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Tax Expenditures: It's Time to Change the Process

by Robert J. Kleine

Whenever the legislature debates the need for additional revenue to balance the state budget or fund new programs, the discussion always comes around to tax expenditures. This has been particularly true in recent years as the recession has reduced available revenues and forced sharp budget cuts. Tax expenditures are a controversial subject. On one side are those who view tax expenditures as giveaways to special interests and as an unwarranted end run around the budget process. On the other side are those who view the effort to eliminate tax expenditures as a backdoor tax increase; they also claim that the concept of tax expenditures assumes that the government has a right to all of one's income and property.

These arguments may become clearer if we look at the definition of tax expenditures. They are most commonly defined as revenue foregone due to exemptions, exclusions, or deductions from the tax base, credits against a tax liability, or preferential tax rates. A more narrow definition includes only those tax features that are changes from the normal tax structure. This definition includes only those tax provisions that are substitutes for direct budgeted expenditures, such as the credit against the state income tax for property taxes paid. An example of a tax expenditure that meets the broader but not the narrower definition is the capital acquisition deduction from the single business tax (SBT), which is a necessary component of a consumption value-added tax.

Traditionally, tax expenditures have had three purposes.

1. To reduce taxes for specific individuals or firms, thereby changing the distribution of incomes and usually improving the equity of the tax. Examples: the personal income tax exemption, the exemption of food and drugs from the sales tax, and the SBT credit for small, low-profit firms.

2. To influence the behavior of taxpayers. Example: the property tax abatement for industrial facilities.

3. To improve the administration of the tax. Example: the base exemption from the SBT, which excludes small firms that likely would pay too little tax to cover administrative costs.

Even if the need for revenue is not a consideration, there are other reasons for questioning the use of tax expenditures. First, these expenditures are not part of the regular budget process and therefore escape the public debate about the allocation of public resources. Unlike direct expenditures, there is no accountability attached to tax expenditures. They are administered by no public agency, no one is called to defend them, and there is generally no opposition to their extension because there is little information available about costs or effects. The legislature and the public, for example, should be able to choose between cutting the higher education budget and eliminating certain tax expenditures, but this never happens.

Second, the expenditure may not promote the desired activity. For example, there is considerable evidence that industrial property tax abatements do not increase economic activity statewide as intended but rather redistribute activity among communities (see discussion below).

Third, there is no control of the growth in tax expenditures, regardless of the condition of the state budget. This creates a bias toward growth, and decision makers and the public remain largely in the dark about this growth and its effect on other direct expenditure programs. The House Fiscal Agency has estimated that tax expenditures increased 52.5 percent from 1982 to 1988, while general fund/general purpose expenditures

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increased 46.9 percent. In the last several years this discrepancy in growth rates likely has widened in favor of tax expenditures.

Of course, there are advantages to tax expenditures. Tax-subsidized programs largely administer themselves, requiring no large bureaucracy. Taxpayers decide whether to engage in the subsidized activity and claim the subsidies by filing tax returns; generally, no applications are required. Authorization is also easy; no funds are appropriated and no program reviews are required. Supporters claim that an annual review process should not be required because the beneficiaries make decisions based on these subsidies and should have some certainty as to the continuation of the subsidy.

FISCAL EFFECT OF TAX EXPENDITURES

Public Act 72 of 1979 requires the governor to submit, with the annual budget message to the legislature, a report on specific tax expenditure items. The act does not define tax expenditures but lists the specific items required for each tax. Unfortunately, the requirements of this act are sometimes ignored and a report is not submitted. The latest report, which was prepared jointly by the departments of Treasury and Management and Budget, contains estimates for fiscal years 1988–89 and 1989–90.

The cost of tax expenditures in FY 1989–90 was estimated at $10.3 billion, compared with total revenue collections of $18.1 billion (see Exhibit 1). Although this is a very large revenue loss, many of these tax expenditures have solid justification or would be politically very difficult to eliminate. A list of Michigan's larger tax expenditures is included in Exhibit 2; these account for 95 percent of the total. Two of the larger tax expenditures are the personal income tax exemption ($667 million) and the homestead property tax credit ($713 million). Both improve the fairness of the tax system, and there is almost no support for their elimination. In fact, the personal exemption was increased several years ago, and there are proposals to increase it further. The exemption for food ($434 million) and drugs ($17.5 million) listed under the sales tax are constitutionally exempt and also improve the fairness of the tax system. Although, as discussed below, a tax credit would be a more efficient method to provide this exemption, there is almost no chance that the voters would approve its removal. The exemptions from the federal income tax total $1.4 billion. These could be taxed by changing the definition of state taxable income, but most of these exemptions are politically sacred and there is little chance that the legislature would attempt to tax these items.

EXHIBIT 1

Revenue and Tax Expenditures for Major Taxes, FY 1990

Tax	Revenue (000)	Tax Expenditure (000)	Expenditure as a Percent of Revenue
Single business	$1,819,950	$1,109,140	60.9%
Sales/use	3,158,496	2,098,920	66.5
Income	3,902,913	3,297,072	89.6
State property	388,272	810,760	208.8
Transportation	1,198,100	59,098	4.9
Local property	7,593,100	2,723,406	35.9
TOTAL	$18,062,831	$10,298,397	57.0%

Tax-exempt property totals an estimated $2.2 billion, but much of this is church, charitable, and government property and will not be taxed. Another problem with eliminating local property tax exemptions is that Article IX, section 31 of the state constitution (Headlee amendment) requires that if the definition of the base of an existing tax is broadened, the maximum authorized rate of taxation must be reduced to yield the same amount of revenue. This reduces the incentive to eliminate these exemptions, although some still may be unwarranted. The taxpayer, however, would benefit from their elimination as a broader tax base would result in lower millage rates for owners of taxable property.

