required. In the 24 states that facilitate economic activity this way, resources include the umbrella issue of an IDB, a one-time appropriation from the state general fund, or a revolving fund in which new loans are financed through prior loan repayments. A similar business incentive was created in the 20 states that guarantee private loans or offer interest subsidies.

Start-up companies have a greater risk associated with achieving success, but they also offer the prospect of greater employment opportunities. As a result, 18 states had established state-funded or state-chartered equity/venture capital corporations by 1991. In addition, 10 states had created privately sponsored credit corporations that assist small businesses. Although credit corporations are mostly funded from private sources, they are authorized by state legislation and follow state guidelines.

In one way or another, the incentive programs described thus far are all geared to attract economic development to a state by reducing the business cost of machinery, buildings, and land. As a result of the increasing sophistication required of labor in most current production processes, 45 states have also designed state-run manufacturing training programs as a way to recruit new manufacturing activity. Criteria for eligibility for most of these programs stipulate that employees volunteer and that the employer has job openings of the type sought by the newly trained.

The most direct method by which a state reduces the cost of doing business within its boundaries is through a tax incentive. In the United States, these have taken the form of tax exemptions, credits, abatements, and special treatments. In 1991, every state had the option of providing relief from at least one of its major taxes. For example, 34 states provide that the inventory held by a business can be at least partially exempt from property taxation. Minnesota, North Dakota, and New Jersey also offer some form of exemption or credit toward the state corporate income tax. Efforts to conserve energy are granted special tax treatment in 27 states, while 38 states offer preferable tax treatment for pollution-control equipment. A state-based investment tax credit exists in at least 25 states. The same number of states offer a business tax credit or exemption for new job creation.

Local governments could abate or exempt business property from taxation in 33 states by 1991. State and/or local governments could also exempt a business from sales and use taxes in Illinois, Minnesota, and New Jersey. Another form of tax incentive, begun in California in 1952, is the tax increment finance authority. An authority is established and a specific zone within the community is designated where incremental property tax revenue attributed to the development activity of the authority is used to fund the purchase and maintenance of the zone's infrastructure. Sometimes the authority also sets up an economic development program office. The stated goal of a TIFA is increased economic development within a designated geographic area of a community. Huddleston (1984) noted that at least 28 states in 1982 allowed cities to establish their own TIFAs. Chapman (1996) recorded more recently that at least 44 states and nearly 5,500 local agencies now use this tool to encourage local economic development.

The final form of direct business incentive offered by states is the enterprise zone (EZ), which targets activity in designated areas of a state. These incentives are usually restricted to areas that have had a slow rate of development, high unemployment, and/or high welfare payments per capita. Tax concessions, tax credits, employee training programs, and/or the relaxation of environmental or workplace rules are offered to businesses choosing to locate within these zones. In 1991, NASDA reported that 28 states had created EZs of some sort. Subsequently, Ladd (1994) reported that 37 states plus the District of Columbia had formed EZs.

Our focus is on local government incentives offered within a specified substate region. Of the menu of available incentives offered in the states in Table 1.1, only a few are under the autonomous control of local governments. These include the issuance of local manufacturing revenue bonds, the issuance of local general obligation bonds, the abatement and exemption of local property taxes or sales/use taxes, and the establishment of TIFAs. In most cases, the offering of a local incentive is also subject to approval of the state. Even in the absence of the requirement of specific state approval, states still have a constitutional right to intervene and to restrict the offering of local incentives by communities that abuse the practice. Considering the anecdotal evidence observed in Michigan and other states, in most cases the approval of a local incentive by a state agency is a rubber-stamp process. This is not surprising given the strong tradition of local autonomy and home rule that exists in the United States.

