The High Cost of Economic Development Incentives as a Tool for COVID-19 Recovery

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Overview:

The last sustained period of economic downturn in the United States saw explosive growth in the size and scope of state and municipal tax credit and abatement programs, subsidies, grants and other forms of economic development incentives. With the benefit of hindsight and new research making the ineffectiveness of these incentives clear, America's state and local policymakers must not make this mistake again in response to the impending economic impact of the COVID-19 pandemic.

Targeted business incentives awarded by state and municipal governments roughly tripled between 1990 and 2017, with the largest spike occurring during the Great Recession. The results were not positive for America's communities in the long run, with many governments struggling in recent years to fund public services with a heavily abated tax base even during a time of relative economic prosperity.

State and local policymakers should take advantage of what we have learned. Since the rapid spread of targeted incentive programs across the country during the Great Recession, the evidence has become clear that these deals:

- Do not play a significant role in companies' site selection decisions,
- Do not reliably create net new jobs or economic growth,
- Have a negative impact on the long-term fiscal health of governments that employ them,
- Can harm the quality of critical public services provided by local governments, and
- Have other negative externalities

While the political pressure for state and local officials to "do something" to subsidize business activity will be significant, policymakers should ensure their constituents understand that these programs come at an unacceptable cost to taxpayers, to the business community as a whole and to public services such as police, fire, roads, schools and other public goods on which everyone in a community depends.

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Size, Scope and Growth of Targeted Incentive Programs

Estimates vary as to the aggregate cost of state and local economic development deals across the country. There is no formal reporting process, and only in 2015 did Government Accounting Standards Board (GASB) rules change to require governments to report the amount of taxes abated for economic development purposes in a fiscal year in their annual financial reports. [i]

Widely cited estimates of the aggregate cost of targeted business incentives include:

- Timothy Bartik at the W.E. Upjohn Institute for Employment Research estimated $48 billion in 2017 costs, a tripling in aggregate size since just 1990. [ii]
- Good Jobs First, which uses GASB disclosures in government annual financial reports and other tools to develop databases of incentive tax breaks, estimates $70 billion. [iii]
- A 2012 investigation by *The New York Times* identified $80.4 billion in business incentives awarded by cities, counties and states. [iv]

Any of these estimates demonstrate the massive existing burden of state and local economic development incentives on government budgets, and the danger to expanding that total with new spending and abatements in response to the coronavirus. (For context, the $70 billion Good Jobs First estimate is enough to fund the nine smallest state budgets in the United States, combined.) [v]

Negative Outcomes of Existing Incentive Programs

Richard Florida, one of the best-known urban policy experts in North America, bluntly calls targeted business incentives "useless," noting that there is no connection between how much a city or state spends on them and any meaningful measurement of economic well-being. [vi] Using data from *The New York Times*, he wrote in 2012, "We found no statistically significant association between economic development incentives per capita and average wages or incomes; none between incentives and college grads or knowledge workers; and none between incentives and the state unemployment rate."

Florida's overview has been supported and expanded by a broad range of academic research published in recent years, much of it taking advantage of previously unavailable data generated since 2015 by the GASB 77 disclosure requirements.

Additionally, enough time has passed for many incentive deals from the Great Recession era to be ripe for analysis. The results are overwhelmingly negative, such as from researchers at the University of Illinois at Chicago who looked at Rust Belt states' incentive programs and found no "compelling evidence that economic development subsidies created or retained jobs to help municipalities recover from the Great Recession." [vii]

Minimal Impact on Site Selection

The fundamental reason that targeted incentives are ineffective at changing economic reality is that they play a far smaller role in business decisions than their supporters – and recipients – claim. A 2018 literature review by Bartik at the Upjohn Institute found that targeted incentives make a difference in at most 25 percent of business decisions. [viii] "In other words, for at least 75 percent of incented firms, the firm would have made a similar decision location/expansion/retention decision without the incentive," he explained.

While businesses regularly claim that incentives are critical to their decisions – and are often legally required to say so in order to receive them – they do not behave as if this were true. Nathan Jensen at the University of Texas at Austin has studied the difference between what companies say and what they do, and found that "incentive recipients highly recommend this program to other firms" but few actually increased employment or would have moved elsewhere if the incentives had not existed. [ix]

This should not be surprising for anyone who has been involved in making a significant business decision in the "real world." While incentives certainly do play a small role in site selection, they are overshadowed in importance by fundamental business factors such as the location of customers, competitors and suppliers; availability and cost of the necessary workforce; broad tax and regulatory climate; quality and appropriateness of infrastructure; labor laws and regulations; proximity to natural resources and more.

The best evidence for the minimal impact that incentives have on site selection decisions is Amazon's high-profile "HQ2" process. In the Washington, DC area, the finalist sites in Bethesda, Md. and Arlington, Va. were only 10 miles apart. While Maryland offered a reported $8.5 billion in incentives, Virginia's combined package totaled less than $1 billion. [x] [xi] As Amazon's vice president for public policy Brian Huseman told CNBC to explain why Amazon chose Virginia over Maryland despite the subsidies on offer, "It's not just monetary incentives, but it's looking at the comprehensive environment to allow companies to flourish." [xii]

The fact that more than $7 billion in incentives failed to shift Amazon a mere 10 miles should make policymakers stop and question the impact their far smaller incentive offers are truly having on business location decisions in their communities.

