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EVALUATION OF COMPETITIVE IMPACTS OF GOVERNMENT INTERVENTIONS

-- -- Paper by Mr. Kenneth P. Thomas --

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THE EFFECT OF INVESTMENT INCENTIVES ON COMPETITION

By Kenneth P. Thomas[*]

1. Abstract

1. This paper considers the effect of investment incentives (location subsidies) on competition and competitors. Using examples from the retail industry in the St. Louis, Missouri, metropolitan area, I show that the widespread use of investment incentives by local governments there has harmed existing competitors, such that one mall sued a city providing a subsidy to its competitor (it lost) and another exited the market just nine years after attaining its peak sales performance. The St. Louis retail market also shows evidence of smaller competitors being squeezed out and a growing geographic concentration of retail activity. In the period from 1990 to 2007, local governments provided approximately $2 billion in subsidies to retail, creating only 5400 low-quality retail jobs, which promptly vanished with the recession. The paper concludes with five ex-post indicators of harm to competition exemplified in this case.

2. Main Body

2. Investment incentives (subsidies to affect the location of investment) carry with them the potential for lower economic efficiency, greater (post-tax, post-redistribution) income inequality, and in some cases environmental harm (Thomas, 2011, pp. 3-4). In this paper, I will focus exclusively on the first of these, the potential for subsidies to be inefficient and, even more specifically, inefficiencies due to the harm they cause to competition and to other firms in an industry.

3. As the UK Office of Fair Trading (2004) posits, there are three main avenues by which subsidies may affect competition:

- "Causing firms to set output and pricing levels inefficiently,
- Keeping inefficient firms in the market, discouraging entry by efficient companies or encouraging entry by inefficient firms, and
- Distorting investment and research and development decisions."

4. One important example of distorting investment decisions in an inefficient manner is highlighted in a recent draft paper by the EU's Directorate-General for Competition (2013, p. 9): "Did the aid…attract activity away from other locations?" This underscores a major issue with location subsidies, that they could induce the recipient company to set up a facility in a suboptimal location, thereby reducing efficiency and overall economic growth. Multiplied many times over, this effect could be significant. It could also lead to firms expending significant effort into obtaining subsidies rather than focusing on

[*] The views expressed here are those of the author and do not necessarily represent the views of the OECD or its Members.

business fundamentals, one example of the phenomenon known as "rent-seeking" (Krueger, 1974; see Gabe and Kraybill, 2002, p. 719 for a potential example in the case of incentives).

5. The retail industry in the St. Louis, Missouri, metropolitan area provides a number of examples where the provision of location incentives to mall and other retail developers has had clear impacts on competition and competitors. Even with the difficulties in obtaining critical data on industries (this was true even for the NERA study OFT 2006, which was able to obtain data on its six case study firms only by providing anonymity to the firms studied, not even revealing their industry), there is enough information in the public domain to infer a great deal about the competitive effects of the subsidies involved.

6. In the United States, local governments have used a wide variety of subsidy tools to attract retail, an industry that they highly prize because it generates sales tax revenue for the municipality. Their arsenal includes: Low-cost loans (usually bonds issued by the city itself, making them tax-free to the bond buyer under U.S. federal tax rules and therefore carrying a lower interest rate than an equivalent taxable bond); property tax (rates) abatements, which can last as long as 40 years in some states; special taxing districts, where an extra sales tax is charged in the development to pay for infrastructure improvements a developer would normally have to pay for itself (in Missouri "transportation development districts," this can be up to 1% additional tax); free or low-cost land, through a variety of mechanisms, including tax increment financing discussed below; as well as free project-specific highway, sidewalk, and other infrastructure. All these tools greatly accelerate the normal market replacement of older retail facilities by new ones ("creative destruction") and contribute to substantial misallocation of capital into the retail sector. This is especially true in Missouri, where the specifics of state law governing local subsidies allow quite large awards to retail projects, contributing to a persistent oversupply of malls and other retail projects (LeRoy 2005, pp. 146-147).

7. In Missouri, the most common local subsidy is called tax increment financing, or TIF. In essence, expected future increased tax revenues are mortgaged to pay for the investment project. Eligible costs include infrastructure, land assembly, relocation costs for displaced households, etc. As tax revenues increase from the pre-development baseline, the "incremental" revenues are either paid to the developer or are used to pay off bonds that were used to finance the development (Mason and Thomas, 2010, 169-170). TIF is used in almost every state in the United States, and it is controversial for many reasons, most of which will be ignored in this paper.