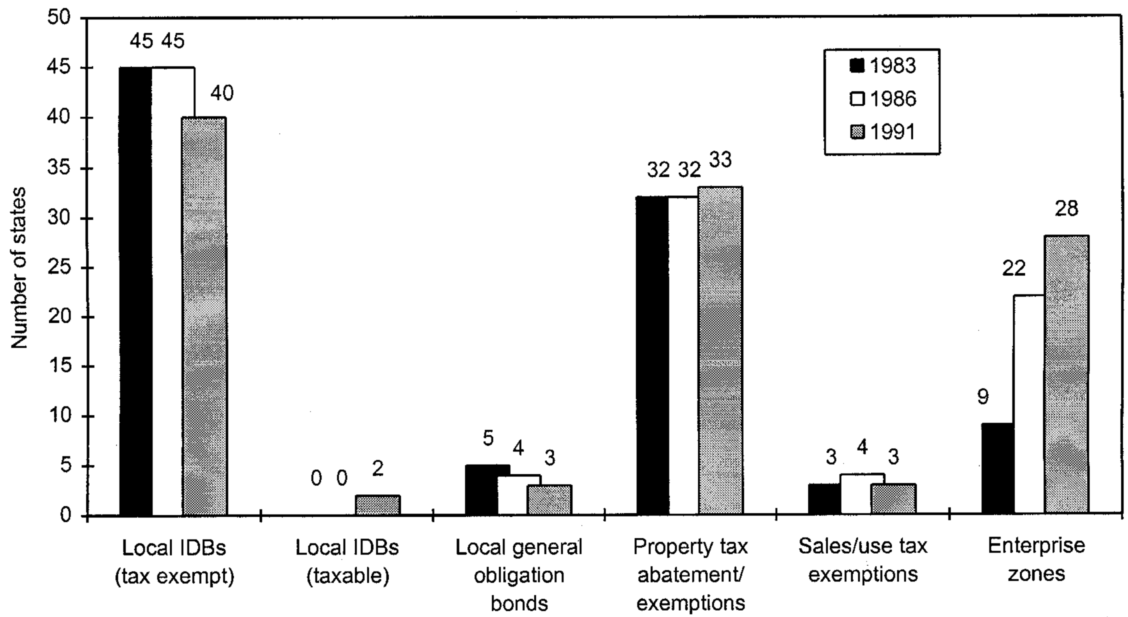
As a final piece of background on the use of local incentives in the United States, Figure 1.1 shows the number of states that allowed six specific types of incentive programs in 1983, 1986, and 1991. These years were chosen because they correspond to the published dates for the NASDA Directory of Incentives for Business Investment and Development in the United States. This directory offers the only known reliable source on the use of economic development incentives in the entire country. Notice that by 1983 the use of tax-exempt IDBs, general obligation bonds, and property tax or sales/use tax exemptions had become well established. There was little or no growth in the use of these local incentives by additional states through the early 1990s. The innovation of IDBs only began in the late 1980s. Although EZs in the United States are not a locally controlled incentive, they are also shown in Figure 1.1 to document their recent rapid rise in popularity. This increase is discussed in our final policy suggestions.

DIFFERENCES IN LOCAL INCENTIVE OFFERS

> *[Economic development] programs aimed at individual towns or suburbs within a metropolitan area raise different issues.*
>
> —Timothy J. Bartik (1991)

In *Who Benefits from State and Local Economic Development Policies?* (Bartik 1991b), the author concluded that state and local economic development incentives may increase productivity, redistribute jobs to areas in most need of employment, and increase national employment. Bartik made this claim based on a summary of previous research and on his own study of subnational incentive policies designed to influence economic activity inside a region (either a state or metropolitan area). He used the tentative "may" in his conclusion because the direct empirical evidence on whether competition for economic development causes productivity gains, employment redistribution to needy areas, and national employment increases was sparse in 1991 (Bartik 1991b, p. 201). An important issue, for which there is

Figure 1.1 Number of States That Allowed Specific Incentives in a Given Year



SOURCE: NASDA (1983, 1986, and 1991)

still not enough empirical support, is whether competition for economic development causes economic growth in the most needy areas.