There are several expenditures on the list that are fair game, such as industrial facilities and tax increment districts (property tax), the capital acquisition deduction (SBT), and exemption of services (sales tax). But even here there are questions. The capital acquisition deduction is an integral part of the SBT and under some definitions is not a true tax expenditure. The exemption from the sales tax for services is a tax expenditure, but many believe elimination of the exemption would constitute a direct tax increase, no different from raising the rate. The only two tax expenditures on the list that appear clearly to be unwarranted are exemptions for interstate sales (sales tax) and mobile homes (property tax). Several of the SBT exemptions, such as the small business low-profit credit, are also of questionable validity.

The point of this discussion is that $10.3 billion in revenue is not available from eliminating tax expenditures, or an amount even close to that. Including the sales tax on services, we would estimate the available revenue at less than $2 billion. This is still a very significant amount, but the lower figure puts the issue in better perspective. As discussed below, a realistic approach would be to focus the debate on developing classifications of tax expenditures that make clear how much revenue is available from a practical standpoint.

CRITERIA AND GUIDELINES FOR GRANTING TAX EXPENDITURES

The purpose of this paper is not to make the case for or against tax expenditures. The purpose is to suggest a better process for evaluating tax expenditures and for making decisions either annually or periodically about their worth. To this end there are a number of criteria that should be considered and guidelines that should be followed when tax expenditures are granted.

"Public purpose" should be the basic rationale for tax expenditures; thus, preferences not serving a public purpose should not be granted. Also, since tax expenditures are a public subsidy, they should be granted only if a direct appropriation to the recipient can be justified. Making these decisions can be difficult and politically sensitive. Included below are

EXHIBIT 2

Estimated Cost of Selected Tax Expenditures, FY 1989–90 (dollars in millions)

Tax Expenditure	Cost
State Income Tax	
Homestead Property Tax Credit	$713.3
Personal Exemption	666.5
Adjustments to Income	507.0
Farmland Development Credit	65.0
Federal Income Tax	
Employer Pension Plans	548.1
Employer Contributions to Health and Life Insurance	388.9
Social Security Benefits	296.8
IRAs	81.2
Interest on Life Insurance Savings	52.8
Workers Compensation	30.5
Single Business Tax	
Capital Acquisition Deduction	405.0
Excess Compensation Deduction	310.0
Business Loss Deduction	95.2
Nonprofit Organizations	65.0
Gross Receipts Limitation	63.4
Small Business Low-Profit Credit	50.0
Statutory Exemption	42.0
Sales Tax	
Services	1,088.5
Food	433.8
Industrial Processing	310.5
Interstate Sales	48.7
Agricultural Products	44.2
Nonprofit Organizations	25.7
Newspapers, Periodicals & Films	23.0
Collection Fee	21.5
Prescription Drugs	17.5
Local Property Tax	
Tax Exempt Property	2,200.0
Industrial Facilities	250.0
Tax Increment Districts	127.4
Mobile Homes	69.8
Air and Water Pollution	49.8
Other	
Intangibles	
Banks and Savings and Loans	401.1
U.S. Bonds and Obligations	167.6
City Income Tax	
Nonresident Reduced Rate	119.8
Inheritance Tax	
Life Insurance	65.8
TOTAL	**$9,845.4**

seven criteria and three guidelines that can be useful in the decision process. The criteria should be systematically applied to all tax expenditures.

Criteria

1. Tax expenditures should be consistent with constitutional mandates or guidelines.

The supremacy clause of the U.S. Constitution establishes the federal government as the dominant partner in the intergovernmental system. Therefore, state laws, including preference statues, must conform with the federal constitution. For example, Michigan exempts property owned by religious organizations from taxation. While some claim that the exemption is an inappropriate subsidy for religious organizations, a more compelling case can be made on constitutional grounds in favor of such preferences. The U.S. Supreme Court has held that the power to tax is tantamount to the power to destroy. Therefore, if religion is to be free from government intervention, as required by the First Amendment, exemption of religious properties is required.

2. Tax expenditures may be used appropriately to avoid difficult administrative problems.

Certain types of activity that theoretically should be subject to taxation may pose administrative problems that result in unfair treatment of the taxpayer or excess costs for the tax collector. For example, providing a base exemption from the single business tax makes sense because it sharply reduces the number of returns to be processed without significantly reducing revenue and provides relief for very small businesses for which filing a return could impose a hardship. Above a minimum level, however, the exemption could become an unwarranted tax expenditure, if the revenue loss significantly exceeds the administrative savings.

3. Tax expenditures should be related to the purpose of the organization and the use of the property.

The exempt property or income should be central to the goals of the organization and the property should not produce net income. Each exemption law should state the public purpose served, and the preference should be contingent on the continued performance of that purpose. The objective is to avoid exemptions based solely on ownership. Such exemptions can result in the property being used for income-producing purposes.

