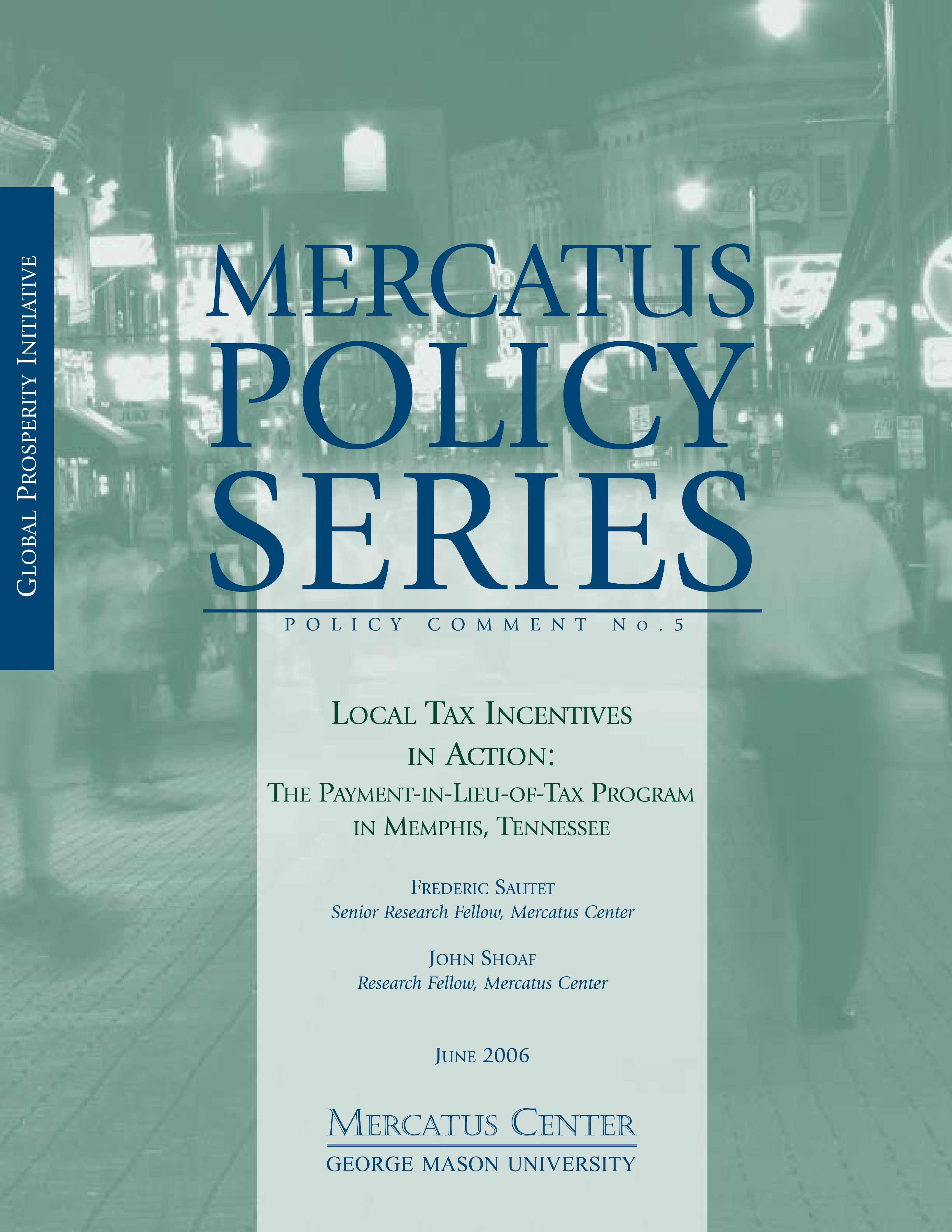

Global Prosperity Initiative

MERCATUS POLICY SERIES

POLICY COMMENT No. 5

Local Tax Incentives in Action: The Payment-in-Lieu-of-Tax Program in Memphis, Tennessee

Frederic Sautet
Senior Research Fellow, Mercatus Center

John Shoaf
Research Fellow, Mercatus Center

June 2006

Mercatus Center
George Mason University

About Frederic Sautet, series editor (with Susan Dudley) & co-author

Frederic Sautet is a Senior Research Fellow at the Mercatus Center at George Mason University. He is also a member of the Graduate Faculty at George Mason University. Prior to joining Mercatus, Frederic was a Senior Economist at the New Zealand Commerce Commission and a Senior Analyst at the New Zealand Treasury. Frederic holds a doctorate in economics from the Université de Paris Dauphine and did the course work for his doctorate at the Institut des Etudes Politiques in Paris. He also studied at New York University as a post-doc. Frederic's current work focuses on entrepreneurship, institutions, and social change.

About John Shoaf, co-author

John Shoaf is a Research Fellow at the Mercatus Center at George Mason University. Originally from Chattanooga, Tennessee, he graduated Phi Beta Kappa from The University of the South (Sewanee, TN) with a B.A. in Economics. John's current work focuses on local and federal economic development policy.

For more information about the Mercatus Center's Global Prosperity Initiative visit us online,
www.mercatus.org/globalprosperity, or contact Carrie Conko, Director of Communications,
at (703) 993-4899 or cconko@gmu.edu.

Front cover photo: John Hoffman - Beale Street, Memphis.
Back cover photo: John Hoffman - Riverside Drive, Memphis.

MERCATUS CENTER
GEORGE MASON UNIVERSITY

LOCAL TAX INCENTIVES IN ACTION:
THE PAYMENT-IN-LIEU-OF-TAX PROGRAM IN MEMPHIS, TENNESSEE

FREDERIC SAUTET AND JOHN SHOAF

EXECUTIVE SUMMARY

With a heightened focus on job creation, cities are relying on targeted tax incentives to attract businesses. This study considers the characteristics of property tax incentives and examines their effect on growth.

Because of the city's high unemployment, Memphis's Payment-in-Lieu-of-Tax (PILOT) program allows us to evaluate various tax incentive designs. The PILOT reduces the property taxes of select businesses in order to create new jobs and investment. As our analysis causes us to question the effectiveness of the PILOT, after discussing its specifics, analyzing available data, and surveying relevant literature, we suggest alternative policies for improving Memphis's growth prospects.

Economic growth creates jobs; jobs do not create growth. Thus, job creation in itself is not an advisable policy end. Though tax reductions may create jobs, the PILOT allows policymakers to exercise excessive discretion to the detriment of the Memphis area. Rather than allowing market participants to discover opportunities made viable by non-discriminatory tax reductions, citizens expect policymakers to actively create jobs while businesses lobby politicians for favors.

The motivation behind the PILOT is understandable. Fortunately, Memphis can cultivate economic growth via tax reform, either by embracing tax consistency or generality. The former requires that the PILOT program adhere strictly to a coherent system for evaluating PILOT applications, encouraging governments to tax comparable businesses equally and reducing businesses' incentives to lobby for favors. The latter option, though politically difficult, requires policymakers to eliminate the PILOT, streamline governance, and reduce taxation in order to rein in the cost of doing business and promote entrepreneurial discovery.

The lessons of the PILOT program in Memphis are applicable to tax incentive policy elsewhere. The more tax incentives involve officials' discretionary decision making, the less likely they are to produce the benefits of genuine tax reform. Localities that employ targeted tax incentives in an attempt to rectify economic problems should seek to remedy the causes of economic distress by removing barriers to entrepreneurship, rather than trying to steer economic activity.

For more information about the Mercatus Center's Global Prosperity Initiative visit us online, www.mercatus.org/globalprosperity, or contact Carrie Conko, Director of Communications, at (703) 993-4899 or cconko@gmu.edu.

Local Tax Incentives in Action:

The Payment-in-Lieu-of-Tax Program in Memphis, Tennessee

"It is not by planting trees or subsidizing tree planting in a desert created by politicians that the government can promote… industry, but by refraining from measures that create a desert environment."[1]
-The Economist (March 3, 1990)

INTRODUCTION

Businesspeople, policymakers, and citizens have long debated the merits of local tax incentives. With the Supreme Court having considered some legal issues surrounding local tax incentive policy, the arguments, both for and against, are louder and more prevalent than they have been in some time.[2] In the United States, policymakers have offered tax incentives in order to recruit businesses since the colonial era.[3] While states and localities have engaged in a variety of tactics in an attempt to lure businesses, firm-specific property tax exemptions have become increasingly popular.

Unfortunately for consumers and citizens, policymakers often misunderstand the economic impact of local tax incentives. This is perhaps not surprising considering that, despite the increasing prevalence of tax incentives and in spite of the fact that the subject has received considerable attention in academia and in the policy world, little consensus exists as to whether tax incentives are a "good" way to foster economic development.

Academics quibble over the theoretical justification for tax incentives on the one hand and discuss their practical effects on the other. Even those who have found theoretical justifications for the incentives struggle to find conclusive empirical support.[4]

This Policy Comment explores the claim that tax incentives have a positive impact on job creation

[1] Alan Peters and Peter Fisher, "Tax and Spending Incentives and Enterprise Zones," *New England Economic Review*, March/April (1997): 135.
[2] DaimlerChrysler Corp., et. al. v. Cuno, No. 04-1704, slip op. at 1-2 (U.S. May 15, 2006). The Supreme Court did not rule on the substantive issues of the case because the Court determined that the plantiffs did not have standing.
[3] See P. Eisinger, *The Rise of the Entrepreneurial State* (Milwaukee: University of Wisconsin Press, 1988), 1-382.
[4] See Terry F. Buss, "The Effect of State Tax Incentives on Economic Growth and Firm Location Decisions: An Overview of the Literature," *Economic Development Quarterly*, No. 1 (2001): 90-105.

and the local economy by looking at the case of the Payment-in-Lieu-of-Tax (PILOT) program in Memphis, Tennessee.

Memphis is an interesting case because it is located at the confluence of a number of jurisdictions, many of which use tax incentives in one way or another. Memphis and Shelby County (the county where Memphis is located) implemented the PILOT program in 1988 to attract businesses to the area. Since the inception of the program, the Memphis economy, while not without improvement, has been struggling. Though the PILOT is not responsible for the less than desirable economic situation in Memphis, it has not had a detectable aggregate impact either. This Policy Comment assesses the merits of the PILOT program relative to other policy instruments that might encourage productive, socially beneficial business activity. In so doing, it will provide guidance to those in Memphis looking to improve the situation as well as others considering related issues elsewhere.

The overall lesson of our research is that local tax incentives may be counterproductive, or at least have counterproductive elements, which we believe is the case in Memphis. While, all things being equal, tax reductions tend to promote economic growth in the long run, localities that offer targeted tax incentives often fail to harness the benefits and economic growth associated with tax reduction.

The reason for this failure is that tax incentives such as the PILOT program become tools of industrial policy, not tax policy. Local municipalities use tax incentives to direct expansion and growth, trumping more entrepreneurial mechanisms. They operate with unrealistic assumptions about their abilities to select which, and to what extent, business investments should be given preferential tax consideration. When localities try to selectively channel investments rather than embracing all investments, the efficacy of tax reductions diminishes, especially if businesses attempt to influence the terms of their tax reduction.

This Comment suggests that the primary factor for the development of localities is the *quality* of the local institutional context. The presence of discriminatory tax incentives can harm that very quality.

Our policy suggestions rest on the premise that economic policy should help foster entrepreneurial activity rather than direct it. For this reason, we recommend that Memphis embrace generality, or at least consistency, in taxation. In this comment, we examine the Memphis case and offer three different levels of policy reform, each with different degrees of political feasibility and expected return:

- If the city and county retain the PILOT program as well as its selection instrument (the PILOT "matrix"), then the policy changes ought to reduce the Industrial Development Board's (IDB) latitude to make discretionary choices. We offer five different steps that would reduce the IDB's discretion and provide for a more consistent application of tax incentives while minimizing businesses' incentives to game the matrix system.

- If the city and county choose to retain the concept of the PILOT program but remove the matrix, the resulting scheme should offer all relocating businesses the same tax break for, say, 10 years. This would provide for a less discriminatory, and thus more effective, tax incentive framework than the first level of reform. In order to provide existing businesses with some consideration, the city and county should simultaneously place a moratorium on tax rate increases.