The tactic taken here is to examine the effects of incentive offers made by local governments within a specific metropolitan area. As Bartik has noted, this approach raises issues that can be ignored if the unit of analysis is the entire metropolitan area or state. We believe, however, that it is a mistake to ignore these intrametropolitan issues if one wishes to know whether local incentives do redirect economic activity to needy areas. In the 1990s, the places in most need of economic revitalization in the United States are central cities and the surrounding inner suburbs. The concern is not just whether one metropolitan area or state offers greater (or fewer) development incentives than others, but how the incentive offers are distributed throughout jurisdictions within a metropolitan area. Assuming that incentives can redirect economic activity, a necessary condition for redirection of activity toward needy areas is that needy areas offer more incentives.

The important difference in incentive offers made by local governments within a metropolitan area can be derived from the anecdote told in one form or another by economic development practitioners across the country. The management of a business new to a metropolitan area, or of one already located in the area, is about to make a location decision. Management gives the local government leaders an impression of seriously considering a site within the area's inner cities, while the existing business already resides there. In order to attract the new business or to retain the existing business, an inner city puts together an incentive package of local tax breaks, IDBs, and other incentives. Of course, the cost of doing business in the inner city is likely to be greater due to higher crime rates, higher taxes, and lower public service quality. The inner city policymaker finds it necessary to offer an incentive package as a form of compensating differential. The mobile business firm presents the inner city's incentive offer to a suburban municipality and asks for a matching offer. The firm is able to provide a fiscal surplus, or an excess of local tax payments over the cost of local services provided, to the suburban city. The firm also extends the promise of additional jobs for the suburban community. The inner city's offer is matched by the suburban city, and the firm locates in the suburb,[6] the same place it would have most likely gone without the incentive.

Such a scenario can also be played out between two states or metropolitan areas competing for a major manufacturing facility. This occurred repeatedly in the battles for the locations of auto manufacturing plants such as Saturn, Toyota, and Mitsubishi.[7] The difference in local incentive offers is that the situation of an offer/counteroffer is more likely to occur between two competing jurisdictions in a metropolitan region. There is more than one reason for this. First, the nonfiscal factors that influence a firm's location decision are prone to be constant across cities within a region. Thus, the manipulation of fiscal factors through incentive offers carries greater weight. Second, the arsenal of local incentive tools is necessarily the same between competing cities in a metropolitan region in the same state. The excuse that the state does not allow the city to match the competing incentive offer is not credible. Third, the proximity of cities within a metropolitan region makes the transmission of information and the bargaining process much easier to accomplish. A firm shopping for a new site can negotiate with an inner city in the morning, present the offer to the outer suburban city in the afternoon, and call for a response by the suburban city council at its meeting that evening. These three factors combine to force local policymakers to take the threat of alternative sites and competing incentive packages very seriously.

The unique aspect of communities within a substate area competing with each other to attract economic development has been recognized by other researchers as well. Wolman and Spitzley (1996) have provided an extensive review of the literature on the politics of local economic development. The researchers point out that many local officials perceive their city's economic performance as being held hostage to the ease of capital mobility between border cities. Incentives offer a tool to combat this mobility. An environment of uncertainty and turbulence surrounds most local economic development projects and also creates the opportunity for officials to pursue *credit-claiming* activities. A local elected official claims credit for a desirable firm location decision by offering an incentive that then is attributed as the key factor in the choice.

Wassmer (1993) pursues a more economic approach that considers communities in a metropolitan area to be providers of land for business use. The issue is whether cities compete or collude with each other in the provision of land for business use. It is in the collective interest of cities in a metropolitan area to cooperate and to pursue joint incentive policies through cartel-like allowance of land for business use. In so doing, cities maximize the total fiscal surplus extracted from business in the metropolitan area, although it is still in the interest of any one city to pursue a noncooperative strategy and to independently offer local incentives to business. Wassmer provides empirical evidence that the norm in the Detroit metropolitan area has not been collusion in local incentive offers, but local competition that has steadily increased over time.

