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TESTIMONY

UNDERSTANDING WHY ECONOMIC DEVELOPMENT SUBSIDIES ARE A PROBLEM AND WHAT CAN BE DONE ABOUT THEM

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State of Vermont House of Representatives, House Committee on Ways and Means
State of Vermont Senate Chamber, Senate Committee on Finance

January 29, 2020

Chair Ancel, Chair Cummings, members of the House Committee on Ways and Means, and members of the Senate Committee on Finance:

My name is Michael Farren, and my research at the Mercatus Center at George Mason University focuses on evaluating government efforts to foster economic development. I am grateful for the invitation to discuss the problems associated with economic development subsidies and the possible solutions available for Vermont.

Today, I will illustrate why economic development subsidies are a problem, why they remain a problem despite growing agreement that they should be phased out, and opportunities for unilateral and multilateral solutions.

First, academic research shows that economic development subsidies generally don't succeed in achieving their stated goals.[1] That is, they don't result in broad improvements in local and state welfare (although they obviously benefit the companies receiving them). This occurs for several reasons:[2]

1. The taxes needed to fund economic development subsidies create a negative economic effect that can reduce—or even exceed—the stimulating effect of the subsidy.
2. Subsidies disrupt the normal workings of a healthy market and cause economic waste by
    a. protecting the privileged company from competition, enabling less efficient production,
    b. encouraging companies to take improperly risky bets or motivating forms of production that are suboptimal, and
    c. encouraging companies to spend resources lobbying rather than focus on pleasing customers.
3. On a national level, subsidies for economic development are, at their very best, a zero-sum game that fails to encourage improved economic outcomes for all Americans.

1. Matthew D. Mitchell, "Florida Man Seeks a Quarter of a Billion Dollars That Won't Help State," *Medium*, October 30, 2015.
2. Matthew D. Mitchell et al., "The Economics of a Targeted Economic Development Subsidy" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, November 2019), 18–31.

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Despite these economic problems, political-economic analysis implies that governments continue to pursue economic development subsidies because the subsidies appear to be beneficial for the policymakers who support them:[3]

1. Academic research has shown that politicians seem to benefit by being seen as "doing something" to improve the local economy.[4] That is, good intentions and the short-run goal of good optics appear to matter more (especially with regard to reelection campaigns) than the real long-run economic effects (which are hard to accurately measure).
2. Most nonacademic studies of economic development subsidies use a "benefits-only" analysis that ignores the economic impact of the taxes needed to fund the subsidies, creating a culture of misinformation regarding the expected effect of the subsidies.
3. The uneven distribution of benefits (which are concentrated on the subsidy recipients) and costs (which are spread out across all other taxpayers) means that the recipients have a strong incentive to lobby for their subsidies, while the difficulty of organizing many dispersed taxpayers inhibits their ability to mount an effective protest.
4. The pressure to offer subsidies is particularly difficult to resist when politicians in other cities and states engage in the practice, creating a prisoner's dilemma where a policymaker feels compelled to support offering subsidies, even if it doesn't seem right.

Thankfully there are some opportunities for reform that can address the problems caused by economic development subsidies.

1. Constitutional provisions, called anti-aid clauses, exist in most states and technically disallow many state and local subsidies. However, the legal understanding of which government subsidies are disallowed has eroded over time, leading to the current era where subsidies proliferate.[5]
2. An interstate compact to end corporate subsidies is drawing increasing interest in many state legislatures. A compact would offer a credible way for states to commit to ending the subsidy arms race they find themselves in.[6]

Thank you for the opportunity to speak to you today. I look forward to your questions.

Most Sincerely,

Michael D. Farren, PE, PhD
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3. Mitchell et al., "The Economics of a Targeted Economic Development Subsidy," 32.
4. Nathan M. Jensen and Edmund Malesky, *Incentives to Pander: How Politicians Use Corporate Welfare for Political Gain* (Cambridge: Cambridge University Press, 2018).
5. Matthew D. Mitchell, Robin Currie, and Nita Ghei, "A Summary of the History and Effects of Anti-Aid Provisions in State Constitutions" (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, December 2019).
6. Michael D. Farren and Anne Philpot, *With Amazon HQ2, the Losers Are the Winners: Why Economic Development Subsidies Hurt More than They Help* (Arlington, VA: Mercatus Center at George Mason University, 2018), 19.