- Finally, if politically viable, the city and county should establish lower levels of taxation and spending in place of the PILOT. In so doing, they would create the best context possible for entrepreneurial activity and economic growth.

These three alternatives are superior to the current PILOT program. While a tax incentive of some kind may be desirable as long as Memphis maintains a high cost environment for business, the PILOT as it now stands is not the most preferable scheme. There are superior alternatives that would improve the business climate even in the absence of a change in the overall cost environment.

We begin this comment by explaining why we chose to study Memphis's tax incentive scheme. After discussing our motivation and describing Memphis's PILOT program, we review other studies of the program as well as the academic literature on such programs. We then offer an alternative view of the mechanics of economic prosperity and conclude with policy recommendations.

A. Why Focus on Memphis's Tax Incentive Program?

Given the dominance of local property tax incentives in the United States,[5] why study tax incentives in Shelby County and Memphis, Tennessee? Memphis is a compelling case because it is a city where, for several reasons, one might reasonably expect property tax incentives to produce especially beneficial outcomes relative to other localities.

First, Memphis currently suffers from high unemployment, an element of which is likely structural. As such, the city is perhaps more apt to derive positive net benefits from jobs-based targeted tax

[5] For information on the most common types of tax incentives, see Buss, "The Effect of State Tax Incentives on Economic Growth and Firm Location Decisions: An Overview of the Literature," 90-105.

incentives, as compared with low-unemployment areas, particularly if one assumes that Memphis is relatively well-situated in terms of existing infrastructure.[6]

Second, the combined Shelby County and Memphis property tax is the highest of any city-county pair in Tennessee and compares unfavorably with many of its peer locales and nearby competitors. To the extent that the high property tax dissuades businesses from locating in Memphis, especially capital-intensive businesses for which property tax payments are often substantial, one would expect the amelioration of this tax to help Memphis grow.

Third, the Memphis area is geographically predisposed towards excelling in distribution, warehousing, and logistics. These typically high-volume, low-margin, capital-intensive industries do not usually depend on local demand for their services and are more likely to consider local taxes because of their low profit margins.

Forth, given that the Memphis metro area encompasses three states (Tennessee, Arkansas, and Mississippi), eight counties, and numerous cities that have distinct political representation vying for businesses, the intraregional competition for business recruitment and retention in and around Memphis is especially fierce. Thus, tax considerations become more important on the margin, and as a result, Memphis engages its geographically proximate competitors by exercising the PILOT tool with force (see Section III.E. for further discussion of the magnitude of the program). As economist Terry Buss puts it, "In smaller geographic areas, factors of production… are likely similar, so differences in tax levels across communities become more important in the locational decision."[7] Indeed, the fact that intraregional competition among politically distinct entities is especially intense (e.g., Shelby and De Soto Counties) should not be surprising given that the metropolitan statistical area (MSA) is relatively homogenous and enjoys the same advantages and disadvantages in the nationwide competition for business.

While the intraregional competition in the

[6] See Timothy J. Bartik, *Who Benefits from State and Local Economic Development Policies?* (W.E. Upjohn Institute for Employment Research, 1991): 1-354. Bartik points out that targeted tax incentives are more likely to produce social benefits in environments where unemployment is high and infrastructural capacity is present. While it is difficult to do comparative analysis of various cities' infrastructural advantages and capacities, numerous businesspeople have suggested that Memphis enjoys excellent telecommunications infrastructure, primarily due to Federal Express's large presence in Memphis. Moreover, in terms of the infrastructure related to transportation and shipping industries, Memphis excels: it is located directly on the Mississippi River, at the crossroad of five Class I railroads, two major interstates, and seven state highways. Memphis is a day away by truck from two-thirds of the U.S. population.

[7] Buss, "The Effect of State Tax Incentives on Economic Growth and Firm Location Decisions: An Overview of the Literature," 96.

Memphis area is partly a political artifact that drives the intense competition for business, it is not the only force that encourages the widespread use of the program in Memphis. With unemployment particularly high among some poor residents, local politicians might attempt to use this program to demonstrate that the government in Memphis is committed to fighting unemployment. In addition, because Memphis suffers from an increasingly difficult fiscal situation,[8] the property tax tool offers an off-budget mechanism for trying to enhance the economy.[9] Though debates abound about the PILOT program's actual fiscal impact, it is certainly a more politically viable economic development tool than those that require direct spending or lending.

B. PILOT Program Mechanics

B1. Legal Background

According to the Tennessee constitution, all private property must "be subject to taxation… and each respective tax authority shall apply the same tax rate to all property within its jurisdiction." A subsequent Tennessee statute permitting the creation of the PILOT-style programs in Tennessee specified that localities' IDBs were to hold the property title for PILOT companies during the period of abatement, presumably because it would otherwise have been unconstitutional to exempt or abate taxes on private property in Tennessee. According to TCA §7-53-102, the legislature created the IDB and authorized PILOT programs as part of a statute designed to:

[8] Memphis is experiencing frequent budget problems in spite of a tax increase in July 2005. Though Shelby County has long carried large debt levels, the city's debt has also recently increased. According to Census figures, the city's debt was $2.48 billion or $3,820 per capita in 2003, though this is partly due to the city's prepayment for electricity. If one weights the county debt based on the current city-county population balance, an admittedly rough metric, each resident of the city of Memphis was responsible for approximately $6,100 dollars of combined city-county debt as of 2003. Moreover, according to Memphis's "2005 Comprehensive Annual Financial Report," http://www.cityofmemphis.org/pdf_forms/2005 Comprehensive Annual Financial Report.pdf, its spending increased between 1996 and 2005 by over 25% in real terms. Because of its current economic and fiscal situation, Moody's downgraded Memphis's bond rating from Aa2 to Aa3 in May of 2005. Other bond rating agencies such as S & P and Fitch had already downgraded the bonds previously and/or revised their outlook on the bonds. At that time, rating agencies cited the city's inability to maintain a comfortable level of reserves. Soon after these downgradings, Memphis raised taxes to generate more revenue and increase reserves, but S & P downgraded Memphis's general bonds again in October of 2005 by two notches from AA to A+ as a result of some public accounting mistakes that led to further reserve depletion. S&P was reacting to the news that the city, operating in the red for the third consecutive year, had underestimated its deficit by $15.5 million. The city spent most of its reserves to compensate for the accounting error. As of November 2005, the city had reserves of approximately $1 million, an amount that is $49 million less than the rating agencies prefer. Left with almost non-existent reserves, city officials chose to place a moratorium on expenditures for all new capital improvement projects. Currently, the city has a plan to increase reserves to $50 million and improve its bond rating to AA.

[9] Buss, "The Effect of State Tax Incentives on Economic Growth and Firm Location Decisions: An Overview of the Literature," 92.

> Increase employment opportunities… by promoting trade, industry, [and] commerce… by inducing manufacturing, industrial, governmental, educational, financial, service, commercial… enterprises to locate in or remain in this state…

In addition, the statute suggests that the legislature intended the ordinance to provide "economic activity and stability" and "to relieve the emergency created by the continuing migration from Tennessee of a large number of its citizens in order to find employment elsewhere."[10]

B2. The Basics

Memphis and Shelby County's primary local tool for attempting to generate employment opportunities and economic growth is their PILOT incentive program. Like other local tax incentive programs, the PILOT program seeks to make the area more attractive to business and to thus create employment opportunity. The PILOT program offers property tax reductions for a specified duration, usually between 3 and 15 years, to select businesses that locate or expand in Shelby County and Memphis. The main goal of the program is to generate a "net increase in the number of jobs within the Memphis area."[11] City administrators, planners, and others sometimes suggest that, at least as an added benefit, the program should attract and retain capital, provide social stabilization of the inner city, maintain and expand the tax base, reduce poverty, and slow or reverse Memphis's outward migration.[12]

In order to meet these various goals, the city and county have devised a system wherein PILOT companies provide an annual payment to the city in an amount equivalent to what the tax would be on the *unimproved* value of the real estate for which their new project or expansion will take place; after rendering this payment, these companies are not responsible for paying city taxes on real property *improvements* that occur while the company has a PILOT incentive. Furthermore, PILOT companies only pay $100 annually in city personal property taxes. Essentially, this entails a full abatement of personal property taxes on personal property *improvements*.

Shelby County formerly offered the same arrangement as the city, but in 2000, the county elected to make the incentive less lucrative.[13]

[10] TCA §7-53-102.

[11] See "City of Memphis and County of Shelby, Tennessee Payment-in-Lieu-of Tax (PILOT)," http://www.dobizinmemphis.com/incentives/assets/pilotpolicy_0302.pdf.

[12] Former President and CEO of the Memphis Regional Chamber, R. Marc Jordan, mentioned some of these additional goals/outcomes. See Jordan, "Incentives Keep Area's Competitive Edge Sharp," *The Commercial Appeal*, November 3, 2002.

[13] Christopher Barton, "How Sweet It Was! Tax Freeze Falls to 75%; Board Trims Business Incentives to Help Finance Schools," *The Commercial Appeal*, July 6, 2000.

Currently, the Shelby County system essentially offers PILOT companies an annual 75% abatement on their current assessed real estate and personal property.[14] In exchange for receiving tax reductions, PILOT companies agree to provide jobs and capital investment within the Shelby County area.

For PILOTs occurring outside of a certain segment of downtown Memphis but in the City of Memphis or unincorporated[15] portions of Shelby County, the IDB is the primary entity responsible for administering the program.[16] The IDB, an appointed nine-member board,[17] offers PILOTs to qualified applicants that are pursuing industrial, pollution control, distribution, office, service, and other non-retail projects.[18]

The IDB, with assistance from The Pilot Evaluation Committee,[19] determines the durations of the tax incentives offered to potential PILOT applicants by utilizing an eligibility and consideration matrix (see table 1 on p. 9).

[14] Program description taken from IDB PowerPoint presentations and personal conversations with IDB personnel. Note that the City of Memphis and Shelby County overlap such that PILOTs located within the city receive an abatement on their city and county taxes. PILOTs located outside of the city but within the county receive an abatement only on county taxes because they do not pay city taxes.

[15] The "unincorporated" area of Shelby County excludes Memphis and the suburban towns of Shelby County such as the City of Bartlett, the Town of Collierville, the Town of Arlington, and the City of Germantown.

[16] Unless otherwise noted, any reference to the PILOT program is a reference to an IDB granted PILOT. Other boards—such as the Memphis Center City Revenue Finance Corporation (CCRFC), Center City Development Corporation (CCDC), the Memphis Health, Educational and Housing Facilities Board (MHEHF), the Shelby County Health, Educational, and Housing Facilities Board (SCHEHF)—have PILOT granting authority but will not be considered closely in this analysis. The IDB issues the majority of the PILOTs in Memphis and focuses on industrial and commercial business recruitment and retention. For more information about these boards, see the "PILOT Evaluation Program Project: Evaluation Report," http://www.shelbycountytn.gov/FirstPortal/dotShowDoc/dotContent/Government/CountyServices/PlanningandDevelopment/PILOT_Eval_%20Rrt_Final.pd; also see the CCRFC description of its PILOTs, http://www.downtownmemphis.com/domain/documents/PILOT_Application.pdf.

[17] The IDB is composed of four city-appointed members, four county-appointed members, and one jointly-appointed member. For more information see, http://www.shelbycountytn.gov/FirstPortal/appmanager/scexternal/content?_nfpb=true&_pageLabel=GovLevel4PortalPage&contentselected=%2FdotContent%2FGovernment%2FBoardsandCommissions%2Findustrialdev.htm&PortletName=HomeGovernment.BoardsandCommissions.

[18] See "City of Memphis and County of Shelby, Tennessee Payment-in-Lieu-of Tax (PILOT)."

[19] The PILOT evaluation committee consists of three IDB members, two city councilmen, and two county commissioners. This committee makes recommendations to the full IDB regarding terms and acceptance. See "PILOT Evaluation Program Project: Evaluation Report."

