W.E. UPJOHN INSTITUTE FOR EMPLOYMENT RESEARCH

Employment Research Newsletter

Volume 14 | Number 2 Article 2

4-1-2007

Better Deals for State and Local Economic Development

Ann R. Markusen
University of Minnesota

Citation

Markusen, Ann R. 2007. "Better Deals for State and Local Economic Development." Employment Research 14(2): 4–6. https://doi.org/10.17848/1075-8445.14(2)-2

Ann Markusen

Better Deals for State and Local Economic Development

This article highlights some key issues discussed in the author's new book, Reining in the Competition for Capital, *which is available now from the Upjohn Institute. Read the first chapter at http://www.upjohninstitute.org.*

In early 2007, North Carolina "won" a $600 million Google server farm at a cost of around $260 million in tax abatements and grants by the state, the city of Lenoir, and Caldwell County. The city and county forgave 100 percent of Google's business property taxes and 80 percent of its real estate taxes for three decades, even though Google will create only 210 jobs, many of which require advanced degrees that only a fraction of current residents possess. In negotiating the deal, Google demanded that lawmakers keep its name secret from the public, even from residents who were asked to sell their homes and properties for the project.

Effective economic development requires strenuous reforms to produce good, long-term jobs and improve efficiency and equity in the process.

This case is typical of heightened global incentive competition in which companies face off against state and local governments in a "market for jobs." Increasingly, state governors and local mayors in countries as diverse as Australia, Brazil, and India are being pressed for similarly large grants and tax breaks under conditions of minimal transparency and where governments lack expertise to make good deals.

And in large metro areas, similarly huge sums are bid to influence where low-wage retailers like Wal-Mart and Cabela's locate, with no net benefit to the region and negative consequences for existing smaller retailers.

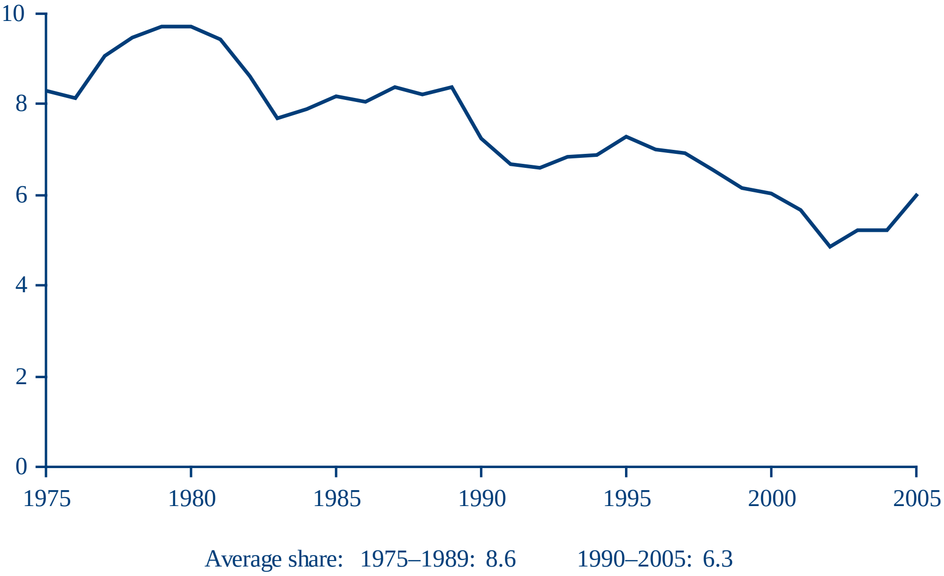
Are incentives good, bad, or a mixed bag, and how do we know? In *Reining in the Competition for Capital*, top U.S. scholars and practitioners working on this issue explore the reasoning, evidence, and practice under incentive competition. Though working from disparate disciplines and points of view, all oppose either banning incentives altogether or continuing with the status quo. Rather, we argue, effective economic development requires strenuous reforms to produce good, long-term jobs and improve efficiency and equity in the process.