8. According to the regional planning organization for the St. Louis metropolitan area, the East-West Gateway Council of Governments (2011, p. 1), giving retail subsidies in a stagnant regional economy "is a zero sum game. Retail sales follow the accumulation of wealth, not the reverse. Without real growth and wealth creation in the region's economy, it is axiomatic that one community's gain becomes a loss elsewhere." Thus, there is a strong presumption that new development merely shifts existing retail sales from one location to another. When a new grocery store, shopping center, or mall is built, it is almost certain that the new facility's sales come at the expense of existing retail establishments.

9. Two cases in particular stand out in which we can observe the negative effects of newly subsidized investment in retail affecting competitors in real time. One is the case of West County Center, owned by mall developer Westfield America in the suburb of Des Peres, which received a $29.8 million subsidy. The other is the decline of Northwest Plaza in suburban St. Ann, once reputedly the "world's largest shopping center,"[1] which saw its sales drop dramatically as newer subsidized malls opened nearby until it was forced to close.

1 Kohler (2013).

10. In 1998, the city of Des Peres authorized a $29.8 million TIF subsidy for West County Center to attract the first upscale Nordstrom department store to the St. Louis area and to build a parking garage. Two days after the subsidy's final approval, competitor Chesterfield Mall (which had just completed an unsubsidized renovation) and nine private citizens filed a lawsuit against the subsidy (Faust, 1998). Chesterfield Mall is 9.6 miles (15.4 km) away by car (under 15 minutes as it is an all-motorway journey) from West County Center. This may have been the first time in U.S. history where one mall sued another over a subsidy.[2] If you are interested in more details about this case for its significance on the subsidy mechanism, see Reinert (2001). For our purposes, however, what is striking is that in 2002, Westfield bought Chesterfield Mall (it already owned five St. Louis area malls), prima facie reducing competition in the retail sector. (I am currently searching for information on the price to lease prime mall space, but have yet to be able to do so.) Unfortunately, it is impossible to determine what happened to total retail sales at Chesterfield Mall because that is confidential under Missouri law.

11. In the case of Northwest Plaza, it is easier for us to get an indication of the scale of lost sales due by competition, because the mall accounted for a gigantic proportion (as high as 60%)[3] of total retail sales in St. Ann, population 13,000.[4] As suggested to me by *St. Louis Post-Dispatch* business editor David Nicklaus, total sales for St. Ann, which is public information, is a good proxy for sales at Northwest Plaza. There are also occasional press reports giving sales data for the mall.

12. The biggest single blow to Northwest Plaza was the opening of the St. Louis Mills in Hazelwood, only four miles (6.4 km)[5] away, in 2003. This brand-new mall, fought bitterly by residents whom it displaced, received $18.5 million in TIF subsidies and a further $34 million subsidy known as a transportation development district.[6] Table 1 shows the decline of taxable sales in St. Ann from 1990 to 2012.

2 There may be an even earlier case in the neighboring state of Illinois (Castel Properties, Ltd. v. City of Marion, 631 NE2d 459, 465 (Ill. App. 1994), but I have yet to find sufficient information to be sure. The plaintiff was definitely a real estate developer.

3 Heisler (2006).

4 http://censusviewer.com/city/MO/St.%20Ann.

5 http://en.wikipedia.org/wiki/Northwest_Plaza.

6 Logan and Nicklaus (2010).

Taxable Sales ($ millions)
St. Ann, Missouri

Year	Amount	Year	Amount
1990	238.2	2002	270.4
1991	258.0	2003**	230.4
1992	284.5	2004	216.1
1993	313.6	2005	192.0
1994	315.5	2006	175.2
1995	303.0	2007	157.1
1996	309.8	2008	145.9
1997	308.5	2009***	112.2
1998	309.1	2010****	96.6
1999	314.7	2011	94.7
2000	302.1	2012	92.0
2001*	290.2		

Source: Missouri Department of Revenue (various years)

*Peak of Northwest Plaza sales, according to Volkmann (2009)
**St. Louis Mills opens.
***Northwest Plaza foreclosed upon, according to Volkmann (2009)
****Northwest Plaza closed at year-end

13. As we can see, the year St. Louis Mills opened coincided with the largest dollar drop in taxable sales in St. Ann, some $40 million or 17% of the total. The year it was foreclosed upon saw the largest percentage drop in St. Ann's taxable sales, at 23%. From the 2001 mall sales peak until its closure in 2010, St. Ann's sales dropped every year, totaling an astonishing $193.6 million or 67% decline. This gives us an indication of how greatly important the mall's sales were to the city. According to Heisler (2006), the mall's sales in 2004 had totaled $147.5 million, and at the time of his article, "Northwest Plaza ma(de) up roughly 60 percent of the city's sales tax base." In 2011, the mall's sales were 0.