Currently, companies that participate can receive up to a 15-year property tax incentive.[20] The main criteria for the IDB's matrix are as follows:

1. Anticipated number of net new jobs created[21]
2. Median wage of new jobs
3. Capital investment
4. Location[22]

In the case of job creation and capital investment, the matrix sets various thresholds for which the point value of adding jobs or capital diminishes. Though the matrix does not limit the number of points companies can receive based on their job creation projections, it does cap the points a company can acquire for investing capital. In addition, IDB has the authority to award bonus points for special considerations at its discretion. Once the IDB calculates a company's PILOT score, it translates the score into years based on an established scale. Projects scoring less than 31 points do not get PILOTs, but it is quite easy to meet the 31 point threshold. This could be accomplished in a number of ways. For example, if a company were to locate in the City of Memphis and hire 15 workers that it did not previously employ in Shelby County at a median wage approximately equal to the per capita wage of the county, the company would score a 33 and would thereby be entitled to a three year tax freeze (see table 1 on p. 9). In 2003, the average length of a PILOT contract was about seven years.[23]

B3. The PILOT's Community Reinvestment Credit

Starting in 2003, the IDB introduced the Community Reinvestment Credit (CRC) as a part of the PILOT program in order to encourage companies to occupy vacant commercial space. Apparently, due to the way Tennessee treats personal property tax, the PILOT program was biased towards greenfield development; companies were building warehouses and office space simply to obtain the PILOT incentive, even though suitable vacant properties were available.[24] Otherwise known as "Second Generation PILOTs," this modification was structured to

[20] The maximum duration of PILOT incentives was formerly five years but increased to 15 years in 1996. Also in 1996, it was determined that the 15 year limit could be waived with the approval of the Shelby County Board of Commissioners and the Memphis City Council. The 15 year limit is slightly shorter than the 20 years which is permitted by Tennessee state law. See "PILOT Evaluation Program Project: Evaluation Report."

[21] In order for a job to be counted as a "net new job," a company cannot count employees that it is transferring from any other operations that the PILOT company is operating in the county. For example, if a manufacturing company has an existing operation in Memphis but expands it, any employees transferred from the pre-existing operation to the expansion project cannot go towards a company's job count.

[22] Various levels of location points are given for locations within the city, unincorporated areas of the county, and federally determined Renewal Community Areas and New Market Tax Credit Areas.

[23] R. Marc Jordan, "Incentives Keep Area's Competitive Edge Sharp," (2002).

[24] A number of economic development officials in Memphis mentioned that the CRC was designed to address the previous bias against brownfield development.

Table 1

Payment-In-Lieu-Of-Tax Eligibility and Consideration Matrix

JOB CREATION (No Max.)	WAGES (Max. 30 Points)	CAPITAL INVESTMENT (Max. 30 Points)	LOCATION (Max. 40 Points)	POINT-TERM CONVERSION (points→years)
Net New Jobs 15 - 50: **1** pt per **5** jobs 51 - 150: **10** pts plus **1** additional pt per **10** jobs after the first 50 >151: **20** pts plus **1** additional pt per **20** jobs after the first 150 **For example:** **60 - 11 pts** **150 - 20 pts** **250 - 25 pts**	**Median Wage** For median wages **within 10%** of the per capita income (PCI) for Shelby Co.: **10** pts For wages **less than 90%** of the PCI, subtract **2** pts for each additional **5%.** **For example:** **90% - 10 pts** **85% - 8 pts** **80% - 6 pts** For wages greater than **110%** of the PCI, **add 2** pts for each additional **5%.** **For example:** **110% - 10 pts** **115% - 12 pts** **120% - 14 pts**	**Real and Personal Investment** < $500,000* **No PILOT** $500,000 - $2 Mil **5 pts** $2Mil - $5 Mil **10 pts** $5 Mil - $10 Mil **15 pts** $10 Mil - $25 Mil **20 pts** $25 Mil - $40 Mil **25 pts** ≥ $40 Mil **30 pts** **Community Reinvestment Credits (CRC)** Existing bldg. < $5 Mil. **5 pts** Existing bldg. ≥ $5 Mil. **10 pts** *CRC projects can still receive a PILOT even if they invest less than $500,000.	**Memphis 20 pts** **Shelby Co. 10 pts** (unincorporated areas) Renewal Community Area **20 pts** New Markets Tax Credit Area **10 pts**	**< 31 0 yrs** **31 – 40 3 yrs** **41 – 50 4 yrs** **51 – 60 5 yrs** **61 – 70 6 yrs** **71 – 80 7 yrs** **81 – 90 8 yrs** **91 – 100 9 yrs** **101- 110 10 yrs** **111 – 120 11 yrs** **121 – 130 12 yrs** **131 – 140 13 yrs** **141 – 150 14 yrs** **151 or greater 15 yrs** **The IDB has the discretion to give bonus points for special circumstances.**

allow for expanding or relocating businesses to use an existing building for a project and still receive PILOT consideration.[25] The CRC has become quite popular. Of the 19 IDB-issued PILOTs in 2003, 11 were under the CRC aegis.[26]

B4. PILOT Application Process

The process of applying for a PILOT begins with a pre-application conference between the applicant and local economic development officials to get a preliminary idea of incentives that the IDB might offer. If PILOT applicants choose to proceed, they file supporting documentation that includes the project description, project cost estimates, current and projected employment, audited financial statements, a phase one environment audit, parcel information and legal description, application fee,[27] and recommendations from the city and county mayors.[28]

Following the submission of supporting documentation, the economic development staff transmits a report with a recommendation to the IDB and mayor(s). The prospect then obtains an official application, essentially a more detailed version of the aforementioned supporting documentation, and a lease agreement.

The prospect reviews the terms of the lease and negotiates any final terms with the IDB. If the two parties reach satisfactory terms, the IDB assigns PILOT benefits, and PILOT recipients schedule a closing date, at which time they must provide closing documentation and fees to the IDB. The closing fee is 5% of the recipient company's PILOT-induced tax savings.[29]

After receiving a PILOT, a company must submit an annual performance report.[30] The IDB can penalize those who do not meet their job, wage, and capital investment promises. Currently, PILOT companies have two years to meet 80% of their job and capital promises, or they face the risk of having the IDB reduce the duration of the

[25] See "City of Memphis and County of Shelby, Tennessee Payment-in-Lieu-of Tax (PILOT)."

[26] See the IDB's *2003 Annual Report (unavailable online)*. Companies that agree to contract with minority, women owned, and/or small businesses may be eligible for PILOT incentives of a longer duration. Moreover, companies that relocate their national headquarters may obtain additional PILOT incentives.

[27] The amount of the application fee is a function of the estimated project investment at the time of application. Fees range from $1,000 for estimated investments of less than $750,000 to $4,000 for estimated investments greater than $5 million. If the company enters into a PILOT contract, the application fee is credited towards the payment of a PILOT closing fee-provided that the closing occurs in an allotted amount of time and the closing fee is paid in a specified amount of time. These fees are used to fund the PILOT program and other economic development initiative. See p. 15 of "City of Memphis and County of Shelby, Tennessee Payment-in-Lieu-of Tax (PILOT)."

[28] See "City of Memphis and County of Shelby, Tennessee Payment-in-lieu-of Tax (PILOT)." For a synopsis, see p. 8 of the "PILOT Evaluation Program Project: Evaluation Report."

[29] The fee must be a minimum of $1,500 and a maximum of $300,000. See p. 16 of "City of Memphis and County of Shelby, Tennessee Payment-in-Lieu-of Tax (PILOT)."

[30] See the IDB's "Payment in Lieu of Tax Program's Performance Report," http://www.dobizinmemphis.com/incentives/assets/2004_report_form.pdf.

PILOT incentive. The practice of docking PILOT companies who are not in compliance has become more common lately. This is likely due to the creation of a Performance Committee in 1999 and the city and county's mounting fiscal troubles.

B5. Magnitude of the Program and Its Fiscal Impacts

Evidence of the magnitude of the program, while conflicting, demonstrates the popularity of the PILOT program's usage. Though the IDB has been issuing PILOTs since 1988,[31] establishing an exact figure on the number of outstanding PILOT contracts is somewhat difficult.

According to a 2004 report from the Tennessee Advisory Commission on Intergovernmental Relations, an estimated $1.94 billion of PILOT property in Shelby County produced $5.63 million in PILOT payments ($2.04 million to the city and $3.58 million to the county) for 2002. In addition, these PILOTs resulted in a "loss" of $57.5 million in tax revenue ($23.09 million for the city and $34.45 million for the county) that the city and county would have collected if they did not offer the PILOT incentive. This substantially exceeds the amount of "revenue loss" in Davidson County (home to Nashville, TN)[32] and represents more than half the PILOT induced "revenue loss" in the state of Tennessee for 2002.[33] Moreover, since 1993, entities from Shelby County filed 415 economic development agreements—just over half the statewide total— with the Tennessee Division of Property Assessments.[34]

According to a second estimate from the Shelby County Trustee's office, there were 557 active

[31] See Younger Associates, *Economic Impact Analysis: Memphis and Shelby County PILOT Program 1988-2000*, October 2000 *(unavailable online)*.

[32] Of course, the fact that Shelby County and Memphis have "lost" more revenue than Davidson County should not be surprising as Davidson has issued fewer PILOTs historically and has a considerably lower tax rate than Shelby County and Memphis.

[33] It should be noted, that in this context, the idea of "revenue loss" is somewhat of a misnomer; this calculation assumes that the PILOT companies would have moved to Memphis in absence of receiving a PILOT reward. In reality, it's only an actual "loss" in tax revenue when Memphis gives incentives to companies that would have located there in absence of the incentive.

[34] See p. 14 of the Tennessee Advisory Commission on Intergovernmental Relations 2004 Report, "Payments in Lieu of Taxes: Impact on Public Education," http://www.state.tn.us/tacir/PDF_FILES/Taxes/prop_tax_abate.pdf. Note that this tally is an accounting of the number of PILOT parcels, not the number of companies who own PILOTs. A number of companies have multiple PILOTs. Also note that this may underestimate the number of PILOT parcels, as TCA § 4-17-301 (the code requiring the reporting of economic development agreements to the state) does not specify whether a government entity or a private entity is responsible for reporting a given agreement. As a result, some agreements may not get filed with the state comptroller despite the requirement.

PILOT parcels in 2003.[35] The county estimates the PILOT leases' assessment value[36] at $1.26 billion and calculates that Shelby County received $8.9 million in 2003 from PILOT parcels while "losing" $42.4 million in tax revenue that PILOT companies would have paid if they were taxed as "non-PILOT" properties. According to a third estimate from the Tennessee comptroller, the IDB held 334 PILOT properties in 2004. With combined estimated value of $2.2 billion, these properties yielded $9.1 million in city and county taxes in 2004. In addition, companies saved a combined $44.1 million in city and county taxes.[37]

While it is difficult to precisely determine the fiscal impact of the PILOT program, it is clear that the PILOT program occupies a dominant presence on the fiscal front. In comparing the Trustee's estimate of forgone tax revenue to the county's 2003 property tax receivables, the county "lost" just over 7% of its property tax revenue to PILOT contracts; the city lost 7.4% in 2002.[38] Historically speaking, "lost" *county* tax revenue from the PILOT has increased an inflation adjusted 125% from 1999 to 2003.[39]

B6. Existing Reports on the IDB's PILOTs

Several additional reports have evaluated the PILOT program. Rather than just estimating the size of the program, these reports reflect more generally on the desirability of the program. Consultants from NexGen Advisors and URS Corporation, hired by Shelby County and Memphis, completed the most recent of these on December 1, 2005. In this section, we offer a synopsis of their principal findings on the efficiency and effectiveness of the program. Broadly speaking, the authors believe that the PILOT program is a valu-

[35] See p. 10 of "The 2004 Shelby County Trustee's Annual Report," http://www.shelbycountytrustee.com/Reports/b_Annual%20Reports/2004%20Annual%20Report.pdf. Note that this tally is an accounting of the number of PILOT parcels, not the number of companies who own PILOTs. Some companies have multiple PILOTs.