4. Services provided by an organization receiving a tax preference should benefit the public at large.

Because a tax expenditure is a subsidy that burdens all taxpayers, there should be some public benefit. For example, since all taxpayers benefit from clean air and water, the exemption of pollution abatement equipment can be justified. It is unreasonable to expect that all taxpayers will benefit from all tax expenditures, but at a minimum all taxpayers should receive an indirect benefit, and the services provided by any group receiving a tax preference should be available to all who seek them.

Identifying indirect benefits that extend to all taxpayers can be a subjective task. For example, most people regard the YMCA and the Boy Scouts of America as organizations that help build character in young people and thereby improve society. Consequently, the summer camps operated by these organizations are exempt from taxation although attendance at such camps is limited to only a segment of the population. The exemption lowers the cost of providing the service to the public, increasing the likelihood that the tax expenditure will benefit the largest possible population. When an exemption extends to properties that provide a service, public access to the service should be guaranteed (that is, membership should be open to everyone).

5. Tax expenditures should be limited to organizations performing functions that government otherwise might have to provide.

Rather than providing all public services itself, government often contracts with private organizations to provide certain services. Contracts can take a variety of forms and need not involve a direct exchange of funds. If government were performing these functions, the property used would be tax exempt; thus, property used to provide a service otherwise required of government also should be exempt (if not used for profit purposes). An example is nonprofit homes for the aged and chronically ill; if the care were not provided by the private sector, government would have to provide care for these persons.

6. ***A tax expenditure should not create an unfair competitive situation for taxable organizations providing the same or similar service.***

An example of a preference that creates an unfair competitive situation is an industrial facilities abatement that may be given to a new firm locating in an area but not to an established firm in that area that is not expanding. This is clearly unfair and is a major weakness of property tax abatements. Another example is an exemption for a nonprofit organization that may be running a business that competes with for-profit businesses.

7. ***A tax expenditure may be appropriate if it protects low- and moderate-income persons from a heavy tax burden.***

Shielding low-income persons from taxation is generally considered a valid public purpose. The only questions generally are the size and type of preference to be provided. Many of the tax expenditures listed in Exhibit 2 are designed for this purpose. However, some may view the homestead tax credit as too liberal, as it provides relief for taxpayers with incomes as high as $83,000. (The credit is phased out for taxpayers with incomes from about $73,000 to $83,000.) Therefore, the relief provided above a certain income level may be viewed as an unwarranted tax expenditure.

Guidelines

1. ***Tax expenditures should be clearly defined and the intended beneficiaries specified rather than loosely defined and broadly aimed.***

Defining public purpose is a legislative responsibility, but if preference statutes are vaguely worded, as many are, this function may be usurped. This is a particular problem with property tax exemptions that must be administered by local assessors. For example, if the law is imprecise, different assessors may treat similar properties differently. This occurs most often with the exemption of nonprofit theater, educational, cultural, and scientific organizations.

2. ***Tax expenditures should be efficiently targeted and not used to grand broad-based relief.***

For example, the Michigan sales tax exempts food at a cost of more than $400 million annually. This exemption is intended to reduce the regressivity of the sales tax, which it does. However, as a study by the House Fiscal Agency has pointed out, this could be done more efficiently and at a much lower cost by providing a targeted tax credit for food purchases that is phased out at higher income levels.[1] The current exemption provides a subsidy for the purchase of higher priced food items not affordable to low-income consumers. The elimination or revision of this tax expenditure would require a constitutional amendment.

3. ***Tax expenditures should be granted for a limited period.***

All tax expenditures should be given a sunset date so that their benefit and cost can be periodically and publicly reviewed. The perception of public purpose can change, as can the purposes for which organizations

1 House Fiscal Agency, *Silent Spending: Tax Expenditures and the Competition for Public Dollars*, May 1990.

exist, and once public-spirited organizations can become self-serving. Also, the purpose for which the preference was originally granted may no longer exist. Therefore, each preference should be granted for a limited time to provide for periodic review to ensure that it continues to serve a public purpose. The concept of limitation has been used very sparingly in Michigan. One example was the property tax exemption for commercial facilities. The initial legislation, passed in 1976 (PA 255), imposed a sunset date. The act was extended once, but the exemption was allowed to expire on December 31, 1985.

In summary, the first criterion should be whether the property or activity has constitutional protection from taxation, i.e., religious and federal property. The second criterion should be whether a tax would be too difficult to administer, that is, whether the revenue raised would cover the administrative costs or the administrative burden on the taxpayer would be too great. If a tax expenditure does not meet these two criteria, then the other five criteria discussed above should be used to determine if the expenditure is justified.

The three guidelines listed above should be followed after a decision is made to grant a tax expenditure. If a tax expenditure does not meet all of the criteria, it still may be justified if the criteria it satisfies are deemed of sufficient importance. In most cases, any activity that provides a service that would otherwise have to be provided by government has a strong case for exemption. When there is a conflict between two or more criteria, the legislature will have to weigh the relative importance of each. For example, exemptions for industrial property may be viewed as serving a valid public purpose and as a benefit to the public at large, but the exemption also may create an unfair competitive situation for other businesses.