Understanding Why Economic Development Subsidies Are a Problem

and What Can Be Done about Them

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Section 1:

Understanding the Problems with Economic Development Subsidies

Subsidies Don’t Actually “Work”

1) They generally don’t lead to broad improvements in local and state public welfare
2) They can actually reduce local economic development and almost certainly reduce national economic development
3) They generally don’t sway company decisions regarding where to locate, expand, or maintain operations

Subsidies Reduce Long-Run Economic Growth

- Subsidies require tradeoffs: Higher taxes on other businesses, individuals, and households, or reductions to public services, or both.
  - Bartik (2018): A 1% increase in taxes reduces the long-run local GDP by 0.5%
  - Wang (2016): Subsidy agreements are associated with future expenditure reductions in publicly provided services, such as education, transportation, corrections, police, fire, and sanitation.

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Subsidies Reduce Long-Run Economic Growth

- Subsidies protect inefficient production
  - When shielded from competition, businesses are less motivated to avoid wasting resources

"For a variety of reasons people and organizations normally work neither as hard or as effectively as they could. In situations where competitive pressure is light, many people will trade the disutility of greater effort, or search for the utility of feeling less pressure and of better interpersonal relations."

-Harvey Leibenstein (1966)

Subsidies Reduce Long-Run Economic Growth

- Subsidies encourage overly risky bets
  - Being protected from the consequences of failure tends to increase risk-taking

"government privilege often encourages undue risk-taking. The problem is especially acute when gains are privatized while losses are socialized (for example, through a bailout or the promise of a bailout). The economic term for this behavior is "moral hazard." It refers to the tendency for individuals to take on undue risk when they know they will not bear the full costs of failure."

-Matthew Mitchell (2014)

Subsidies Reduce Long-Run Economic Growth

- Subsidies reward unproductive entrepreneurship
  - Talented entrepreneurs are motivated to pursue profit using politics rather than by finding better ways to serve customers

"…there are a variety of roles among which the entrepreneur's efforts can be reallocated, and some of those roles do not follow the constructive and innovative script that is conventionally attributed to that person. Indeed, at times the entrepreneur may even lead a parasitical existence that is actually damaging to the economy.

How the entrepreneur acts at a given time and place depends heavily on the rules of the game—the reward structure in the economy—that happen to prevail."

-William Baumol (1990)

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Subsidies Hurt National Economic Efficiency

- Subsidies motivate inefficient production decisions
  - Economically motivated investment decisions are more efficient than politically motivated ones

"when a subsidy does change the company's decision of where to locate or expand, then it is generally the case that the policy has persuaded the company to do something it shouldn't have done.

In short, the government has encouraged a particular investment decision and the use of scarce resources that would have been better used elsewhere or in different ways."

-Michael Farren (2020)

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Subsidies Don't Sway Decisions

- Location and expansion decisions are based on production and profitability factors
  - E.g., access to resources or a skilled workforce, supply chain synergies, proximity to customers

"While corporate decision-makers' top location concern is the availability of education and training, policymakers and lay people often think that tax incentives matter most.

Tax incentives and tax packages are uniformly viewed as low priorities by location consultants, relatively unimportant to the basic decision."

-Natalie Cohen (2000)

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Subsidies Don't Sway Decisions

- Opportunities for long-term growth take precedence over short-term subsidies
  - Farren and Philpot (2018): If the best location for HQ2 enabled Amazon to grow total revenue just 1% faster than the 2nd-best location, we project an extra \$3–\$23 billion in profits over 15 years

"Typical incentives probably tip somewhere between 2 percent and 25 percent of incented firms toward making a decision favoring the location providing the incentive.

In other words, for at least 75 percent of incented firms, the firm would have made a similar location/expansion/retention decision without the incentive."

-Timothy Bartik (2018)

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Section 2:

Why Do Governments Continue to Offer Subsidies?

Subsidy Analyses Don’t Consider Costs

- Economic development officials and corporations often enlist consultants to produce economic impact analyses to justify subsidies
  - These reports provide a “benefits-only” analysis, failing to incorporate costs
  - Nor do they compare the subsidy with alternatives uses of the funds
- The taxes needed to fund the subsidies impose economic costs that counteract the benefits
  - The net effect may actually *harm* the local economy over the long run

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Policymakers Are Rewarded for Subsidies

- The political payoff from subsidies is quite different than the economic consequences
  - Jensen and Malesky (2018): Politicians benefit from being seen as “doing something” to improve the local economy
- The uneven distribution of benefits and costs motivates proponents to lobby harder than taxpayers
- Implied competition with other jurisdictions adds further motivation

Section 3:

Solutions to the Subsidy Arms Race

Solving the Economic Development Subsidy Dilemma

- The solution to a collective action problem is institutional reform that changes the choices or the payoffs

- Unilateral reforms are possible, but would likely be even more politically difficult than cooperative, multilateral reforms

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Institutional Reforms for the Economic Development Subsidies Dilemma

- Unilateral Solutions
  - State constitutional amendments or ballot initiatives prohibiting state and local subsidies
- Multilateral Solutions
  - Federal government preemption, based on the Commerce Clause (an imposed “multilateral” solution)
  - Interstate agreements, similar to the NYC-NJ-CT agreement in 1991 and the recent KS-MO agreement (voluntary, but not enforceable)
  - Interstate compacts (the most durable and enforceable voluntary agreement)

Summary

- Economic development subsidies may be politically popular, but they are wasteful and harmful to broad economic growth
  - Subsidies enable inefficient production, motivate risky bets, and reward unproductive entrepreneurship
- Escaping the subsidy arms race requires changing the rules of the game.

Thank You

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Addenda Slides

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Review: The Prisoner's Dilemma

Prisoner A Choice	Prisoner B Choice: Cooperate	Prisoner B Choice: Betray
Cooperate	(-1 , -1)	(-3 , 0)
Betray	(0 , -3)	(-2 , -2)

Review: The Prisoner’s Dilemma

	Prisoner B Choice	
Prisoner A Choice	Cooperate	Betray
Cooperate	(-1 , -1)	(-3 , 0)
Betray	(0 , -3)	(-2 , -2)

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The Economic Development Subsidy Dilemma

Economic Payoffs

Policymaker B

Policymaker A	Don't Offer	Offer TEDS
Don't Offer	(2 , 2)	(1 , -1)
Offer TEDS	(-1 , 1)	(-2 , -2)

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The Economic Development Subsidy Dilemma

Economic Payoffs

Policymaker B

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Don’t Offer	(2 , 2)	(1 , -1)
Offer TEDS	(-1 , 1)	(-2 , -2)

The Economic Development Subsidy Dilemma

Political Payoffs

Policymaker B

Policymaker A	Don't Offer	Offer TEDS
Don't Offer	(-1 , -1)	(-2 , 1)
Offer TEDS	(1 , -2)	(2 , 2)

The Economic Development Subsidy Dilemma

Political Payoffs

Policymaker B

Policymaker A	Don’t Offer	Offer TEDS
Don’t Offer	(-1 , -1)	(-2 , 1)
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The Economic Development Subsidy Dilemma

Economic Payoffs

Policymaker A	Policymaker B: Don't Offer	Policymaker B: Offer TEDS
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Political Payoffs

Policymaker A	Policymaker B: Don't Offer	Policymaker B: Offer TEDS
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Interstate Compacts

- Relatively unknown, but established in the US Constitution
  - Intended to solve supra-state, sub-federal coordination problems
  - “treaties between the sovereign states”
  - Slightly higher in stature than state constitutional amendments because of their contractual nature
- Only limited by imagination and the willingness of state legislatures or Congress to authorize

Recent Interstate Compact Legislation

- Non-compact legislation
  - KS-MO (2014 & 2019); NYC-NJ-CT (1991)
- Stadium subsidies
  - ALEC model legislation (2017); AZ SB1453 (2018)
  - VA-MD-DC compact RE: Washington Redskins (2018 & 2019)
- First attempt at broader compact legislation (2019)
  - NY (A05249), IL (SB0203), WV (SB643), AZ (SB1322)
  - Many more states are joining the discussion in 2020

Important Elements of an Interstate Compact to End the Economic Development Subsidy Dilemma

1) Transparency
   - Any compact should mandate the highest standards of transparency for all economic development negotiations and outcomes
2) What subsidies does the compact cover?
   - E.g., anti-poaching only, all cash and asset gifts, project-required infrastructure, public services benefits, regulatory favoritism, etc.
3) How and when does the compact take effect?
   - Trigger clauses would mitigate the first-mover problem

Important Elements of an Interstate Compact to End the Economic Development Subsidy Dilemma

4) How will the compact be enforced?

- Creating 3rd-party enforcement mechanisms (e.g., giving taxpayers legal standing to bring suit) would help ensure compact adherence

5) Is exit from the compact allowed?

- No opportunity for exit is preferable, but if necessary to include it should not allow current politicians to benefit by offering subsidies

6) Will the compact be updated?

- A compact board that meets regularly could help improve an initial compact, but political capture of the board needs to be avoided