14. Certainly, subsidized competition was not the only factor hurting Northwest Plaza. Westfield owned the mall from 1997 to 2006[7] and, as Tritto and Brown (2005) relate, the company did not invest in Northwest Plaza, which by 2004 had the second-highest vacancy rate of all its U.S. malls.

15. It is worth noting that retail subsidies were extremely common in the St. Louis metropolitan area. East-West Gateway Council of Governments (2011, p. 18) found that local governments there put at least $2 billion in subsidies into retail development between 1990 and 2009. Nevertheless, the industry as a whole only gained 5400 jobs through 2007 (i.e., before the recession), for a cost of $370,000 per net new retail job.[8] Moreover, total taxable sales only increased 13.3% from about $30 billion per year in 1993 to $34 billion in 2000, then remained flat through 2007, followed by a sharp decline in the recession to just over $30 billion in 2009 (Chart 3, p. 19). The report notes (pp. 28-30) several aspects of consolidation in the industry. From 1998 through 2007, while the industry saw an increase of 2700 jobs overall, 598 retail establishments with 10 or fewer employees closed, indicating that smaller players were squeezed out during the period. Moreover, there was a substantial geographic concentration of retail into a smaller numbers of communities, with 52 zip codes seeing increases in the number of retail establishments and 89 experiencing declines. On the accompanying map (Map 3), the biggest concentration of lost retail facilities can be seen to be precisely in St. Ann.

7 http://en.wikipedia.org/wiki/Northwest_Plaza.

8 Retail jobs in the United States tend to be relatively poorly paid and have poor employee benefits.

16. In addition to geographic and establishment concentration, we can also see the potential market power of Westfield, which intensified when it purchased a mall that had sued it, Chesterfield Mall. The direct harm to competitors, documented above for Northwest Plaza, has also been suggested in press reports in relation to Gravois Bluff's $80 million TIF harming Crestwood Plaza (Logan and Nicklaus, 2010) and the effect of St. Louis Mills on Jamestown Mall (Huber, 2012).

17. We thus have at least five indicators of harm to competition resulting from investment incentives:

1. Increasing firm size;
2. Geographic concentration of facilities;
3. Market power for the subsidy recipient; and
4. Direct harm to identifiable competitors, including market exit.
5. Oversupply caused by diversion of capital into the subsidized industry.

3. Conclusion

18. Investment incentives in the St. Louis retail industry have been exceptionally expensive, and the evidence here shows that these subsidies have had an appreciable effect on competition and competitors of subsidized shopping malls. As we have seen, Chesterfield Mall felt so threatened by the subsidized expansion of West County Center in a neighboring suburb that it unsuccessfully sued to stop the subsidy. Subsequently, the owner of West County Center purchased Chesterfield Mall, adding to its potential market power.

19. In the case of Northwest Plaza, subsidized competition in its immediate area appears to have contributed to a rapid decline in the mall's fortunes: It hit its maximum sales volume in 2001, but closed in 2010. Because Northwest Plaza represented a good 60% of total retail sales in its suburban jurisdiction, we can use sales in the city as a whole (which is publicly available) as a good proxy for sales at Northwest Plaza (which is not publicly available).

20. In addition, a study by the East-West Gateway Council of Governments (the regional planning association for the St. Louis metropolitan area) found that $2 billion in subsidies went into retail from 1990 to 2009, but that the net job growth of only 5400 jobs to 2007 was most likely due to increased personal income. In any event, the jobs disappeared with the onset of the recession at the end of 2007. This report further found evidence that small retail establishments had been driven from the market and that the geographical location of retail sales became more concentrated over the 10 years from 1998 to 2007. There is some journalistic evidence of further instances of harm to competitors due to new subsidized malls, but the dominant trend appears to have been an increase in total retail space as the subsidies sent large amounts of capital into the sector, to the detriment of the rest of the local economy.

21. We can thus identify at least five ex post indicators of damage to competition due to these retail incentives, which are likely to be present in similar situations: 1) Increasing firm size; 2) Geographic concentration of facilities; 3) Market power for the subsidy recipient(s); 4) Harm to identifiable competitors, including in this case market exit; 5) Overcapacity in the market due to the subsidies, to the detriment of the broader economy.

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