The Reasoning

There are three schools of thought regarding incentive competition. One school, stated succinctly by Burstein and Rolnick (1995), argues that incentives are both inefficient (they transfer consumer surplus to firms that would locate there anyway and interfere with optimal siting) and inequitable (they impose tax and public service burdens on existing firms and residents). This camp proposes that Congress tax away all such incentives, rendering them ineffective. Another school, an analogue to the famous Tiebout hypothesis about fiscal competition among fragmented local governments, argues that the status quo is efficient and should be left as is.[1] The intricate logic of these positions is explored in the Markusen and Nesse and Thomas chapters of the book.

A third school of thought argues that in an integrating world economy where central governments are devolving responsibility for economic development

Figure 1 Corporate Income Tax as a Percent of Total State Tax Revenue, 1975–2005



SOURCE: Data prior to 1991 from U.S. Advisory Commission on Intergovernmental Relations (1992, p. 120); data for 1991–2005 from U.S. Census Bureau (2006).

onto lower-level governments, often without the resources to do so effectively, we have no choice but to champion state and local governments' rights to shape their relatively open economies. Bartik, in his chapter, argues that increasing local employment can yield substantial net social benefits, especially if jobs go to existing local residents, if costs of serving incentivized businesses is less than the new revenues they generate, and if no better uses of public resources are on the horizon.

But the market for jobs and tax base is rife with failures, the authors in this collection say. Multilocational companies, the suppliers of jobs, control crucial information in the deal-making process and have greater power in bilateral negotiations. Through the remarkable rise of site consultancy as an intermediating institution, Markusen and Nesse argue, they are able to informally collaborate in extracting spending and tax breaks, while the public sector agents bidding for jobs are unable or are too intimidated to share information with each other. The result is a strong bias toward overestimating benefits, according to Bartik. Furthermore, the flurry over deal making obscures a longer-term erosion in the business share of public sector revenues and often impoverishes "winning" local governments' future operating budgets, especially if firms fail or decamp in a short time for even lower-cost locations.

The Evidence

There are few long-term studies or data with which to evaluate promised jobs and tax base increments envisioned in deals of the past, but hard-hitting analyses are emerging. A path-breaking analysis of a recent North Carolina economic development initiative involving more than $1 billion in public sector liabilities found that only 4 percent of the jobs created were actually induced by the program at an exorbitant cost of nearly $40,000 per job (Luger and Bae 2005; Schweke chapter). In a pioneering study of 366 Ohio expansions between 1993 and 1995, Gabe and Graybill (2002) find that those receiving incentives overannounced employment targets but created no new jobs (in fact, reduced overall jobs), while those that did not receive incentives accurately forecast their job expansion and did create new jobs. Studying the extent to which incentives create jobs for existing residents, Bartik (1993) finds that in the long run, about 80 percent of new jobs in local economies go to outsiders.

The corporate income tax share of state revenues, Fisher's chapter shows, has dropped by 40 percent between 1980 and recent years (Figure 1), an erosion he attributes largely to rising incentives and related changes in taxation practices aimed at competitiveness. As a result, a larger share of the public sector service burden, including that provided to firms, is borne by households in the form of sales and property taxes. Since these are highly regressive taxes, the net result is to shift the tax burden from the highest income households to the lowest (Table 1).

Reforming the Market for Jobs

The authors document many encouraging experiments for improving incentive competition currently in place as well as reform proposals for federal, state, and local levels. Sinnaeve, a top regulator of incentive competition at the European Commission, explains lucidly how the EU system of deterrence works. EU members are prohibited from giving incentives to firms except under certain circumstances and only then if they

Table 1 State and Local Taxes as Shares of Family Income

	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%	Top 1%
1989	10.2	9.4	8.8	8.4	7.5	5.5
2002	11.4	10.3	9.6	8.8	7.3	5.2
Change (%)	+1.2	+0.8	+0.7	+0.4	−0.1	−0.3

NOTE: Tax burdens are shown after the federal offset; that is, these are the net burdens on families after taking into account the deductibility of state and local taxes on federal returns for those who itemize (generally higher-income taxpayers).
SOURCE: Institute on Taxation and Economic Policy (2003, pp. 118–119).

apply to the Commission for permission. The exceptions involve less-developed regions, which may offer certain types of incentives—for training, research, and technology, for instance—to encourage new plants and offices. The EU system largely deters governments from bidding wars for existing plants, because under most circumstances, they would simply not be permitted. While the regulatory process is expensive, it restrains tremendous distortions and giveaways in business sitings worth many times its cost.