It is not in the scope of this paper to analyze individual tax expenditures. However, as an example of the type of analysis that should take place, a section from our 1986 study on property tax exemptions is included as Appendix A.[2] In this material all property tax exemptions in effect at that time are classified by criteria and evaluated, and the elimination of a number of them is recommended.

PROPERTY TAX ABATEMENTS

Because the industrial facilities property tax exemption has been under particular scrutiny recently, we are singling it out for special attention in this paper. Two events in the past year have focused attention on this tax expenditure. First, the Democrats have recommended its elimination to cover some of the cost of their property tax relief plan, which will be on the November ballot. Second, the closing of the Willow Run plant by General Motors drove home the point that even plants that receive an abatement can close. Some local officials want GM to pay back the abated taxes. In addition, the escalating cost of the exemption in a time of fiscal stress has many localities questioning the validity of this tax expenditure.

Property tax abatements for industrial property were established by Public Act 198 of 1974. The law authorizes the legislative body of a city, township, or village to establish "plant rehabilitation districts" and "industrial development districts" within which industrial facilities are eligible for property tax abatements. Approval of an abatement request by the local governing body and the State Tax Commission exempts a new facility, speculative building, or a replacement or restored facility from general ad valorem property taxation. In place of property taxes, an industrial facilities tax is levied. For a new facility or speculative building this amounts to 50 percent of the ad valorem tax. For a replacement or restored facility, the industrial facilities tax exempts the increased value of the facility from taxation. Abatements cannot be granted for more than twelve years but may be for fewer; they apply to industrial real property (excluding land) and machinery,

2 Public Sector Consultants, Inc., *Michigan Property Tax Exemptions and Their Effect*, July 1986.

equipment, fixtures, and furniture (personal property). An antiraiding restriction prohibits abatements that would cause jobs to be shifted from one local government to another without the agreement of the unit losing the jobs.[3]

It is impossible to calculate the effect of tax abatements on economic growth with complete accuracy, because there is no way of knowing if the abated property would have expanded or located in a particular area without the abatement. The available evidence appears to indicate that much of the activity would have occurred without the abatement.[4] It also seems clear that most firms receiving abatements would have located in Michigan even without the abatement. Therefore, although abatements may help certain local communities, they do little to create additional economic activity statewide. Meanwhile, state government bears a large share of the cost as lower property values (SEV) per pupil increase the state aid payment to in-formula school districts.

The amount of property currently exempt under the Industrial Facilities Development Act is $1.7 billion in state equalized value (SEV) for restoration or replacement property and $15.2 billion in SEV for new facilities. These figures do not take into account depreciation or the possibility that some certified property still may be under construction, or that some projects may be scaled back. Therefore, in estimating the cost of this tax expenditure, the SEV base was reduced by 40 percent. As a result, the amount of taxes abated is estimated at about $325 million for 1991. (Exhibit 3 provides a year-by-year listing of property currently exempt under P.A. 198.[5]) The cost of these abatements is borne by local units of government, out-of-formula school districts, and the state, which reimburses in-formula school districts for lost revenue through the school aid formula. The cost to the state is estimated at $60-65 million for 1991.

Property tax abatements are available to large and small companies, but the major beneficiaries are larger firms. For example, based of 1987–91 data, about 44 percent of the property abated was for motor vehicle related businesses, largely General Motors, Ford, and Chrysler.

In sum, there is little or no evidence that property tax abatements have been effective in attracting or retaining business in the state. There is even evidence to suggest that abatements give little or no advantage to one locality over another. Furthermore, abatements often are unfair to existing businesses and may cause financial harm to some school districts.

There is disagreement about how much state-controlled business taxes influence business location decisions. Nevertheless, if Michigan is to improve both the image and substance of the state's business climate, it would be wiser to lower business taxes for everyone. This also would reduce competition between communities, eliminating a "coercive" atmosphere in which local governments offer unnecessary abatements to forestall anticipated competition from their neighbors. Since most states offer property tax abatements, their elimination should be accompanied by an across-the-board reduction in taxes, possibly of the personal property tax on machinery and equipment.

An alternative to complete elimination of abatements would be to limit them to distressed areas, such as Detroit and Flint, as was the intention of the original legislation, and allow the state to grant abatements in cases where careful analysis indicates it may be a factor in attracting or saving a significant number of jobs.

3 In 1978 (P.A. 255), abatements were adopted for commercial property. The law is no longer in effect, but the abatement is still in effect for some property. The commercial abatement is not discussed in this paper.

4 See *Municipal Government Economic Development Incentive Programs in Michigan* (Lansing and Detroit: Citizens Research Council of Michigan, February 1986) and *Michigan Property Tax Exemptions and Their Effect*, July 1986, chapter 5.

5 The estimated annual cost of commercial tax abatements is $15 million, an amount that is declining each year, as no new abatements are being granted.