[36] "Assessment value" and "market value" are different concepts. The former is computed by multiplying the market value of a property by a constant, predetermined coefficient that is less than one. Currently in Shelby County, the assessment ratio on real commercial and industrial property is 40%; the assessment ratio on personal commercial and industrial property is 30%. In personal communications with IDB personnel, we were told that this reported aggregate assessment value did not consider the depreciation of capital and that the assessment value, and thus tax loss, is overstated in this respect.

[37] See the Tennessee Comptroller of the Treasury "IDB/H&ED Report – 2004 Summary," http://www.comptroller.state.tn.us/sb/idbsumm5.htm. The source of the discrepancies in these reports is not readily identifiable. Some is attributable to the fact that the estimates cover slightly different time periods and that the Shelby County Trustee counts PILOTs issued by other entities.

[38] See p. 10 of "The 2004 Shelby County Trustee's Annual Report" and p. 18 of "Shelby County's 2004 Comprehensive Annual Financial Report," http://www.shelbycountytn.gov/FirstPortal/dotShowDoc/dotContent/Government/CountyServices/AdminandFinance/2003_CAFR_Index.htm.

[39] See p. 10 of "The 2004 Shelby County Trustee's Annual Report."

able and necessary tool for creating jobs and growth in a high-cost[40] environment such as Memphis but they note that the process for obtaining a PILOT has become more politicized as of late. [41]

However, the report suggests that the IDB place more emphasis on targeting the industries and locations that the IDB wants to grow by using the PILOT as well as other incentives.[42] In order to accomplish this reform of the PILOT program, the authors advocate changes to the decision making authority as well as to the decision making criteria for PILOTs. They advise that:

- The City Council and County Commission make the final decision on PILOT applicants. The IDB should become an advisory board.[43]

- The city and county eliminate the matrix, allowing PILOT awards to be more flexible. Awards should last for up to 20 years and provide for different percentages of abatement.

- The applicant companies justify the need for public assistance. Although this would shift some burden onto the applicant, it would remove the one-size-fits-all approach that is currently in place that requires PILOT prospects to fill out a "very detailed and not exceptionally applicable" application in order to meet "esoteric criteria." The consultants suggest the applicants meet a "but for" test.

- Contracts include penalties for not meeting job and capital projections. The city and county should enforce penalties based on actual job creation numbers verified by an independent third party.

The Tennessee Advisory Commission on Intergovernmental Relations conducted another report in 2004 on municipal and county PILOTs within Tennessee. Though not specific to Memphis, this report has some additional advice. The primary relevant findings of this report indicate two things:

[40] See p. 13 of "PILOT Evaluation Program Project: Evaluation Report." It states that "without a reduction in business operation costs, Memphis cannot remain competitive." It bases this assertion on a comparison of the cost of doing business in Memphis for various industries (distribution, bio medical, high tech, and professional services) to the cost of doing business in some of Memphis peer cities/counties (DeSoto County, MS; Indianapolis, IN; Louisville, KY; Nashville, TN). When estimating the "cost of doing business," the report considers factors such as average labor rates, cost of land/building, utility cost, tax costs, and incentives.
[41] See "PILOT Evaluation Program Project: Evaluation Report," 2004.
[42] On p. 14, the report faults the Tennessee legislature for prohibiting other types of business incentives that are needed in order to "meet the needs of today's highly competitive environment."
[43] On May 2, 2006, members of the City Council began their deliberations of a resolution that would adopt this portion of the consultants' suggestions. At the time of press, the outcome of these deliberations could not be established. The city council is meeting on June 6, 2006 to take up this issue and potentially other suggestions from the consulting report.

- The data are insufficient to determine whether the various municipal and county PILOTs increase or decrease local tax revenue in the long run.

- The cost-benefit analyses that accompany most PILOT arrangements needs to be substantially modified. Specifically, the analyses should include community impacts such as PILOT induced infrastructure costs, congestion, etc.[44]

Younger Associates conducted a report, at the request of the IDB, covering PILOTs from 1988 to 2000. They suggest that the PILOT program created a substantial number of jobs, attracted considerable private investment, and yielded a more than two-fold increase in local tax revenues. The authors calculate that, between 1988 and 2000, the 212 PILOTs created 65,366 jobs, almost $4 billion in direct capital investment, and $7.7 billion in indirect construction and capital investment. The report estimates the cumulative total economic impact of $15.2 billion from 1988 to 2000. For PILOTs granted in 1999, the report estimates $2.47 in benefits for every dollar of "tax expenditures." In addition, the authors find the average "payback period" of the PILOTs to be 2.58 years; that is, the city and county recoup the "lost tax revenue" in 2.58 years on average.[45]

Unfortunately, the Younger Associates report does not recognize the crucial "but for" issue—an issue mentioned in the more recent 2004 consulting report.[46] That is, the Younger report assumes that none of these companies would have located in Memphis without the program and that the PILOT did not induce some of these companies to "crowd out" existing investment or investment that would have occurred in absence of these PILOTs. Moreover, the economic impact estimates rest on the use of regional multipliers which are highly dubious.[47] In addition, the report does not address the Tennessee Advisory Commission's point that the cost-benefit analysis should include a variety of costs in addition to the forgone tax revenue. The report also excludes a number of benefits, some of which it acknowledges.

The IDB adopted a similarly flawed model to estimate the costs and benefits of individual applicants. As a result, the cost-benefit analysis used in PILOT evaluations is of little practical use.

[44] See Tennessee Advisory Commission on Intergovernmental Relations 2004 Report, *Payments in Lieu of Taxes: Impact on Public Education*, 2004.

[45] See Younger Associates, *Economic Impact Analysis: Memphis and Shelby County PILOT Program 1988-2000*, October 2000.

[46] See "PILOT Evaluation Program Project: Evaluation Report," 2004.

[47] For an excellent critique of analysis predicated on multiplier effects, see Edwin S. Mills, "Should Governments Own Convention Centers?," *Heartland Institute Policy Study*, No. 33 (1991): 6-11, http://www.heartland.org/pdf/10797.pdf. As it turns out, the aforementioned report by NextGen and URS includes impact analyses based on some of the same incorrect assumptions and flawed methodology.

C. What Are the Actual Results of the PILOT Program?

According to the IDB annual reports, from 1996 until 2003, 245 PILOT projects pledged to provide 38,764 jobs and $5.42 billion (2003 dollars) in investment.[48] Of course, not all the companies met their job projections. So, assuming that companies fulfill 85% of the job projections in the aggregate within three years, the program will have created roughly 33,000 jobs by 2006 within Shelby County according to the IDB.[49]

Given that the IDB started approving PILOT projects extensively in 1996, one would expect a positive impact to be discernable by 1999—the year that 1996 PILOTs had to comply with their job and capital projections—granted the effect of the program should increase over time if there are spillovers that take time to surface. With that said and despite the job and capital creation specified in the Younger Report, the Memphis area economy has struggled in the recent past.

With residents fleeing, employment/establishments decreasing, and government deficits climbing, it is hard to detect the effect of the PILOT. From 1998 to 2003, the number of establishments in Shelby County decreased by 3.2% (as compared to a nationwide increase of 4.5%), employment declined by 5.0% (as compared to a nationwide increase of 4.9%), and payroll increased an adjusted 2.6% (as compared to a nationwide increase of 8.2%).[50] This casts some doubt on the Younger claims. Moreover, while the 1998 unemployment rate for the City of Memphis was a low 4.9%, by 2005 the unemployment rate had increased to 7.1% due to a 39.8% increase in unemployment and a 3.9% decrease in the labor force. A similar trend can be seen at the county level. Shelby County's unemployment rate increased from its 1998 level of 4.0% to its 2003 level of 5.9%.[51]

Of course, one can hardly expect the effect of the PILOT to be visible simply by looking at these aggregates. Many factors could contribute to the

[48] See the IDB *Annual Reports 1996-2003 (unavailable online)*.
[49] The 85% achievement rate comes from the 1999 IDB annual report and is based on the three-year achievement rate of 1997 PILOT companies. As such, this estimate may deviate notably from the average annual aggregated achievement rate. According to the IDB's 1998 annual report, the 1996 job achievement rate was 94% by 1998, so 85% may be a low estimate. Also note this job creation estimate relies on the assumption that all companies who received a PILOT located in the Memphis/Shelby County area; this is not necessarily the case. It may be the case that the IDB offered a few of the companies PILOTs, but the companies chose to locate elsewhere. Of course, there may be a reporting bias in the achievement rates generally because they are based on unaudited self-reported data. Moreover, achievement rates may be rising over time because of the IDBs new emphasis on penalizing those who do not meet their projections. More current IDB reports do not include achievement rates but rather the number of PILOTs not in compliance.
[50] For more information, see the Census Bureaus' County Business Patterns series, http://www.census.gov/epcd/cbp/view/cbpview.html.
[51] See Bureau of Labor Statistics Local Area Unemployment Statistics, http://www.bls.gov/lau/home.htm.

area's declining economic activity and perhaps the PILOT program is keeping the city afloat. Another way to evaluate the program's impact would be to find a series of control cities—cities similar to Memphis that do not use PILOT-style programs to the same extent.

Unfortunately, it is difficult to obtain data for an empirical test that can control for city specific characteristics and still isolate the effect of the PILOT program. Anecdotally, Nashville is the most comparable city in many respects because it is similar to Memphis in size and is also in Tennessee. Nashville uses PILOT incentives sparingly, but it has done well economically. In comparing the economic activity and poverty of these two cities, Nashville typically performs better than Memphis, though this is sensitive to the measure used. This comparison does not necessarily suggest that Nashville excels because it operates without as many PILOTs, but rather, it suggest that the PILOT-style programs are not a necessary component of economic growth.[52]

However, this comparison sheds little light on the situation. Demonstrating that a city similar to Memphis has done well without the widespread use of PILOT incentives does not reveal whether the incentives provide net benefits for Memphis or whether the incentives are superior to an alternative arrangement. As a result, a more thorough examination of the theory and empirics related to the PILOT program is necessary.

D. What Has Been Said about PILOT-Style Programs in General?

Given the inconclusive results of the PILOT program in Memphis, the question arises regarding what theory and experience tell us about tax incentive programs and their effects on local development.

The literature on the theoretical justifications and empirical effects of taxation is voluminous.[53] Whether exploring taxes and interjurisdictional competition, optimal tax theory, or the economics of targeted tax incentives, it is difficult to cover a portion, much less all, of the existing literature. Though extensive examination of these and related literatures is beyond the scope of this paper, a review of some of the existing literature may help evaluate a number of the claims and

[52] The Younger Associates 2000 report includes a comparison of Memphis's program with that of its peer cities and finds that businesses will find the Memphis's PILOT program more lucrative than similar programs in competitor cities. Yet, it is still not possible to infer much from this, as even Memphis's peer cities differ from Memphis in many dimensions.

[53] For a general piece on taxes and economic development, see Michael Wasylenko, "Taxation and Economic Development: The State of the Economic Literature," *New England Economic Review,* March/April (1997): 37-52.

hypotheses advanced by both policymakers and academics.[54]

Politicians in Memphis and elsewhere almost uniformly justify and tout targeted tax incentives on the grounds that they create jobs, attract capital, maintain the tax base, and increase tax revenue in the long-run. Some have also suggested targeted tax incentives serve as good advertisement for cities, provide for social stabilization, or establish a more equitable distribution of resources.[55]

Economists often justify tax incentives theoretically, on the basis of various market failure arguments.[56] Prominent among these is the externality argument, which stipulates that optimal private investment does not occur because when entrepreneurs invest, they cannot capture the full return of their investments, as other people also benefit from them. Often, these externalities take the form of knowledge spillovers, which occur when entrepreneurial activity yields knowledge that also benefits third parties and thus, according to the theory, reduces the incentives for entrepreneurs to invest in the first place.[57]

Broadly speaking, the economic literature on targeted tax incentives tends to consider a number of recurring questions:

- To what extent, if at all, do tax incentives drive businesses' decisions about where to locate or expand?
- Do tax incentives help localities retain and/or recruit jobs and capital investment?
- To what extent do tax incentives promote economic growth?[58]

[54] For literature reviews on targeted tax incentives, see Buss, "The Effect of State Tax Incentives on Economic Growth and Firm Location Decisions," 90-105; Bartik, Timothy, "Jobs, Productivity, and Local Economic Development: What Implications Does Economic Research Have for the Role of Government," *National Tax Journal*, No. 4 (1994): 847-861; Katherine L. Bradbury et al., "The Effects of State and Local Public Policies on Economic Development: An Overview," *New England Economic Review*, (March/April 1997): 1-12; Peters and Fisher, "Tax and Spending Incentives and Enterprise Zones," 109-137.