In the United States, many state and local governments have designed reporting requirements that raise transparency in bargaining and awards. Others have pioneered performance requirements in written contracts, often with penalties and repayment provisions. Weber, in her chapter, explores many of these and shows how they enable public sector economic developers, like good customers in any market, to get a better deal. She shows that some governments plan in advance what they want and are prepared for sudden requests and bidding wars, invest their public dollars in place-based assets rather than firm-based ones, and extend benefits only after firms have produced the jobs they promise. Clawbacks—requirements that firms that renege on contracts pay back some or all of the incentives—and job quality standards are increasingly being incorporated into deals, as is school board input on abatements and tax increment financing (the devotion of future tax revenue from increased property values to paying off bonds for improvements).

Incentive reform is a big and incremental project at local, state, and federal levels. Sunshine, claims LeRoy in his chapter, is the best antiseptic. He reviews the 12 states that already have some form of incentive disclosure, a few of those—Virginia, Maine, and North Carolina—include corporate income tax breaks. He also recommends disclosing state taxes paid to corporate shareholders. LeRoy argues that the adoption of state unified development budgets would enable citizens and decision makers to see the combination of spending and tax expenditures involved in all programs, as a public interest group in Kentucky has pioneered for their state (Mountain Associates for Community Economic Development 2005). Markusen and Nesse and LeRoy recommend legally defining site consultants as lobbyists, blocking success fees that tend to escalate deal dollars, and ending dual agency and other practices that exacerbate market failures.

States can also restrain the contribution of incentives to sprawl. To curtail the economic war among the suburbs for retail, LeRoy recommends that states ban retail subsidies altogether except in depressed inner-city markets that are demonstrably underserved.

The federal government could considerably moderate incentive competition by creating federal carrots against job piracy. LeRoy notes that federal program funding has been held up to induce states to raise legal drinking ages and implement school reform. A share of economic development funding from the Federal Departments of Commerce and Labor could be held until states adopted certain reforms.

To curtail the economic war among the suburbs for retail, states could ban retail subsidies altogether except in depressed inner-city markets that are demonstrably underserved.

Overall, these seminal papers respond to a growing crisis in state and local finance, where high-profile recruitments cost community too much for the jobs created, or worse, leave them holding the debt bag when firms fail to perform. State and local responsibility for economic development is a growing reality everywhere in the world, and incentives are among the most powerful tools available. Like any market, this one would benefit from clearer information and a more level playing field. The authors in *Reining in the Competition for Capital* present models, evidence, and doable reforms that can help public sector economic developers accomplish that within the decade.

Note

1. Tiebout (1956) argues that local governments in a metropolitan area compete to offer packages of public services at the best tax "price," thus optimally allocating resources when residents "vote with their feet" in choosing where to live.

Ann Markusen is a professor in the urban and regional planning graduate program and director of the Project on Regional and Industrial Economics, Humphrey Institute of Public Affairs, University of Minnesota.

References

Bartik, Timothy J. 1993. "Who Benefits from Local Job Growth: Migration or the Original Residents?" *Regional Studies* 27(4): 297–312.

Burstein, Melvin and Arthur Rolnick. 1995. "Congress Should End the Economic War among the States." *Federal Reserve Bank of Minneapolis 1994 Annual Report* 9(1): 3–20.

Gabe, Todd and David Kraybill. 2002. "The Effect of State Economic Development Incentives on Employment Growth of Establishments." *Journal of Regional Science* 42(4): 703–730.

Institute on Taxation and Economic Policy. 2003. *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States.* 2nd ed. Washington, DC: Institute on Taxation and Economic Policy.

LeRoy, Greg. 2005. *The Great American Jobs Scam: Corporate Tax Dodging and the Myth of Job Creation*. San Francisco: Berrett-Koehler Publishers.

Luger, Michael and Suho Bae. 2005. "The Effectiveness of State Business Tax Incentives: The Case of North Carolina." *Economic Development Quarterly* 19(4): 327–345.

Mountain Association for Community Economic Development. 2005. *Accounting for Impact: Economic Development Spending in Kentucky.* Berea, KY: MACED.

Tiebout, Charles. 1956. "A Pure Theory of Local Expenditures." *Journal of Political Economy* 64(2): 160–164.