INTRAREGIONAL USE OF INCENTIVES

> *Although much of the extant literature on public sector competition for economic development is set at the state level or examines the competition between major cities, the fiercest competition for private investment is often between neighboring cities or cities within the same region.*
>
> —Edward Goetz and Terrence Kayser (1993)

The previous section presented arguments as to why it is important to examine the redistribution of economic activity caused by incentive offers of cities within a metropolitan area. Next, we review the available evidence on the degree to which communities in major U.S. metropolitan areas have the potential and have chosen to compete with each other for economic development by offering incentives. It is unfortunate, however, that there really is little direct information to offer. A 1991 study of interjurisdictional tax and policy competition (Advisory Commission on Intergovernmental Relations 1991) concluded that evidence on this issue is lacking due to definition and measurement problems that make it difficult to assess the degree of competition.

Given the lack of direct data on intrametropolitan incentive competition in the United States, an alternate method is to ask how much competition for local economic development could exist between municipalities in the largest U.S. metropolitan areas? A key tenet of economic theory is that competition is only possible if there are a substantial number of suppliers and demanders of the good or service under consideration.[8] If cities are the suppliers of land for business use, and business firms are the demanders of that land, then the competitive requirement is satisfied on the demand side, as there are many business firms in large metropolitan areas of the United States.

Fischel (1981) examined the competitive requirement on the supply side by applying the notion of concentration ratios to local governments in large U.S. metropolitan areas. In the field of economics known as industrial organization, a common technique is to measure the percentage of sales in an industry captured by the four largest firms in the industry (four-firm concentration ratio). A high percentage indicates greater concentration and hence a lack of competition. For the 25 largest urbanized areas in the United States in 1970, Fischel calculated two forms of concentration ratio for the four largest suburbs in each region. The first was the total square miles of the four largest cities divided by the urbanized land area of the Standard Metropolitan Statistical Area (SMSA). The second was the total square miles of the four largest cities divided by the land area of the SMSA outside the central city. His results (excluding Washington, D.C.) are reproduced in Table 1.2.[9]

The central cities listed in italic type in Table 1.2 exist in metropolitan areas where the two concentration ratios are both less than 40 percent. In these metropolitan areas, the four largest suburban cities comprise less than 40 percent of the urbanized land, and less than 40 percent of the suburban land in the total metropolitan area. A concentration ratio of less than 40 percent is often regarded as a necessary condition for competition to exist in an industry. A further condition for competition is a large number of cities in the metropolitan area. As shown in Table 1.2, the metropolitan areas containing the 11 most populated cities in the United States (New York to Minneapolis) satisfy the concentration condition and contain from 58 to 399 cities in their respective metropolitan areas. By most standards, this is adequate evidence that these metropolitan areas exhibit competitive markets for manufacturing and commercial business location. In addition, the smaller metropolitan areas of Milwaukee and Cincinnati also meet the two requirements of low concentration ratios (less than 40 percent) and a large number of cities.

In order to assure competition, not only must the structure of local governments be competitive, but local governments must also have the capacity to offer local incentives. Table 1.2 indicates that all the metropolitan areas that were competitive in structure in 1970 also had the state-granted ability in 1991 to offer at least one form of local incentive. Ten of the metropolitan areas were in states that allowed the offer of two or more forms of these incentives. The most prevalent type of local incentive in the large U.S. metropolitan areas defined as competitive was the capability to issue property tax abatements or exemptions. The comparison between Fischel's calculation of 1970 concentration ratios and the 1991 ability to offer local incentives should pose little problem. Subsequent change in the number of local governments in these metropolitan areas has been minor.[10]