[55] See Harold Wolman and David Spitzley, "The Politics of Local Economic Development," *Economic Development Quarterly*, No. 2 (1996): 115-150.

[56] See Ed Glaeser's comments on Teresa Garcia-Mila and Therese J. McGuire, "Tax Incentives and the City," *Brookings-Wharton Papers on Urban Affairs*, (2002): 115-124, http://muse.jhu.edu/journals/brookings-wharton_papers_on_urban_affairs/v2002/2002.1glaeser.pdf.

[57] For more information on the characteristics of "knowledge spillovers," see Glaeser et al., "Growth in Cities," *Journal of Political Economy*, No. 6 (1992): 1126-1152.

[58] See Buss, "The Effect of State Tax Incentives on Economic Growth and Firm Location Decisions: An Overview of the Literature," 90-105. As Buss points out, the literature examines the question of location and the question of economic growth extensively, but it is important to understand that while the tax driven location decision is related to whether the tax has growth enhancing properties, the two questions are distinct and should be treated as such.

- To the extent that the incentives do "create" jobs by some measure, who is most likely to obtain these jobs?

- If tax incentives promote net job growth, at what cost do they accomplish this?

Economists and other researchers have used a variety of methods in examining these questions: econometrics, case studies, surveys, hypothetical firm techniques, and general equilibrium analysis.[59] In the end, their answers seem to be quite sensitive to a number of factors, making it difficult to establish a definitive stance about the ability of tax incentives to generate economic activity. Wasylenko suggests that tax incentives have a small, statistically significant effect on location that is not "substantial." Others remain even less convinced about the economic and statistical significance of the location impacts.[60]

The question of the job impact of these programs remains unresolved as well, though there may be some empirical weight behind the proposition that the tax incentives can direct employment or "create" jobs. A majority of the studies in Wasylenko's review of the subject find positive job effects, but Wasylenko is hesitant to accept this "consensus" fully because he finds considerable flaws in the methods and data of some of the studies.[61]

Bartik is more optimistic about the ability of tax incentives to create jobs; in surveying 48 articles, he finds that a 10% decrease in taxation leads to an average increase in employment, investment, or plant births of 3%. Bartik does note that these jobs come at a considerable cost, especially in areas where the incentive promotes growth in a location that has inadequate infrastructure. He estimates that local tax incentives produce a job at an average cost of $4,000 in annual forgone tax revenue. In addition, he notes that an average of 20% of these jobs go to local residents, putting the cost of creating a local job at $20,000 per job per year. Yet, he finds that the job creation increases long-run employment rates and long-run real wages in the impacted area.[62]

Blanchard and Katz disagree with Bartik's assessment and conclude that in-migrants capture all of the created jobs in the long run.[63] Regardless, those who are skeptical of these programs' ability

[59] See Fisher and Peters, *Industrial Incentives: Competition among American States and Cities*. (W.E. Upjohn Institute for Employment Research, 1998): 1-305.
[60] See Wasylenko, "Taxation and Economic Development: The State of the Economic Literature," 37-52. For a more skeptical view, see Buss, "The Effect of State Tax Incentives on Economic Growth and Firm Location Decisions: An Overview of the Literature," 99.
[61] See Wasylenko, "Taxation and Economic Development: The State of the Economic Literature," 37-52.
[62] Bartik, "Jobs, Productivity, and Local Economic Development," 853-4.
[63] Oliver Blanchard and Lawrence Katz, "Regional Evolutions," *Brookings Papers on Economic Activity*, (1992): 1-75.

to produce jobs and investment have a collection of empirical evidence they can rely on as well.[64]

Ultimately though, as Courant points out, the substantial intellectual resources brought to bear on the debate in order to decipher the job, capital, and other effects of tax incentives may be misplaced. While these questions are certainly of political interest, economically speaking, these goals are not necessarily desirable policy ends.[65] Bartik agrees that, "Job creation in and of itself should not be seen as the ultimate goal of economic development programs."[66] Moreover, given current data limitations, most empirical techniques are ill-suited for an exercise designed to measure the job impact of a PILOT style program even if "jobs created" were a good outcome measure.

E. So, How Are We to Think about Economic Development and Evaluate the PILOT Program?

E1. Counting Jobs

In Memphis, the IDB and other local authorities are fixated on the supposed job creation properties of the PILOT program. They also focus, to a lesser extent, on capital investment, wages, and future tax revenues. Yet, even if jobs and these other objectives were good measures of successful economic development, actually measuring "net new jobs" or "net new capital investment" is fraught with difficulties.

For every job that the government subsidizes at firm A, firm B may lose an employee. The PILOT forbids companies to shift jobs from one operation to another to get a PILOT. So, for example, when a Memphis McDonald's reduces employment at one location and increases employment at another, the increase cannot count toward its job creation totals for PILOT purposes. Yet, when McDonald's adds a job under the program, Wendy's may lose an employee as a result. This dynamic process wherein PILOT sanctioned jobs displace at least some of the existing jobs makes the "net job creation" calculus difficult.

A more pertinent example might involve an industrial enterprise. For every job a new distribution company adds, an existing Memphis

[64] See, Alan Peters and Peter Fisher, "The Failure of Economic Development Incentives," *Journal of the American Planning Association*, No. 1 (2004): 27-37.
[65] Paul N. Courant, "How Would You Know A Good Economic Development Policy If You Tripped Over One? Hint: Don't Just Count Jobs," *National Tax Journal*, No. 4 (1994): 863-881. See also Ben Powell, "Promoting Economic Development: Government Programs or Economic Freedom?" *Mercatus Center Working Paper*, No. 17, http://www.mercatus.org/pdf/materials/444.pdf.
[66] Bartik, "Jobs, Productivity, and Local Economic Development," 859.

> *"Existing job creation estimates assume that all of the PILOT companies would have located elsewhere absent the PILOT incentive. This assumption is incorrect."*

company may lose a job. At a minimum, one would expect some displacement.

With the widespread use of the PILOT, it is even possible that PILOT companies are adding a job at the expense of other current or previous PILOT companies. In various conversations with Memphis businesspeople, it became evident that many of the medical device firms, for example, have PILOTs and swap employees relatively frequently. At an extreme, one could envision the PILOT not only as a sponsor of labor mobility (rather than a creator of labor), but also as a facilitator of job swapping among PILOT companies. In either case, it is hard to say that economic growth occurs.

In addition to the displacement issue, there is the "but for" factor. That is, it is difficult to determine which companies would not have located in Memphis or which companies would have a reduced presence in Memphis but for the presence of the PILOT program. Existing job creation (as well as cost and benefit) estimates assume that all of the PILOT companies would have located elsewhere absent the PILOT incentive. This assumption is incorrect. Many companies locate in Memphis because of its unique geographical position and solid infrastructure. While the PILOT program may induce some firms to move to Memphis, it is not a necessary recruitment tools for all companies who receive one.[67]

Moreover, if job growth is a path towards social stability or a way to stem local unemployment, the PILOT program may not deliver these results because many of the individuals benefiting from the program are not from the Memphis area. As mentioned previously, Bartik estimates that only 20% of gross "job creation" from tax incentive programs go to local residents. Of course,

[67] Some economists have even surmised that the outcome of tax competition could be the absence of location effect. Indeed, if tax competition were "perfect" and if every locality in the US were engaged in it, the presence of tax incentives would cancel each others out. At the end of the day, no company would ever relocate because of the presence of tax incentives In this view, tax incentives would work best (i.e. they would cause businesses to relocate) if Memphis was the only place in the US to use them. See James Rogers's presentation and paper at the Minnesota Law School's conference on state tax incentives, http://www.law.umn.edu/constitutionallaw/statetaxconf05_agenda.html.

Memphis may see local labor absorption at a greater or lesser rate.[68]

Even if the PILOT could create jobs, the jobs were measurable, and the jobs led to some degree of increased social stability, strong net job creation would not necessarily demonstrate that PILOTs help foster economic growth. This is because economic performance does not hinge on job growth *per se*, but on labor productivity and entrepreneurship—which ultimately translate into higher employment. To the extent that the PILOT program distorts the desired labor-capital mix, productivity may suffer rather than increase. Indeed, if job creation was an advisable goal, the government could give tax deductions to a company to dig a canal with spoons (and thus lots of laborers). However, would Memphis be a better and more prosperous place in such a case?[69] If labor and capital productivity is the goal—that is, if the goal is prosperity— then policy improvements require a different conception of economic growth and a different set of government "incentives."

E2. What Drives Economic Growth and What Does It Mean for Tax Incentives?

Economic development and growth result from the accumulation of capital, which enables people to achieve more goals with what they have. The accumulation of capital over time leads to a complex web of interrelated capital goods. This process of accumulation does not take place automatically—entrepreneurial decisions drive the process. Entrepreneurs make decisions based on their knowledge of the local situation and the profit opportunities they discover.[70] Capital accumulation enables people to become more productive and thus to receive higher pay over time.[71]

Entrepreneurs try to capture, as much as possible, the profit they create in the course of doing business. In order to do so, they set up firms and design complex contracts often simultaneously dealing with many suppliers and employees. Entrepreneurial activity drives product innovation as well as new forms of contracting whereby entrepreneurs establish the conditions for long term production.[72] One outcome of economic

[68] Bartik, "Jobs, Productivity, and Local Economic Development," 854.
[69] In some respects, it is not surprising that politicians want to create employment because the public at large often misunderstands the economic role of jobs. See Bryan Caplan, "Straight Talk about Economic Literacy," http://www.mercatus.org/pdf/materials/32.pdf.
[70] On the role of entrepreneurship in markets, see Israel M. Kirzner, *Competition and Entrepreneurship* (Chicago: University of Chicago Press, 1973); and Israel M. Kirzner and Frederic Sautet, "The Role of Entrepreneurship in Markets: Implications for Policy," *Mercatus Policy Primer No. 4*, 2006. On the issue of entrepreneurship and growth, see Kirzner, "The Entrepreneurial Process," reprinted in *Discovery and the Capitalist Process* (Chicago: University of Chicago Press, 1985); and Randall Holcombe, "The Origins of Entrepreneurial Opportunities," *Review of Austrian Economics*, No. 1 (2003): 25-43.
[71] Jane Jacobs emphasized the kinds and varieties of new work as crucial to prosperity. See for instance Jacobs, *The Economy of Cities* (New York: Random House, 1969), 49-84.
[72] In more technical terms, entrepreneurs take advantage of information asymmetries and contract over property rights in order to internalize, as much as possible, the profits they have discovered.

> "Economic performance does not hinge on job growth per se, but on labor productivity and entrepreneurship, which ultimately translate into higher employment."

development and entrepreneurially-driven capital accumulation is the generation of jobs, jobs that encompass a wide variety of industries and skill sets. Genuine job growth is the result of labor and capital productivity increases that result from entrepreneurial activity. By freeing up resources, productivity increases enable labor to be employed in new, more productive areas.

It is difficult to see how city planners could successfully supersede the entrepreneurial process that creates a complex web of interwoven capital goods. Entrepreneurs are guided by the profit mechanism, which acts as a compass and steers them where their activity is most beneficial. In the absence of the guidance of the profit and loss mechanism, directing investment where it is most valuable is guesswork.