Minimal Impact on Job Creation

At their core, these incentives are supposed to create jobs. That is how they are sold to voters, taxpayers and other constituencies. But research from Mary Donegan at the University of Connecticut and T. William Lester and Nichola Lowe of the University of North Carolina – Chapel Hill found that not only are incentives ineffective at creating jobs, but that in the long term it appears that incentivized companies actually create fewer jobs than their nonincentivized peers. "This simple but direct finding—that incentives do not create jobs—should prove critical to policymakers," they wrote. [xiii]

This holds true for urban, suburban and rural communities. As Carlianne Patrick at Georgia State University explained in the *National Tax Journal*, creating new tools for local governments to assist private businesses actually has at best no impact and potentially a negative impact on rural county employment levels, and "creating more tools for governments to aid private capital is an ineffective local job creation policy." [xiv]

The biggest concern that policymakers and their constituents have over limiting or eliminating targeted incentives is essentially that "all the jobs will go someplace else." The consistent evidence that these programs at best have nothing to do with job creation – and may in fact serve as a drag on the economy's natural creation of jobs – should mitigate those concerns.

Negative Impact on Fiscal Health

In 2018, the Mercatus Center's Matthew D. Mitchell and Tamara Winter demonstrated the opportunity cost of these programs by quantifying how much states could reduce their overall tax burdens if they were to eliminate targeted corporate incentives. [xv] At the time, three states (Michigan, Nebraska and Oklahoma) could have eliminated all corporate income taxes simply by ending their corporate tax credits.

In 2004, an overview of economic development incentive program results in the Journal of the American Planning Association by Alan Peters and Peter Fisher at the University of Iowa concluded that "the best case is that incentives work about 10% of the time, and are simply a waste of money the other 90%." [xvi]

More recently, a team of researchers at North Carolina State University dug into the broad impact of incentives on state fiscal health, with sobering results. "While incentives may draw in more economic growth, they also pull resources from the government's coffers and may commit future funding for public services that benefit the incentivized business," they wrote. "Ultimately, the results show that financial incentives negatively affect the overall fiscal health of a state." [xvii]

Negative Impact on Public Services

Money paid out in grants or other transfers or abated in taxes that would otherwise have been collected is not available for spending on other government priorities. Research by Jia Wang at the University of the South has demonstrated how development incentives "crowd out" spending on public services in the U.S. According to her research, incentives show up long-term in "decreases in expenditures on productive public goods such as education, health and human services, sanitation and utilities." [xviii]

The easiest way to see this in action is to compare the budgetary impact of incentives to that of public services. For instance, Louisiana's FY 2018-2019 state budget included $565 million in costs for "Incentive Expenditure Programs." [xix] That is more funding than the Louisiana legislature appropriated to run the state's departments of Wildlife & Fisheries ($175.3M), Natural Resources ($54.6M), Environmental Quality ($136.2M) and Agriculture & Forestry ($72.6M), combined.

Worst-Case Scenarios

One of the most high-profile examples of a government struggling with limited revenues because of past economic development decisions and making disastrous decisions is Ferguson, Missouri. In 2013, Ferguson collected $2.6 million of its $12.8 million of general fund revenues from fines and public safety fees, compared to just $1.5 million in property taxes and $1 million in intergovernmental transfers from the state and county. [xx] A U.S. Department of Justice investigation into the 2014 "Black Lives Matter" protests that would rip the city apart the next year concluded:

> Ferguson's law enforcement practices are shaped by the City's focus on revenue rather than by public safety needs. This emphasis on revenue has compromised the institutional character of Ferguson's police department, contributing to a pattern of unconstitutional policing, and has also

shaped its municipal court, leading to procedures that raise due process concerns and inflict unnecessary harm on members of the Ferguson community. [xxi]

At least some of the responsibility for Ferguson's reliance on "policing for profit" to fund its general governmental operations can be traced back to targeted incentives handed out in previous years. An investigation by *The Atlantic* uncovered widespread use of enterprise zones, tax increment financing and other targeted incentives that dramatically limited the city's revenues from major employers and property owners. [xxii]

While Ferguson is admittedly an extreme case and many complex factors played a role in the unrest of 2014, it is far from the only city that has made poor decisions under the pressure of an abated tax base. For instance, Tax Increment Finance (TIF) districts were first created in Chicago in 1983. Since then, the districts have spread to the point that more than $840 million per year – roughly a third of Chicago's tax receipts – are controlled by 136 TIF district boards rather than the city's traditional budget process. [xxiii] This has contributed so dramatically to the city's chronic fiscal problems and high-profile public services challenges that one of new Mayor Lori Lightfoot's first acts upon taking office in 2019 was to institute a moratorium on new TIF districts until sweeping reforms could be developed and implemented. [xxiv]

Conclusion

Targeted incentives at best benefit a few companies at the expense of everyone else. They are not "free money," and resources devoted to them must be secured from other taxpayers and are unavailable for use by other public services.

Constituents understand this tradeoff if it is explained to them. In their investigations into the interactions of politics and economic development, Nathan Jensen at the University of Texas at Austin and Edmund Malesky at Duke University found that while nonpartisan voters broadly support economic development "job creation" when it is presented to them without context, that support disappears when they are simply informed that these incentives take resources that otherwise would be available for other government programs or available for return to taxpayers. [xxv] Elected officials and community leaders who are concerned about backlash from their constituents can and should focus on educating the public about the costs these programs impose on a community.

America's communities are still paying for many of the targeted incentives their elected officials handed out during the Great Recession. Returning to those discredited and often-disastrous programs in response to the inevitable economic fallout of the COVID-19 pandemic would be a mistake we cannot afford.

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