There is evidence of the potential for the competitive use of local incentives to attract business to specific jurisdictions within the largest U.S. metropolitan areas. What about more tangible information on the degree to which incentives are actually used by localities in large metropolitan areas? Such material is harder to obtain. A search of the literature has yielded only a few examples. An early review of the subject by Bahl (1980) reported that the practice of giving local government tax abatements to stimulate commercial and industrial development in blighted areas was growing. Parker (1982) recorded in the *City Almanac* that New York City had already foregone $200 million in annual property tax revenue due to abatements. Glastris (1989) in *U.S. News and World Report* called Hoffman Estates, Illinois, "the latest loser in the tax incentive wars" when it gave an incentive package of land, infrastructure, tax abatements, and worker training valued at $240 million to attract the Sears Corporation from Chicago. Burnier (1992) provided background on local tax abatement policy in Ohio and on its implementation in the city of Chillicothe. She concluded that officials view tax incentives as a tool of competitiveness that they do not intend to relinquish. Reinhard and Scott (1993) reported estimates from the International Downtown Association of at least 1,000 Downtown Management Districts in North America at the time. These districts act to spur central business district development as special tax assessments are used to provide services and infrastructure designed to retain and attract commercial business. Finally, in a recent summary of tax increment financing activity in California, Chapman (1996) indi-

Table 1.2 Suburban Fragmentation and Local Incentives in Large U.S. Metropolitan Areas

		Four largest suburbs concentration ratio (1970)		Availability of a specific local incentive within the metropolitan area's state (1991)[b]		
Metro area's central city	Number of local govt's in area[a]	% of metro area's urbanized land[c]	% of metro area's suburban land[d]	Local IDBs (tax exempt)	Property tax abatement/ exemption	Sales/use tax exemption
New York[e]	399	10	12	No	Yes	Yes
Los Angeles	104	6	10	Yes	No	No
Chicago	178	5	7	Yes	Yes	Yes
Philadelphia	166	11	13	Yes	Yes	Yes
Detroit	97	16	19	Yes	Yes	No
San Francisco	58	17	21	Yes	No	No
Boston	78	11	12	No	Yes	No
Cleveland	91	15	17	Yes	Yes	No
St. Louis	116	11	13	Yes	Yes	No
Pittsburgh	180	12	14	Yes	Yes	No
Minneapolis	89	20	23	No	Yes	Yes
Houston	30	19	72	Yes	Yes	No
Baltimore	4	75	100	Yes	Yes	No
Dallas	23	29	48	Yes	Yes	No

Milwaukee	41	30	38	Yes	No	No
Seattle	29	50	69	Yes	No	No
Miami	22	78	80	Yes	Yes	No
San Diego	12	32	74	Yes	No	No
Atlanta	26	51	74	Yes	No	No
Cincinnati	79	14	19	Yes	Yes	No
Kansas City	46	31	86	Yes	Yes	No
Buffalo	26	28	35	No	Yes	No
Denver	25	21	31	Yes	Yes	No
San Jose	15	27	47	Yes	No	No

SOURCE: Fischel (1981, Table 1) and NASDA (1991).

[a] This is the number of local governments with final zoning authority.

[b] None of the cities in these 24 metropolitan areas were able to offer taxable local IDBs or local general obligation bonds.

[c] The urbanized portion of an SMSA by definition has population density exceeding 1,000 people per square mile.

[d] The suburban portion of an SMSA is all non-central-city land area.

[e] The central cities in italics have concentration ratios less than 40 percent.

cated that in 1950 there were only two TIFA redevelopment areas in the state. By 1990, the number had grown to 658 project areas. The assessed value captured by Californian TIFAs in 1990 was nearly 8 percent of the total assessed value of all property in the state.