Prosperity and economic growth crucially rest on the role of entrepreneurship. While government policy can be useful at creating the right environment for business to flourish, it can also disrupt the context in which innovation and entrepreneurial activity occur. In this sense, the institutional context in which entrepreneurship takes place is crucial to the economic and social outcomes one obtains. In order to foster socially-beneficial entrepreneurial activity, local government must focus on having and maintaining a certain institutional environment: one that respects property rights, honors freedom of contract, and minimizes ill-informed policy interventions.[73]

Though most local stakeholders praise the PILOT program because of its ability to create jobs, some economic theorists justify PILOT-style tax incentive programs based on the fact that market mechanisms are insufficient to promote optimal economic development.[74] This line of thinking discounts what entrepreneurs do and prizes local governments' ability to engage in activities they are not equipped to do well.

Once one appreciates that entrepreneurs are the agents of growth, it becomes evident that the tension in evaluating the PILOT program revolves around weighing the tradeoff between providing tax incentives (generally perceived as good for growth) and government planning (bad

[73] On the subject of entrepreneurship and institutions, see Frederic Sautet, "The Role of Institutions in Entrepreneurship," *Mercatus Policy Primer*, No. 1 (2005), http://www.mercatus.org/pdf/materials/1053.pdf.
[74] According to some economists, externalities (and knowledge spillovers) may lead to underinvestment and various forms of information asymmetries that are detrimental to economic performance. Bartik, "Jobs, Productivity, and Local Economic Development," 847-861.

for growth). The problem occurs when, in trying to do the former, governments end up doing the latter. In other words, it is not possible to provide tax advantages to select groups in a way that would not affect the decision making process of other entrepreneurs operating in the local economy.

Because governments cannot provide tax incentives in a neutral way, economists such as Nobel Prize Winner James Buchanan have recognized the benefits of tax generality and the threats of preferential taxation:

> The requirement for general taxation is politically or constitutionally efficient in the sense that such a constraint will produce patterns of legislative outcomes that will tend to minimize the destruction of economic value through the operation of the fiscal process…general taxation becomes first-best constitutionally, even if it is recognized that such taxation remains second-or third-best from the idealized perspective of benevolent governance.[75]

The main problem with tax incentives and tax competition is not that they exist. Jurisdictional competition is a good thing for citizens and the economy. The main difficulty is that localities such as Memphis become actively involved in disseminating their tax incentives in a counterproductive manner, one that is inconsistent with the principles of tax generality.

E3. Within This Framework of Generality, How Would One Evaluate the PILOT?

Interestingly enough, it appears that previous Tennessee legislatures understood the dangers of allowing localities to selectively assess property tax when they included, in the state constitution, an amendment banning the discriminatory application of local property tax. Yet, as mentioned previously, the Tennessee legislature side-stepped the constitutional mechanism that ensured local tax generality.

While it is evident that the PILOT does not mesh with the generality principle, it is also the case that the program does not comport with the consistency principle either. The IDB frequently awards PILOT leases to firms in a manner that is inconsistent with the core matrix score. This further opens the door to welfare-reducing partnerships between businesses and officials, inviting lobbyists to make their case for preferential treatment. Some PILOT awards extend for a longer time period than the matrix would predict, while some are shorter.

[75] James M. Buchanan, "The Political Efficiency of General Taxation," *National Tax Journal*, No. 4 (1993): 404.

In 2000, SubmitOrder.com promised to invest $79.3 million and generate 971 jobs with a median wage of $27,600. The IDB granted SubmitOrder a 15 year tax freeze despite the fact that the IDB's decision point-matrix estimates the company should have received only an 11 year tax freeze. Incidentally, SubmitOrder.com remained in Memphis for one year, during which it generated only 50 jobs. Of course, with the technology bubble bursting around this time, it is not surprising that SubmitOrder did not meet its projections.[76]

This popular anecdote, of which there are others, simultaneously demonstrates the practical difficulties associated with planning based on projections[77] (the IDB would have needed advanced knowledge of the tech bubble's bursting in order to award an appropriate PILOT term to SubmitOrder) and the proclivity of the IDB to violate principles of tax consistency. Why 15 years and not the prescribed 11?

The year after SubmitOrder received a 15 year break, in 2001, the Ford Motor Company received two PILOTs on different parcels, with each enjoying 6 years more than the matrix estimates—13 years rather than 7. In 2003, Kaz Home Improvement received a 10 year tax break, 3 years longer than the matrix suggests for its projected 400 job increase and its $5,300,000 investment.

Inconsistencies are also evident when comparing similar applicant's PILOT awards. For example, in 2001, McKesson received a PILOT for investing $6,001,000 in capital and creating 35 jobs with a median wages of $28,000. Kellogg's also won a PILOT; it pledged to add $16,900,000 in capital and to create 33 jobs with a median wage of $38,896. Despite Kellogg's considerably larger wages and investment, the two companies received the same PILOT award of six years.

According to the IDB's own cost-benefit analysis, some companies receive PILOTs despite the fact that the costs outweigh the benefits. As stated earlier, IDB's cost-benefit analysis is flawed, but it supposedly only offers PILOTs when the benefits at least match the cost.[78] This gap between the IDB's expressed policies and its application of the policies illustrates the IDB's tendency to violate principles of consistency. From 2000 to 2003, 10 of the 96 PILOT leases did not have projected cost that exceeded the benefits.

According to a subset of PILOT Project Summaries,[79] the IDB routinely distributes special

[76] Paul Kovacs, "Tax Incentive Neither Fair Nor Good for Business," *The Commercial Appeal*, December 12, 2004.
[77] According to a document obtained from the Memphis and Shelby County Office of Planning and Development, at least 19 companies have left the area after fulfilling the terms of their PILOT and at least 21 or more have terminated their PILOTs or failed to complete their terms.
[78] See Industrial Development Board's *Annual Reports* (2000-2003), *unavailable online*.
[79] Project summaries are essentially scoresheets that the IDB maintains during the evaluation process. Unfortunately, it was not possible to obtain many of these.

bonus points. Of the six project summary sheets we inspected, all of the recipients received enough bonus points to acquire at least one extra year of tax abatements. In 2005, for example, IDB gave Medtronic Sofamor Danek 30 bonus points, enough points to gain three more years of PILOT tax relief than the main criteria of the matrix would otherwise offer. Though extra consideration of this magnitude is likely an aberration, in all cases we examined but one, the bonus points added to each applicant's score lend some credence to the idea that the IDB apportions bonus points with the intent of insuring that applicants receive a certain number of additional years.

For example Creative Co-op scored a 50.5 on its PILOT application in 2004, but the IDB granted an additional 0.5 bonus points to guarantee that Creative would receive a five year break (which requires at least 51 points) rather than a four year break. A more flagrant violation of the consistency principle can be seen in the case of American Yeast's PILOT. Before the addition of bonus points, American Yeast received 60 points, enough for a five year tax break. Yet, the IDB granted American Yeast 11 bonus points bringing the companies' total to 71 points, just enough to receive a seven year tax freeze.

One does not have to rely on anecdotes to demonstrate that the PILOT violates consistency principles. From 2001 to 2003, at least 23 PILOTs (or at least 35%) were issued for durations that were inconsistent with the matrix's core criteria.[80] As currently implemented, the PILOT program not only violates the generality principle, but it also violates the consistency principle. Because the PILOT allows officials significant amounts of discretion, it likely compromises otherwise achievable levels of prosperity. We offer solutions aimed at increasing prosperity by minimizing this discretion.

> *"Previous Tennessee legislatures understood the dangers of allowing localities to selectively assess property tax when they included, in the state constitution, an amendment banning the discriminatory application of local property tax."*

[80] The number of programs that received points inconsistent with the matrix's core criteria is probably much higher, but data limitations preclude us from demonstrating this empirically. Of these 23 PILOTs that were inconsistent with the matrix, five companies received PILOTs for shorter terms and the rest received PILOTs for longer terms.

F. Why is Memphis Expensive for Business, and What Needs to be Done to Foster Entrepreneurship and Improve Economic Growth in Memphis?

F1. Why is Memphis an Expensive Location to do Business?

As Rob Robertson of *The Memphis Business Journal* recently wrote, "Memphis itself is generally viewed by outsiders as an unpleasant place to live, with high crime rates, poor schools, high taxes, festering racial tensions and a local government that is ineffective at best, dysfunctional and corrupt at worst."[81] Though the outsider's view is a bit of a caricature of Memphis, it does carry some validity.[82] In recent times, economic activity (as measured by payroll, employment, and number of establishments) in Shelby County has lagged behind several of the nearby counties and several of its national competitors. While aggregates can be misleading, Memphis's population has remained largely flat since the 1970's despite its 28% increase in land area.[83] In the 1990s, Shelby County experienced a net outward migration, as many residents have moved to nearby Desoto County.[84]

In addition, city and county officials recently increased property tax in their respective jurisdictions, despite the fact that the area already had the highest tax burden in the state. At the same time, the city has adopted or increased various fees (e.g., adoption of a rat and mosquito fee,[85] an increase in garbage fees,[86] and an increase in drainage fees[87]). In fact, the recent doubling in garbage fees was significant enough that citizens

> *"From 2001 to 2003, at least 23 PILOTs (or at least 35%) were issued for durations that were inconsistent with the matrix's core criteria."*

[81] Rob Robertson, "Memphis Labor Pool Unmotivated, Unattractive to Outsiders, Study Shows," *Memphis Business Journal*, July 7, 2005.

[82] In a report ranking the 50 most populous cities in Tennessee, Memphis ranked as the least business friendly. See Drew Johnson, "How Business Friendly are Tennessee's Cities," *Tennessee Center for Policy Research Policy Report*, No. 06-01 (2006), http://tennesseepolicy.org/files/pdfs/2006_TCPR_BusinessFriendlyReport.pdf.

[83] For more information, see land area data from The Census Bureau.

[84] See Steve Redding and Sonya Schenk, "The Migration of People and Their Incomes in the Memphis MSA: 1992 to 1997," http://planning.memphis.edu/Migration.pdf.

[85] Michael Erskin, "Rat-Control Fee Could Add 75 cents to Utility Bills: County Commission to Consider Approval Monday," *The Commercial Appeal*, August 4, 2005.

[86] Jacinthia Jones and Bill Dries, "Fee Increases Seem to be Everywhere; Some See It as Just Part of City Living," *The Commercial Appeal*, June 9, 2005.

[87] See Memphiswatchdog.org.

with homes valued at $184,000 or less will find it more costly than the combined city and county property tax hike. Meanwhile, bond rating companies have downgraded Memphis bonds twice recently, as the city's reserves have dwindled to less than a million dollars and the city has run three consecutive budget deficits.[88] Though the county's bond rating just improved, it still remains $3.3 billion in debt (including principal and interest)—a substantial amount of debt for any county, especially one of only 900,000 inhabitants.[89]

With the local government already bloated and serving as one of the only "growth industries" in a city amidst a variety of corruption scandals, Memphis's new CFO has stated: "More than 70% of our budget is tied up in salaries and benefits, and we don't intend to layoff workers… that means there is only a small area we can cut, such as supplies and equipment."[90] Anyone interested in serious reform in Memphis should find this claim troubling.

Having provided a brief picture of Memphis's overall economic position, we will now turn to a discussion of how Memphis might improve its overall entrepreneurial environment. Following this, we suggest policy modifications, some modest and some drastic, as well as the best-case alternative to the PILOT program.

F2. Given the Limits of the Current PILOT Program, What Alternative Policies Would Improve the Business Environment?

Assuming the city and county continue to use the PILOT program, they must avoid implementing it in a more discretionary fashion. At the time of press, the City Council is considering a resolution that would grant the council the final authority to make PILOT decisions. This would put the final decision in the hands of a body that is arguably less bound by the matrix than the IDB. Though the matrix is flawed, it still reduces discretionary decision making. Were the city and county to take the authority to give more preferential treatment to various companies or industries based on an economic development agenda or some other criteria, the hazards of planning would become even starker. More micromanaging and leeway for political gamesmanship is undesirable.