EXHIBIT 3

Act 198 Certificates of Activity, by Year

Totals by Year Issued	Number of Existing Certificates	Existing State Equalized Valuation	Replacement State Equalized Valuation	Number of Existing Certificates	New State Equalized Valuation
1978	7	$34,553,727	$175,951,837	35	$363,589,384
1979	18	10,505,126	50,686,189	119	584,521,512
1980	14	3,184,332	23,777,534	254	1,143,139,752
1981	33	20,420,997	116,101,176	297	1,291,193,963
1982	48	15,921,508	63,485,599	303	588,905,755
1983	27	8,595,190	47,511,835	380	478,074,648
1984	72	65,220,869	309,905,671	620	1,030,298,614
1985	71	56,661,846	613,601,033	708	1,250,976,731
1986	49	15,212,140	17,055,729	656	1,176,983,227
1987	38	24,474,724	50,960,332	639	1,973,196,571
1988	42	37,256,293	69,394,658	597	1,455,136,698
1989	40	24,672,094	70,791,478	644	1,002,553,077
1990	29	13,442,363	41,671,883	625	1,619,041,609
1991	19	7,407,323	68,853,462	565	1,219,169,200
TOTAL	507	$337,528,532	$1,719,748,412	6,443	$15,227,089,828

SOURCE: Michigan Department of Treasury, State Tax Commission.

The state would bear the cost of the abatement, but could require that the taxes generated be shared by several communities, depending on the size of the project.

CONCLUSIONS AND RECOMMENDATIONS

Several changes are needed in the manner in which the state reports and evaluates tax expenditures. First, tax expenditure estimates should be included in the budget document. Estimates currently are published as a separate document and are easy to overlook or ignore. The Department of Management and Budget has not published this document every year. Section 30 (local) spending numbers are included in the budget document, and there is no reason why the tax expenditure report cannot also be integrated into that document.

Second, different classifications for the various types of tax expenditures should be developed. For example, tax expenditures that have constitutional status, such as exemption of churches from the property tax, could be class 1. Tax expenditures that clearly improve the equity of the tax structure, such as the personal income tax exemption, could be class 2. Tax expenditures that are an integral part of the tax structure (under the generally accepted form of the tax), such as the capital acquisition deduction under the SBT, could be class 3. Tax expenditures that have been adopted for administrative purposes, such as the small business deduction under the SBT or the flat deduction from the sales tax (which is intended to compensate for collection costs) could be class 4. The difficult questions here are how large the exemption should be and whether a portion of the exemption should be included in one class and the remainder in another. Tax expenditures designed to promote economic development, such as the industrial facilities property tax exemption, could be class 5. All other tax expenditures, where there may not be a completely clear rationale, could be class 6. These are just examples; it may be a appropriate to have fewer or more classes. For example, a separate class for federal tax expenditures may be appropriate. Too many classes, however, could become very confusing.

There are certain to be arguments against the classification of current tax expenditures, but we believe it would help to focus the debate. We propose that the classification of all new tax expenditures be included in the enacting legislation, and this would become part of the bargaining process.

Our view is that the current practice of lumping all tax expenditures together makes them more difficult to eliminate because of the halo effect. That is, the positive attributes and arguments for retaining the valid expenditures rub off on the less valid tax expenditures. Guilt by association also occurs, whereby good tax expenditures are tainted by bad tax expenditures. Also, the legislature and the public become confused about how much revenue is really at stake, or to put it another way, how much of the tax base has been given away. No one believes the personal income tax exemption will be repealed, but the cost of this exemption is lumped in with all others. Our view is that if efforts are focused on certain classes of tax expenditures more progress will be made. Clearly, we do not have all the answers, but a reasonable classification system can and should be developed.

We believe that each tax expenditure should be reviewed by the appropriation committees as a regular part of the budget process. The review process could be set up on the basis of the tax expenditure class. For example, class 1 expenditures might never be reviewed unless a court case changed the law. Class 2 expenditures might be reviewed every five years, and class 6 expenditures every year. This would insure a careful, systematic review of all tax expenditures with the major effort focused on those of most questionable purpose.

Finally, the legislature should agree on specific criteria to evaluate tax expenditures. A suggested list of criteria were discussed above.

The time has come to implement a more rational method of evaluating tax expenditures. The result will be an improved budget process, a fairer tax system, and a more efficient allocation of resources.

APPENDIX A

EVALUATION OF PROPERTY TAX EXEMPTIONS

This section evaluates all property tax exemptions on the basis of eight of the nine criteria and guidelines outlined in the text. The failure to meet one or even a few of these does not necessarily invalidate an exemption; rather it is the preponderance of evidence that was used to judge whether or not an exemption should be continued or repealed. Table VIII-1 lists each category of property tax exemption and indicates whether or not it meets the criteria and guidelines. Listed below are exemptions that should be repealed or modified, the rationale for the recommendation, and the fiscal loss or gain that would accrue to the state and/or local units of government.

University of Michigan Women's Auxiliary Association

PURPOSE OF EXEMPTION: Legislation was enacted in 1891 to exempt this organization because of its charitable activities.

RATIONALE FOR ELIMINATION: This organization no longer exists, therefore the exemption is not needed. Even if the organization did exist, it would qualify under the exemption for charitable or state-owned property.

FISCAL EFFECT: None.

Special tools

PURPOSE OF EXEMPTION: This allows exemptions for such tools as dies, jigs, fixtures, molds, patterns, and gauges used in the ordinary course of business. This is a subsidy to manufacturing industries, particularly the motor vehicle industry. It is intended to increase investment and hence employment opportunities.

RATIONALE FOR ELIMINATION: This tax exemption is actually a subsidy to specific types of businesses. If state government wishes to assist these industries, it should do so with a direct subsidy or a general tax reduction, either of which would be more efficient. Further, there is no evidence that incentives of this type increase employment or draw firms to the state.