Wolkoff (1985) noted that, because local incentives are largely regarded by states as a community matter, few reliable statewide estimates of their use exist. Researchers who have surveyed local governments directly have obtained some of the best sources of information. Cable, Feiock, and Kim (1993) offered the results of a survey of U.S. cities with populations over 50,000, to which 219 cities responded. Of the replying officials, 42 percent of the officials indicated that they offered tax abatements; 32 percent offered loan subsidies of some sort; 47 percent offered direct loans; 34 percent used cash contributions; and 62 percent offered employee training as local incentives. Bowman (1988) surveyed 84 public and private sector economic development officials in 31 southeastern cities in the United States. Her purpose was to gauge the extent and style of interjurisdictional incentive competition among these cities. Respondents were given the choices of very competitive, fairly competitive, and not competitive. Eighty-two percent of the aggregate group of mayors, business editors, commerce and economic development staff responded that the level of competition for economic development in their city was very competitive. Respondents were given the choices of high, medium, or low to rate the level of competition with surrounding suburbs. Forty-seven percent of the mayors responded high, while 35 percent of the business editors, 19 percent of the chamber staff, and 39 percent of the economic development staff did the same.

A Goetz and Kayser (1993) survey deserves special attention. In 1991, these researchers attempted to contact an economic development official in all 140 municipalities in the Twin Cities (Minneapolis and St. Paul) metropolitan area. In total, 109 surveys on local economic development practices were returned, of which only 15 reported no formal local economic development practices. Of the remaining 31 nonrespondents, 81 percent had populations less than 10,000. Goetz and Kayser concluded that the majority of nonrespondents were likely to have had no formal organization to encourage local economic development. Thus, nearly 70 percent of the communities in this metropolitan area were engaged in local efforts designed to attract and retain economic activity.

An aspect of the Goetz and Kayser survey results that warrants mention here is that 85 percent of the respondents agreed or strongly agreed with the statement that competition for economic development exists within the region. However, only about one-half of the respondents said that they were doing well in their competitive efforts to attract and retain local economic activity. This is not surprising if economic development activity in a region is a zero-sum game. A telling finding is that the cities responding as doing well experienced greater population growth in the last 20 years. Development officials who responded that their jurisdictions were not doing well pointed to negative city characteristics as the cause of their disadvantage. Most officials in this situation thought that the appropriate strategy is greater effort directed at intrametropolitan economic development competition in the future.

Of special interest in the Goetz and Kayser analysis of the Twin City survey data was an attempt to determine which cities compete with each other in a spatial sense. When asked to name their prime competitors, nearly every city chose cities nearby and within a narrowly defined subregion in the metropolitan area. A number of inner cities and first-ring suburbs said that their competition for local economic development was primarily second-ring suburbs. Interestingly, second-ring suburbs viewed their competitors differently and saw their adversaries as other second-ring suburbs within their subregion. Goetz and Kayser also used simple correlation analysis and found that municipalities were more likely to compete with cities of the same population and tax revenue size. Ultimately, 80 percent of the economic development officials thought that their own local development efforts provided benefits to the entire Twin Cities region. At the same time, only 39 percent thought that local economic development activity ought to be regionally coordinated. Considering that an innovative tax base-sharing plan has long existed in the Twin Cities metropolitan area, this is a discouraging finding. It offers little reassurance for potential metropolitan-wide coordination of local incentive offers even in a region that is notable for its cooperation.

LOCAL INCENTIVES IN METROPOLITAN DETROIT

> *Most [property tax] abatement activity has occurred in the counties that have served as the traditional sources of Michigan's economic strength . . . Wayne County, the state's most populous, has had the largest volume of abatement activity within it.*
>
> —Michael J. Wolkoff (1982)

As demonstrated in the previous section, there is circumstantial evidence that most large U.S. metropolitan areas possess the local government structure and the state-granted capability to compete with each other through local incentive offers. Except for some noteworthy survey evidence, there is only anecdotal information on the degree to which specific types of local incentives have been offered by communities within U.S. metropolitan areas. Fortunately, the state of Michigan and the Detroit metropolitan area are anomalies in this regard.[11] Michigan has a longer-than-average history of allowing local jurisdictions to choose among a large array of local incentives. Information on the use of these incentives has been recorded and reported by various state agencies, planning, and watchdog groups.[12]