Though the authors of the most recent consulting report suggested that the City Council and County Commission distribute PILOTs without a matrix, this would be a grave mistake. The "but

[88] Jacinthia Jones, "City's Credit Rating Sinks—Downgrade to Cost Memphis Taxpayers," *The Commercial Appeal*, February 8, 2006.
[89] See The Shelby County Trustee's April 30, 2006 "Bond Indebtedness," http://www.shelbycountytrustee.com/Reports/e_Debt%20Reports/Bond%20Presentation.pdf.
[90] See Memphis Channel 3 News Report, http://www.wreg.com/Global/story.asp?S=4377817.

for" test that the consultants suggest as an alternative to the "matrix" rests on the unwarranted assumption that it is possible to determine, with flawed projections and company provided data, whether a business would require municipal incentives to locate in Memphis. Even the consultants acknowledge the limits of the "but for" test.[91] In reality, removing the matrix would leave the process open to even more planning, lobbying, and corruption—an area where Memphis has not had a sterling record in recent times.

Governments can best foster economic growth by focusing on the quality of the institutions in which entrepreneurs operate. What matters for economic growth is that private individuals and businesses can bet on the future and reap the gains (or suffer the losses) of their bets when they are successful (unsuccessful).

Though the constitutionality of some types of local tax incentives has been reviewed by the Supreme Court,[92] any changes to the PILOT program will likely have to come from within the confines of Shelby County. Various entities, such as The Council of State Governments, have advanced several centralized recommendations intended to curb the misuse of PILOT-style programs with little success.[93] Neighboring states have formed weak cartels and made pacts not to bid on the same companies; yet, without an external enforcement agent with binding authority and the ability to penalize "cheaters," these agreements do not have enough teeth to curb the use of tax incentives.[94] Moreover, a recent bill[95] designed to limit the use of the incentives has not received popular support in Congress.[96]

In the end, local reform in this area is difficult, as political and economic circumstances strongly favor the *status quo*. Politicians, even those who believe that the programs do not work, are participating in a contest to see who can be perceived as trying to recruit the most jobs. Any politician who declines to participate in the job creation game risks suffering politically.[97] Problems with measurement amplify this issue.

[91] See p. 16 of "PILOT Evaluation Program Project: Evaluation Report."

[92] See Amos Maki, "Justices to scrutinize tax breaks—case could ground PILOT—'corporate welfare' to foes," *The Commercial Appeal*, September 28, 2005. In the article, Kisber (Commissioner of the Tennessee Department of Economic and Community Development) indicates that Tennessee's incentives were not subject to the current case (*Cuno vs. Daimler Chrysler*). It is not clear whether Memphis's incentives were at issue though.

[93] See Greg LeRoy, *No More Candy Store* (Washington, DC: Institute on Taxation and Economic Policy, 2002), 1-139.

[94] See LeRoy, *No More Candy Store*, 111.

[95] "Distorting Subsidies Limitation Act of 1999," http://minneapolisfed.org/research/studies/econwar/HR1060.cfm.

[96] W. Fulton, "The Endless Subsidy Cycle," *Governing*, No. 5 (1999): 101.

[97] As James Rogers explains, the outcome is independent of whether game participants know the structure of the game. Politicians could be fully aware that the use of tax incentives is not conducive to growth, but the situation forces them to respond in this way. See his presentation at the Minnesota Law School's conference on state tax incentives.

When businesses apply for tax abatements or even after they have received them, they have little incentive to indicate that the abatement was a small or insignificant part of their locational decision making process because doing so would injure their relationships with politicians/planners and thus decrease their capacity to lobby successfully in the future.

The resulting collective action problems make local tax abatement reform quite difficult. Yet, a few incremental changes could improve the administration of the program and dampen the program's tendency to involve an expansion in suboptimal government planning.

F2-1. Five Actionable Improvements:

1. *Remove the closing fees and charge all PILOTs an application fee that only covers the cost of the PILOT program*.

The governments of Shelby County and Memphis are never going to have ideal incentives for administering a program such as the PILOT in an optimal way. Yet, because the revenue from the 5% closing fee funds economic development activities, the IDB has an incentive to award PILOTs simply in order to generate revenue for its activities and other related economic development initiatives. In 2003, the PILOT program produced approximately $2.8 million in closing fees. This fee-budget loop decreases the IDB's incentive to apply the matrix consistently.

In the near term, one of the easiest opportunities for reform is to repeal the closing fee provision and instead charge each PILOT applicant an upfront fee that only covers the cost of administering a given PILOT. In so doing, the IDB would be encouraged to look at the PILOT process more systematically by concentrating on how it spends money and allocates tax abatements rather than how it can acquire more short-term budgetary resources for economic development.

2. *Remove the matrix's wage criteria and adjust the point-year scale accordingly*.

In addition to revising the fee structure, if politics allows for a reconsideration of the PILOT matrix, then the IDB should remove the wage considerations in order to allow low-paying industries and unskilled workers full consideration. Memphis's tax burden already hampers its ability to recruit and retain its "bread and butter" logistics, warehousing, and distribution businesses. Companies in these industries usually invest in large footprints and/or considerable equipment, so the property tax can have a material effect on profits. While the PILOT dampens this effect to an extent, the wage considerations in the matrix tend to discriminate against potential projects in these industries that often offer low wages to entry level hires.

It is important for economic development officials to resist the temptation to recruit only "good, well-paying jobs."[98] While it may be desirable to have a diverse commercial base and while it may be preferable within the multiplier paradigm to offer better tax incentives to higher paying industries, this sort of discrimination minimizes Memphis's ability to help its citizens improve their employment outcomes. Those unskilled workers currently on the unemployment roll need entry-level employment, and Memphis needs more of its labor force to work.

The bias against distribution hurts Memphis. After all, it is not as if the recruitment of low-paying industries and high-paying industries is mutually exclusive; recruiting distribution does not preclude luring a higher-end operation. While the wage requirement is unlikely to single handedly dissuade distribution from locating in Memphis, it may send the wrong signal, and it certainly transforms the mentality and role of economic developers from "beggars" to "choosers." What is certain is that Memphis's high level of taxes will saddle those industries that get penalized because of their wage levels with disproportionately high property tax.

Removing the wage requirement (and adjusting the point-year scale accordingly) could assist more Memphians in securing employment and could check the policymakers' temptations to select the kind of jobs they want in the area rather than the kind of jobs unemployed local residents can fill.

3. *Limit the IDB's ability to offer bonus points*.

The matrix's greatest asset, when applied strictly, is that it minimizes the IDB's discretionary power. Yet, because the IDB routinely awards bonus points to applicants, it interferes with the matrix's ability to maintain consistency.

Accordingly, the city and county should limit the amount of special points the IDB can authorize and thus check the temptation for business and policymakers to "play politics" with the program. Though the matrix criterion may be flawed, the discretion afforded to the IDB in implementing the matrix does not compensate for the flaws in the matrix. Rather, it leaves the process open to politics and rent-seeking. IDB officials do not have the requisite information or incentives required to compensate for the matrix's ills (i.e. SubmitOrder and the technology bubble). The bonus points cap could be a percentage, say 10%, of the calculated PILOT award, or even an outright prohibition. As there have been a number of accusations recently that the process has become politicized, such a change also would be a valuable step towards restoring the public's confidence in the program.[99]

[98] An added advantaged of removing the wage consideration is that it will encourage companies to provide more flexible compensation packages. As it stands, because the matrix does not consider various employee benefits such as insurance, companies might offer compensation in the form of monetary wages when both the company and the employee would otherwise prefer the compensation to include more non-pecuniary benefits.

[99] See p. 9 of "PILOT Evaluation Program Project: Evaluation Report,"

4. *Remove thresholds from job and capital point system, offer a linear scale for job and capital creation, and eliminate the point cap on capital investment.*

As mentioned briefly in the early stages of this paper, job and capital creation components of the matrix contain thresholds. Using jobs as an example, once a company's projected job creation reaches a given level, the additional points that the company can acquire for creating jobs above the threshold, decline on a per job basis. For instance, if a company creates between 15 and 50 jobs, then it will receive 0.2 points per job. Yet, if another company created between 51 and 150 jobs, then this company would receive 0.2 points per job for the first 50 jobs and then 0.1 points per job for any jobs created after the first 50.

This point system suggests that the first 50 jobs the company creates are somehow more socially valuable than the next 50. While this may have been done to provide small businesses extra consideration, economically speaking, there is little reason for such a scale. Accordingly, the IDB should modify the job creation points to reward job creation based on a linear scale with no thresholds.

The capital thresholds are even more problematic. Because there is no gradation within each interval, companies have a stronger incentive, on the margin, to inflate capital numbers in order to meet the next threshold. For example, a company estimating that it would invest on the high end of the first investment interval (between $500,000 and $2,000,000) has an incentive to invest $2,000,000, so that it can receive 10 points rather than the 5 it would receive if it invested $1,999,999. Indeed, as the matrix is currently constructed, there is an

TABLE 2

REVISED MATRIX

JOB CREATION (No Max.)	CAPITAL INVESTMENT (No Max. Points)	POINT-TERM CONVERSION (points→years)
NUMBER OF NET NEW JOBS 1 pt per 10 jobs	REAL AND PERSONAL INVESTMENT 3 pts per $1 mil COMMUNITY REINVESTMENT CREDITS Existing bldg. < $5 Mil. 5 pts Existing bldg. ≥ $5 Mil. 10 pts	10 pts → 1 year

incentive for the firm on the margin to inflate their projections or to invest wastefully (perhaps buying unnecessary mainframe computers or hot tubs) in order to reach the next threshold and extend the duration of its PILOT award.

Anecdotal evidence of this sort of gaming suggests the phenomenon is not unusual. In 2000, for instance, two PILOT companies projected investment levels of $25,010,000, an amount that is just $10,000 more than the high end of the $10 million to $25 million interval. In so doing, the companies secured an additional five points and perhaps an additional year of PILOT benefits. Two other 2000 PILOT projects appear to have stretched for the $25 million to $40 million interval, with one estimating its investment at $25,020,000 and another estimating $25,060,000. From 2000 to 2003, nine companies seem to have gamed the capital points system, where "gaming" is somewhat arbitrarily defined as matching a capital invested threshold exactly or exceeding it by less than 0.2%. A number of these companies received longer terms because of their strategic approach.[100] In order to discourage companies from gaming the system, IDB should remove the thresholds and offer incremental points, based on a linear scale, for investment.[101]

Finally, though the IDB apportions unlimited points for job creation, it limits the amount of points a project can receive for capital investment. Projects investing more than $40 million can receive the maximum 30 points for capital investment. This limit is not economically justifiable. If Memphis benefits from providing tax subsidies to PILOT companies and the benefits are in proportion to the size of the investment, as the matrix implies, then the IDB should not cap the matrix capital points. Under the current arrangement, two hypothetical firms that each invest $25 million will receive a combined 50 points, but a hypothetical firm that invests $50 million will only receive 30 points. The IDB should address this nonsensical result by eliminating the cap and removing the thresholds.

[100] From 2001 to 2003, only one company chose not to game the system even though it would have been easy to do so. In 2001, Classic Hardware could have received five more points if it had invested $2 million instead of $1,995,000. Yet, if the company were to have inflated its capital projects in order to obtain the additional points, it still would have only 46 points, 5 points below the 51 point threshold needed to extend the PILOT contract to 5 years.

[101] Removing the threshold and establishing a linear scale for the capital reinvestment credits would be advisable for the same reasons. The CRC is advisable in that it helps address the bias against PILOT companies locating in existing buildings. Though it is quite difficult to find a consistent way of treating companies that invest in new buildings and those that occupy existing ones, having some consideration for the latter is important for checking the previously experienced unintended consequences of discouraging brownfield development. While a streamlined version of the CRC points would not be optimal, it would be preferable than not having the CRC at all.
Standardizing the Jobs Plus program by removing thresholds and treating firms equally, irrespective of the duration of the PILOT otherwise obtained under the primary criteria, would provide for greater consistency and less planning as well.

5. *Remove the location criteria.*

The matrix provides extra consideration for companies locating in the Memphis city limits. While this may be part of an attempt to revitalize the city, stop sprawl, or compensate for the city's high tax burden, giving extra consideration to business locating in the city does not do much for overall economic prosperity for the Memphis area. Instead, it increases the planning aspect of the matrix, reducing the chances that the PILOT program will benefit the local economy.