FISCAL EFFECT: Due to the large manufacturing base in Michigan, the potential revenue gain to local governments would be large if this exemption were eliminated.

Trees and shrubs on agricultural land

PURPOSE OF EXEMPTION: This is a subsidy to a specific industry. Fruit farmers receive a special benefit from this exemption.

RATIONALE FOR ELIMINATION: Because of this subsidy, fruit farmers are advantaged over other farmers. This exemption also creates a difficult assessment problem because local assessors must place a value on the trees and shrubs in order to exclude them from the value of the farm. If this property were placed on the property tax rolls, relief could be granted under the farmland tax credit program.

FISCAL EFFECT: The revenue gain to locals would be modest, and any revenue gained would be partly offset by increased farm property tax credits.

Farm products in warehouses, grain in elevators, beet sugar, and mineral spirits

PURPOSE OF EXEMPTION: These are all specific exemptions to help agriculture in Michigan.

RATIONALE FOR ELIMINATION: These exemptions all were enacted prior to the 1976 exemption for inventory property. If they were eliminated, the Michigan tax system would be simpler and these products still would be exempt under the inventory exemption.

FISCAL EFFECT: The revenue implications would be minimal because these properties would be exempt under other statutes.

Wood-harvesting equipment

PURPOSE OF EXEMPTION: The legislature accepted the argument in 1984 that this property is similar to agricultural equipment and therefore also should be exempt.

RATIONALE FOR ELIMINATION: Wood harvesting should not be in the same category as agriculture, as it has nothing to do with food production. There is no reason for singling out this industry for special treatment.

FISCAL EFFECT: It is difficult to estimate the value or the amount of equipment that would be added to the tax rolls if this exemption were eliminated, but it is likely to be minimal.

Home improvements

PURPOSE OF EXEMPTION: In large part this exemption was created to encourage home owners to make improvements to their homes.

RATIONALE FOR ELIMINATION: This exemption has created administrative problems for assessors and inequities for home owners because similar homes can be assessed differently and hence valued and taxed differently. This is unfair to taxpayers. Normal repairs and maintenance should remain exempt, but major renovations should not.

FISCAL EFFECT: The revenue effect is unknown, but it is not likely to be substantial.

Manufactured (mobile) homes in trailer parks

PURPOSE OF EXEMPTION: The exemption was enacted in 1959 partly because this form of housing is used primarily by limited- or fixed-income persons. Also, some argue that manufactured homes are different from other forms of housing in that those situated in parks consume fewer community services than conventional site-built homes. Owners of manufactured homes pay a $3 monthly in-lieu-of-tax fee and a site rental fee, which presumably are sufficient to cover the property taxes of the park owner.

RATIONALE FOR ELIMINATION OR MODIFICATION: The in-lieu, sales, and use taxes should be removed from mobile homes, zoning laws changed, and these homes placed on regular property tax rolls; thus all residential homes would be treated the same. If the exemption is not eliminated, the in-lieu-of-tax fee should be raised. The $3-per-month fee is not adequate to cover local services provided to owners of manufactured homes. If the fee had been adjusted solely to keep up with inflation, it now would be $8.50 per month.

FISCAL EFFECT: The state would lose approximately $8.9 million in sales and use taxes and $2.8 million in in lieu taxes. Localities would gain $33.9 million in additional property taxes for a net gain of $22.2 million. (See Chapter V for calculations.)

Banks and trust companies, savings and loans, and credit unions

PURPOSE OF EXEMPTION: Federal banking law previously prohibited state taxation of the personal property of nationally chartered banks. To provide equal treatment, state-chartered banks and credit unions also were exempted.

RATIONALE FOR ELIMINATION: The federal prohibition no longer exists. In addition, this industry has changed substantially in the last several years, and this exemption gives these businesses an unfair advantage over rival financial institutions. Elimination would foster a more competitive banking environment in Michigan, which would reduce costs to consumers.

FISCAL EFFECT: The elimination of this exemption would have an unknown, but significant, revenue effect.

Blue Cross and Blue Shield of Michigan, Delta Dental, and HMOs

PURPOSE OF EXEMPTION: This exemption was adopted because these are nonprofit organizations that provide medical insurance or services to persons who otherwise would have difficulty buying health insurance or receiving care.

RATIONALE FOR ELIMINATION: Because Blue Cross/Blue Shield, Delta Dental, and HMOs provide health insurance (or, in the case of HMOs, health care in lieu of insurance) in competition with other firms that are taxable, the exemption gives them an unfair advantage. This exemption should be repealed to increase competition in the medical insurance field, which would ultimately benefit consumers.

In the case of HMOs, these organizations are competing not only with private insurers but with private physicians. Granting them a property tax exemption is in effect subsidizing the fringe benefit costs of many profit-making firms.

FISCAL EFFECT: The revenue gain statewide would be modest, but the potential revenue gain to some local governments, particularly Detroit, would be significant because of the large land and building holdings of Blue Cross/Blue Shield.

Railroad maintenance credit

PURPOSE OF EXEMPTION: This credit was adopted to encourage railroads to maintain their rail track. Up to 25 percent of maintenance expenditures may be credited against the state property tax on railroads.