The menu of local incentives available to Michigan communities includes industrial development bonds, manufacturing and commercial property tax abatements, tax increment financing, and downtown development authorities. The first IDB offered by a city in metropolitan Detroit occurred in 1967. As required by the Internal Revenue Service (IRS), the state treasurer's office has kept a record of all locally offered IDBs. Manufacturing property tax abatement has been available to Michigan communities since 1974. Commercial property tax abatement was available to Michigan cities between 1978 and 1988. The State Tax Commission, within the treasurer's office, grants final approval on each local property tax abatement and collects data on abatements granted.[13]

Two other local incentives available in Michigan are the TIFA and the DDA. Michigan municipalities have been able to establish TIFAs since 1980 and DDAs since 1974. DDAs are authorized to create and implement an economic development plan within a city's central business district. They often use tax increment financing as a source of funding. Groups like the Citizen's Research Council of Michigan (1986) and the Southeast Michigan Council of Governments (1990) have kept track of the establishment of TIFAs and DDAs within Michigan jurisdictions.

Using simple descriptive statistics and correlation analysis, Wassmer (1993) found empirical evidence of increasing competition in the use of local incentives in the Detroit metropolitan area over time. Over the 10- to 15-year period that local incentives had been available, there was an average eightfold increase in the mean local use of incentives and a decrease in the coefficient of variation in use for all forms of incentives except IDBs.

In 1995, we published a formal duration analysis of the adoption of manufacturing property tax abatements by Detroit area municipalities (Anderson and Wassmer 1995). Duration analysis allows for the calculation of the probability that a specific jurisdiction will begin to offer manufacturing property tax abatements provided that it has not yet chosen to provide this incentive. In our statistical analysis, we employed time-varying covariates and controlled for local characteristics that could influence a city's decision to offer its first manufacturing property tax abatement. The clear finding from this research is that, the longer a municipality waits to grant a property tax abatement, the greater the probability that it will offer its first incentive in the next period. As time passes, economic and political forces cause a community to be increasingly more likely to make an incentive offer. We attribute this result to the strategic motivations involved with incentive offers as a metropolitan-wide game similar to the prisoner's dilemma.[14] The finding of greater incentive emulation over time provides evidence that the likelihood that a city in a metropolitan area will match a competing city's inducement increases with the length of time since the incentive program began.

SUMMARY

This chapter has provided an overview of economic development incentives offered by local jurisdictions within U.S. metropolitan areas.

Our study of this issue is motivated by the relationship between many of the nation's most pressing social and economic problems and the unprecedented redistribution of residency and economic activity that has occurred in the last 40 years from most of the nation's inner cities to their outer suburbs. As described in detail in O'Sullivan (1999, Chap. 10), the percentage of the U.S. metropolitan population living in central cities fell from 64 percent in 1948 to 39 percent in 1990. The loss in manufacturing employment over the same period was from 67 percent to 45 percent, while wholesale, retail, and service employment in central cities fell even further. In an effort to alter this flow, inner cities have responded with an arsenal of local fiscal incentives, apparently matched in numerous cases by the outer suburbs.

We have also tried to provide reasons why there has been very little formal testing of the efficacy of local incentive offers made within a metropolitan area and to emphasize the importance of studying this issue further. We began with a broad background on the types of subnational economic development incentives available in the United States. Among these, only industrial development bonds, general obligation bonds, property tax abatement, sales tax exemption, and tax increment financing are locally initiated. There is little direct data on the use of these incentives in U.S. metropolitan areas, although an examination of the largest of these areas showed that they exhibit a competitive government structure and possess the ability to issue at least one form of local incentive. Both anecdotal material and survey evidence in support of the existence of intrametropolitan competition were provided.

In addition, we gave a brief description of local incentive use in Michigan, specifically in metropolitan Detroit. A primary reason for the choice of this area as the subject of our empirical study is the availability of information on local incentive offers. In addition, the Detroit area exhibits a competitive local government structure, a greater-than-average number of types of state-sanctioned incentives for local governments, and the ability to offer these incentives for a period longer than the average observed in most other states. Earlier statistical analyses confirm the competitive nature of local incentives in the Detroit metropolitan area.