In addition, the matrix grants additional points to PILOT companies that locate in Renewal Communities (RC) or New Market Tax Credit (NMTC) areas. These federal designations denote concentrated poverty. While the intent behind encouraging economic growth and reducing poverty in impoverished areas is admirable, tax incentives that are geographically targeted on a small area do not often provide additional benefits to residents, as compared with tax incentives that target a city as a whole, because workers and residents are mobile. Those who work in the zone are often not from the zone, and those who live in the zone often do not work in the zone. As a result, a policy that targets a small area might fail to empower an impoverished group living in that area because tying the incentive to the area does not necessarily tie the incentive to the impoverished people of that area.[102]

After implementing these five changes, we obtain a new two-criterion matrix (see table 2 on p. 31). If the IDB had applied this modified matrix from 2001-2003, the average term offered to PILOT applicants would have been similar. This suggests that the redesigned matrix might minimize transitional problems for the city and county by offering comparable fiscal consequences as the existing matrix. However, after using this new matrix to reduce the incentives for PILOT applicants to game the system, the new average duration of PILOT leases may prompt a different fiscal impact.

F2-2. The Incremental Option: Automating the PILOT

If politically feasible, a better option than altering the matrix would be for the IDB to apply more uniformity to the PILOT program. Put the PILOT on autopilot, if you will, by granting any relocating company a tax break for a specified duration (existing PILOT companies could be grandfathered). By removing the IDB's discretionary power, the program would start to resemble sound tax reform rather than industrial policy and would thereby advance toward a system reliant on principles associated with the lessons of the economics of entrepreneurship and tax con-

[102] See Peter Fisher's comments in The University of Minnesota Law School's Tax Policy Conference, http://www.law.umn.edu/constitutionallaw/statetaxconf05.html.

sistency. Memphis would send a welcome message to all types of entrepreneurs who are shopping locations, rather than those whose projects met dubious criteria or have the means to lobby for preferential treatment.

Unfortunately, the incremental process of trying to minimize planning and policy by interest is not so simple. Even if one were to reduce the red tape and planning associated with the process by offering blanket PILOTs of a set duration to any company, one would create a divide between those who are relocating and those who, while already in the jurisdiction, are expanding.[103] In an attempt to determine how to handle "expansion" in a uniform way, one would have to define "expansion" and would fail to rectify the tax discrimination against existing businesses.

In order to offer existing and expanding businesses some tax relief so that they may make informed innovations, the city should accompany the blanket 10 year PILOTs with a moratorium on tax increases. This would help insure that existing businesses do not carry the additional tax burden that might result if the city loses revenue due to the blanket PILOT offering to relocating businesses.

F2-3. The Best-Case Reform: Building an Environment for Growth

The best option would be to embrace the intent behind the Tennessee Constitutional amendment requiring that "each respective tax authority shall apply the same tax rate to all property within its jurisdiction."[104] If Memphis and Shelby County officials discontinued the PILOT program and embraced tax generality (after grandfathering existing PILOT companies), the area would enjoy the fruits associated with increased entrepreneurial activity, provided that the general tax rate was reasonably low and that core public services were adequate. In other words, prosperity would not come from active government policy but be homegrown by letting entrepreneurs use their knowledge of local circumstances in order to build up the capital base and capture opportunities for profit. Despite the fact that surrounding areas would continue to operate within otherwise burdensome tax regimes, Memphis could offer, unilaterally, a reasonable tax rate and thus create an attractive business environment.

In order to establish a "reasonably low" property tax rate, several fiscal reforms are required. Spending reductions must take place, as deficit

[103] In addition, one also maintains a gap between the treatment of existing, non-expanding businesses and new ones.
[104] Tennessee Constitution, Art. 2, Sec. 28. Note that the constitutional amendment is in the spirit of the generality principle developed by James Buchanan and others.

> *Tax incentives… are easy. Elected officials get to cut ribbons and take credit for creating jobs. Using tax dollars to compensate for high taxes… is easier than actually addressing the problems themselves. When used in this manner, abatements are truly unsustainable development—a finger-in-the-dike solution to serious barriers to urban investment.*
>
> *-Stephen Goldsmith, former Mayor of Indianapolis*[105]

financed tax reductions are not going to produce an entrepreneurial environment conducive to economic growth. A system of "cost accounting" or "activity based costing," such as the one former Indianapolis mayor Stephen Goldsmith[106] implemented, would serve Memphis well. In addition, the city would have to undertake some form of the following:

1. With 70% of the city's expenses devoted to payroll, a performance-based strategy involving employee cuts and reshuffling must take place. The current labor strategy is contrary to the performance-based approach because the city pledged not to layoff its workers or to give them raises.[107] While cutting and reallocating employees has the potential to hamper the government's ability to provide quality services, if cuts are made in areas unrelated to the provisioning of the most basic public goods (e.g., roads, education, etc.), then essential services should not be dramatically affected, particularly if the decrease in the tax rate slows the outward migration and increases the tax base as one would expect.[108]

2. In addition to streamlining the existing government workforce, the city must attack one of its looming fiscal liabilities by reducing its future employee pension obligations. The current system provides employees with a pension option after 12 years, a commitment Memphis cannot afford given its financial woes and high level of government employment.

[105] Stephen Goldsmith, *The Twenty-First Century City: Resurrecting Urban America* (Washington DC: Regnery Publishing, 1997): 82.
[106] Stephen Goldsmith, *The Twenty-First Century City: Resurrecting Urban America*, 82.
[107] Jacinthia Jones, "Salary Freeze Chills Talks: Memphis, Unions at Loggerheads on Pay," *The Commercial Appeal*, April 5, 2006.
[108] Joseph Sensenbrenner, "Quality Comes to City Hall," *Harvard Business Review,* No. 2 (1991), 64.

3. Other opportunities exist for reducing government spending. Removing the procurement ordinance that gives preferential treatment to local bidders could help reduce the government's contracting expenses, as would the removal of the prevailing wage ordinance,[109] which forces the city contractors to pay wages and benefits at levels in excess of the market rate.

4. The city needs to liquidate excess assets, such as its golf courses and other non-essential land/equipment.

In tackling these fiscal reforms, Memphis will address some of the causes, rather than the consequences, of its poor economic record. In so doing, Memphis policymakers would reduce the cost of doing business for all businesses. Adhering to the generality in taxation principle will foster a more entrepreneurial environment and will provide Memphis the best chance to succeed in the long term.

CONCLUSION

Memphis and Shelby County offer a window into the actual workings of a tax incentive program designed to spur the relocation of businesses. Most local policymakers are keen to promote economic activity and job growth, and those in Memphis are no exception. The city of Memphis and Shelby County have used the PILOT program for almost two decades, presenting an interesting showcase for the performance of tax incentive schemes.

Assessing the tax incentive approach is not easy. "Has the PILOT program paid off?" More importantly, "What alternatives might be superior?" These are difficult questions to answer. To respond, we have examined the complex mechanics of the program, including the PILOT matrix, in order to determine how the city and county might improve the program.

In the last seven years, the number of establishments in Shelby County has decreased more than 3%, and employment has declined as well. Unemployment is currently high in Shelby County and Memphis. Judging from the general economic context alone, it is clear that, while the PILOT may be helping Memphis tread water, it has not produced any net increase in long-term economic growth.

Overall, it is not clear whether the PILOT program in Shelby County and Memphis has delivered on its job creation, capital investment, and tax base promises. Yet, the economics behind the

[109] See Memphis's Prevailing Wage Policy, http://www.cityofmemphis.org/pdf_forms/PW_policy.pdf.

program suggests that the wrong promises are being made.[110]

If economic prosperity is the result of capital accumulation and entrepreneurial activity, then it is not clear how the PILOT program provides a better context for entrepreneurship. It is true that lower taxes provide incentive for businesses to locate in the Memphis area. However, the actual management of the PILOT program, like any policy, does not take place in a setting of perfect benevolence and perfect knowledge. External influences on the PILOTs selection mechanisms are strong enough to reduce the benefits associated with lower taxes. In other words, the difficulties associated with the management of an active tax policy reduce its chances of success.

The lessons of the Shelby County and Memphis experience with tax incentives show that policy solutions should aim at implementing the generality principle, which consists in applying policy in a uniform way without providing advantages to select groups. While political constraints make it nearly impossible to implement in its ideal, marginal steps toward a more general, or at least consistent, application of tax policy could go a long way. Greater application of the generality principle would reduce the chances for private interests to influence decision making or to nudge the results in their favor.

Depending on the political feasibility of each reform, we suggest policy reform focus on three levels:

1. The most politically achievable level consists of five specific recommendations that reduce the incentives that lead to bad project selection. The city and county should remove the closing fee and charge each PILOT applicant a low, flat fee. In addition, the IDB should remove the wage and location criteria in the PILOT matrix to allow for full consideration of low-paying jobs. The city and county should remove the limit on capital investment points and place a cap on the IDB's use of special bonus points. Moreover, the IDB should refine the job and capital point system so that there is less incentive to game the various thresholds.

2. A more preferable solution would apply the consistency principle to the PILOT program. In this solution, the program would grant any relocating company a tax break for a given duration of 10 years; the IDB would not have any discretionary power. In order to shield existing companies from the threat of tax increases, this automating of the PILOT

[110] Some of our objections to the program are captured in Lafaive, Michael D. and Lawrence W. Reed, "Mackinac Center Manifesto on Economic Development: What Role Should Government Play," (2002), http://www.mackinac.org/depts /ecodevo/article.asp?ID=4194.

should be accompanied by a moratorium on tax rate increases. While this solution might create some difficulties, the outcomes, in terms of local prosperity, of such a policy would be superior to the status quo and the more actionable option.

3. Finally, the best case solution would be to scrap the PILOT program and embrace the intent behind the Tennessee constitutional amendment—that the generality principle be applied in taxation. This would require reforming the tax system in order to provide a low property tax rate, as well as severe fiscal reforms and spending reductions. Of course, even if Memphis maintains the PILOT program for the foreseeable future, incremental tax and spending reform could contribute much to the long term prosperity of the area.

The lessons of the PILOT program in Memphis are applicable to local tax incentive policy elsewhere. The more the tax incentives resemble industrial policy, the less likely they are to produce the benefits of genuine tax reform. Localities that employ tax incentives in an attempt to rectify difficult local economic situations should seek to remediate the causes of economic distress by removing barriers to entrepreneurship, rather than actively seeking a bureaucratic work-around. Instead of competing by offering companies preferential treatment, local governments should compete by exercising their ability to create the conditions for prosperity.

About Mercatus

The Mercatus Center at George Mason University is a research, education, and outreach organization that works with scholars, policy experts, and government officials to connect academic learning and real world practice.

The mission of Mercatus is to promote sound interdisciplinary research and application in the humane sciences that integrates theory and practice to produce solutions that advance in a sustainable way a free, prosperous, and civil society. Mercatus's research and outreach programs, Capitol Hill Campus, Government Accountability Project, Regulatory Studies Program, Social Change Project, and Global Prosperity Initiative, support this mission.

The Mercatus Center is a 501(c)(3) tax-exempt organization. The ideas presented in this series do not represent an official position of George Mason University.

About the Mercatus Policy Series

The objective of the Mercatus Policy Series is to help policy makers, scholars, and others involved in the policy process make more effective decisions by incorporating insights from sound interdisciplinary research. The Series aims to bridge the gap between advances in scholarship and the practical requirements of policy through four types of studies:

- **Policy Primers** present an accessible explanation of fundamental economic ideas necessary to the practice of sound policy.
- **Policy Resources** present a more in depth, yet still accessible introduction to the basic elements of government processes, or specific policy areas.
- **Policy Comments** present an analysis of a specific policy situation that Mercatus scholars have explored, and provide advice on potential policy changes.
- **Country Briefs** present an institutional perspective of critical issues facing countries in which Mercatus scholars have worked, and provide direction for policy improvements.

Mercatus Center
George Mason University

3301 North Fairfax Drive
Arlington, Virginia 22201
Tel: 703-993-4930
Fax: 703-993-4935