RATIONALE FOR ELIMINATION: There is no evidence that this credit encourages railroads to invest more money in rail maintenance. The credit is structured so that any increases in maintenance expenditures, even those normally occurring each year and those needed to keep pace with inflation, are eligible to be credited against the property tax.

FISCAL EFFECT: Approximately ten million would be added annually to the state treasury if the credit is repealed.

Commercial use of county fairgrounds

PURPOSE OF EXEMPTION: The courts have ruled that these activities are exempt in part because they help defray the costs of an annual fair. This reduces the cost to patrons of the fair.

RATIONALE FOR ELIMINATION: Certain activities, such as use of the Saginaw fairgrounds for a racetrack, clearly abuse the original legislative intent of this exemption. A property tax exemption for a commercial enterprise like a racetrack should not be permitted. In addition, these for-profit activities receive an unfair competitive advantage.

FISCAL EFFECT: The local revenue generated from closing this loophole would be minor.

Nonprofit health clinics

PURPOSE OF EXEMPTION: This exemption was enacted to encourage the provision of health care to the residents of Michigan.

RATIONALE FOR MODIFICATION: This exemption should be amended or closely monitored to ensure that its use is limited only to bona fide organizations conducting medical research or meeting the health needs of a community

FISCAL EFFECT: The revenue gained from tightening this exemption would be minor.

Property held by schools but not used for school purposes

PURPOSE OF EXEMPTION: Government property is exempt because taxing such property results only in a transfer of funds from one pocket to another. A blanket exemption was granted because it can be difficult to determine if unused school property is being held for speculation or for future use.

RATIONALE FOR MODIFICATION: This exemption should be modified to disallow exemption for any land being held for speculative purposes. It enables schools are able to keep productive land off the market at no cost to them. The effect is to increase the cost of land in some areas due to the decreased supply available for use.

FISCAL EFFECT: By forcing school districts to sell their speculative land holdings, productive businesses that buy the property will add to the tax base. The revenue effect is difficult to estimate and would vary widely among school districts.

Industrial and commercial tax abatements, commercial housing, economic development corporations, enterprise zones, and technology parks

PURPOSE OF EXEMPTION: These exemptions were enacted to foster economic development.

RATIONALE FOR ELIMINATION: Numerous studies as well as the analyses conducted for this paper show that these types of tax incentives do not increase the amount of investment, but, at best, shift investment between communities. The manner in which these exemptions are granted give specific firms and specific industries an unfair advantage over competitors. Again, the state is fostering an unfair competitive situation. Instead of this collection of misguided "incentives," the elimination of the personal property tax on machinery and equipment would have the greatest incentive value for new investment.

An alternative to complete elimination would be to limit these exemptions to depressed central cities. This would be a valid public purpose if there were reason to believe that such exemptions would promote economic growth—even if it were at the expense of surrounding suburban communities. However, Jacobs and Wasylenko question the effectiveness of such incentives.

> Although tax incentives could attract firms to some inner-city areas, establishing an enterprise zone in the worst inner-city areas . . . will not significantly stimulate economic development. Incentives based on annual operating costs and profits will not alter the start-up costs of establishing or expanding a business, the risks and additional costs of doing business in the area, or the bank's risk of lending money to new entrepreneurs in these areas . . ..
>
> A combination of high fire and property insurance rates due to higher crime rates, lack of available venture capital, difficulties in land site assembly, age and quality of existing structures, poor condition of the public infrastructure, limited access to highways or traffic congestion, and a possible low level of police and fire services all determine the viability

> of these sites for business location. In absence of sufficiently favorable external conditions, tax subsidies alone may not attract many businesses to enterprise zones.[1]

Jacobs and Wasylenko suggest that a better policy would be to address these external factors and offer investment tax credits or employment subsidies for workers earning less than a certain hourly wage.

FISCAL EFFECT: Based on 1985 estimates, elimination of abatements and the exemption for commercial housing alone would save state and local governments about $75 million annually.

State-owned income-producing property

PURPOSE OF EXEMPTION: Property owned by state colleges and universities is exempt from the ad valorem property tax, regardless of use. This may include income-producing property such as an airport or a department store. Public Act 189 of 1953 provides for taxation of property leased by an exempt organization to a profit-making business, but excludes property owned by state-supported educational institutions.

RATIONALE FOR MODIFICATION: Failure to tax commercial operations owned by the state can create an unfair situation for other businesses competing with the state-owned enterprises. Income-producing property owned by municipal governments and nonprofit organizations is not exempt, because the exemption is based on use as well as on ownership. State-owned property should be subject to the same test.

FISCAL EFFECT: The revenue gain statewide would be negligible, although cities where state-owned education property is concentrated would experience a larger, but still modest, increase in tax revenues if this exemption were eliminated.

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1 Susan S. Jacobs and Michael Wasylenko, "Government Policy to Stimulate Economic Development: Enterprise Zones, Financing State and Local Government in the 1980's," in *Financing State and Local Governments in the 1980s,* Norman Walzer and David L. Chicoine, eds. (Cambridge, Mass.: Oelgeschlager, Gunn, and Hain, 1981), pp. 192–193.