Chapter 2 provides the reader with a retrospective on previous work. This includes the determinants of local economic activity, previous attempts to assess the efficacy of local incentive offers, the issue of a spatial mismatch between employees and employers in a metropolitan area, and an explanation of how these topics are related in our study. Chapter 3 gives a descriptive overview of the types of local incentives employed in the Detroit metropolitan area and statistical evidence on a possible spatial mismatch in the area's labor market. Chapter 4 reviews economic models and their implications for the effectiveness of local incentives on employment and capital allocation decisions by business in a substate region. A system of simultaneously determined equations is presented as a framework within which to examine the effectiveness of local incentives. The results of regression estimation of the simultaneous system, and some relevant simulations that use the regression findings, are in Chapter 5. Chapter 6 contains a summary and provides policy recommendations.

Notes

1. As presented in the 1995 *Statistical Abstract of the United States*, published by the U.S. Department of Commerce, 15.6 percent of the U.S. population in 1970 lived in cities with populations of 500,000 or more. By 1990, this percentage had fallen to 12.1. See Downs (1994) for a full description of the relationship between suburbanization and urban problems in the United States. As Downs points out, an additional benefit of the reconcentration of economic activity in a metropolitan area is less urban sprawl, with less traffic congestion and less air polution.
2. The incentive programs listed are the major ones traditionally offered to business. Newer forms of economic development programs became popular in the 1980s and include providing government services to assist in business decisions. Since these *new wave* economic development policies are more likely to be initiated at the state level, and data on their local use are difficult to acquire, this book concentrates on the use of traditional incentives. The National Association of State Development Agencies (NASDA 1983, pp. 13–20) offers a concise description of the various forms of nonfinancial assistance offered within states.
3. Consult Fosler (1988) for a thorough discussion of these alternatives.
4. Netzer (1991) makes this point.
5. NASDA (1991, pp. 773–778) provides a list of all the states offering the various forms of incentives described here.
6. Bartik (1994) recognizes this by concluding, "Competition for jobs among jurisdictions within the same metropolitan area uses public resources without changing overall labor market opportunities in the metropolitan area" (p. 857).
7. See Bartik (1987) for an example.

8. Eberts and Gronbert (1988) have tested the hypothesis that an increased number of local governments per person leads to a more competitive structure and hence less expenditure per person (holding all else constant). They find the expected result that, the greater the government fragmentation in a metropolitan area, the lower the local government expenditures per capita within Standard Metropolitan Statistical Areas.
9. Fischel (1981) also calculated concentration ratios for the Washington, D.C. metropolitan area. These are excluded from Table 1.2 due to the area's overlap with two states.
10. See Wassmer and Fisher (1997) for a description of city formation in large US. metropolitan areas and evidence on the minor degree of change between 1980 and 1990.
11. Throughout this book, the Detroit metropolitan area is defined as Macomb, Oakland, and Wayne counties. This is the same as the 1970 U.S. Census definition of Detroit's SMSA. In 1990, the U.S. Census defined the Detroit Metropolitan Statistical Area (MSA) as containing Lapeer, Livingston, Macomb, Monroe, Oakland, St. Claire, and Wayne counties. We have chosen the more limited 1970 definition because it better accounts for a region where communities are more likely to compete with each other for the location of many of the same businesses.
12. A complete description of the local incentives offered in the Detroit metropolitan area is contained in Chapter 3.
13. Wolkoff (1985) has already used this information to provide a summary of manufacturing tax abatement awards in Michigan counties up to the mid 1980s.
14. The prisoner's dilemma is a widely discussed game in the social sciences demonstrating that, given the inability to coordinate decisions among individuals, the self-interested choice made by one is not in the interest of all.