TABLE VIII-1

EVALUATION OF PROPERTY TAX EXEMPTIONS USING EIGHT CRITERIA AND GUIDELINES

Exemption	Limited Time	Related to Purpose of Organization	Benefits the Public at Large	Performs Function Gov't Would Otherwise	Constitutional Mandate or Guidelines	Directly Targeted	Difficult to Administer	In Lieu Tax More Appropriate
U-M Women's Auxiliary		X				X		
Cemeteries		X	X	X		X		
Charitable, Education, Scientific Institutions (real and personal)		X	X	X		X		
Fairgrounds		X	X			X		
Fire Companies		X	X	X		X		
Libraries		X	X	X	X	X		
Local Government Property		X	X	X	X	X		
Parks and Armories		X	X	X		X		
Personal Belongings			X			X	X	
Property of Indians						X		
Pauper Exemption				X		X		
Religious Property		X		X	X	X		
State of Michigan Property		X	X	X	X	X		
U.S. Property		X	X	X	X	X		
Veterans' Posts and YMCAs		X	X			X		
State-assessed Public Utilities		X	X			X		X
Passenger and Freight vessels		X				X		X
Cremation Companies		X	X	X		X		
Private Forest Reservations						X		X
Commercial Forest Reserves						X		X
Veterans' Memorial Homes		X		X		X		
Oil and Gas						X		X
Credit Unions		X				X		
Low-Income Housing				X		X		
Boy and Girl Scouts		X	X			X		
4-H Clubs		X	X			X		
Intangible Property							X	X
Grain in Elevators						X		X
Nonprofit Hospital Service Corporations		X	X	X		X		
Nonprofit Medical Care Corporations		X	X	X		X		
Registered Aircraft						X		X
Licensed Watercraft						X		X
Licensed Motor Vehicles						X		X
Licensed Trailer Coach Vehicles						X		X
Motor Vehicles in Stock						X		X
Low-grade Ore Mines						X		X
Household Items						X	X	

TABLE VIII-1 (cont.)

Exemptions	Limited Time	Related to Purpose of Organization	Benefits the Public at Large	Performs Function Gov't Would Otherwise	Constitutional Mandate or Guidelines	Directly Targeted	Difficult to Administer	In Lieu Tax More Appropriate
Nonprofit State Leaseback Corporations		X	X			X		
Mechanic's Work Tools						X	X	
Public Facilities Used for Profit by a Business				X		X		
Special Housing for 100% Disabled Veteran			X	X		X		
Farm Products in Public Warehouses						X		
Foreign Insurance Companies						X		X
Householder's Business Property						X	X	
Products in Interstate Transit			X		X	X		
Trailers in Trailer Parks						X		
Boy Scout and YMCA Land		X	X			X		
Airport Landing Areas						X		X
Nonprofit Dental Corporations		X	X	X		X		
Mass Transit Systems						X		
Religious and Educational Organizations		X	X	X	X	X		
Underground Iron Ore						X		X
Fraternity Household Items		X				X	X	
Savings and Loan Associations					X	X		
Special Tools						X		
Air Pollution Control Facilities			X	X		X		
Senior Citizens Homesteads				X		X		
Homestead and Swamp Land						X		X
Farm Personal Property		X					X	
Elderly Housing				X		X		
Nonprofit Health Clinics		X	X	X		X		
Trees, Shrubs, etc. on Agricultural Land		X				X		
Water Pollution Control Facilities			X	X		X		
Community College District		X	X	X		X		
Metro Transit Facilities						X		
Beet Sugar						X		
Farm Implements		X				X		
Nonprofit Housing				X		X		
State Housing Development Authorities		X	X	X	X	X		
Hospital Finance Authority		X	X	X		X		
Property Used for School Purposes		X	X	X	X	X		
Campfire Girls' Organizations		X	X			X		
Vacated Property (to be acquired by local or federal governments)			X	X		X		
Essential Elements of Peppermint and Spe[illegible]nt						X		X

TABLE VIII-1 (cont.)

	Limited Time	Related to Purpose of Organization	Benefits the Public at Large	Perform Function Gov't Would Otherwise	Constitutional Mandate or Guidelines	Directly Targeted	Difficult to Administer	In Lieu Tax More Appropriate
Erosion and Flood Control						X		
Open Spaces			X			X		
Industrial Facilities	X		X[a]					
Commercial Housing			X[a]					
Industrial Development			X[a]					
Economic Development Corporation			X[a]					
Boats, Ships, Vessels						X		X
Inventory							X	
Railroad Companies		X				X		X
Telephone Companies		X				X		X
Home Improvements			X			X	X	
Financing Costs						X		
Solar, Wind, Water, Energy Devices	X					X	X	
Veteran's Homestead for Surviving Spouse				X		X		
Handicapped Families						X		
Commercial Facilities	X		X[a]					
Parent Cooperative Preschools		X	X			X		
Memorial Homes and Posts		X				X		
Nonprofit Cultural Organizations		X	X			X		
Municipal Water Authority			X	X		X		
Wood-Harvesting Equipment						X		
Technology Parks		X	X[a]			X		
Leased Property in Conjunction with Fairs		X				X		
Agricultural Society (leased property)						X		
Enterprise Zones		X	X[a]			X		

NOTE: This table applies the criteria and guidelines in Chapter VIII to the current exemptions listed in Appendix A. An "X" signifies that the specific exemption meets the criteria or guideline.

[a]Only if it is assumed that exemption creates economic growth.

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