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TESTIMONY

USING AN INTERSTATE COMPACT TO SOLVE THE PROBLEMS WITH ECONOMIC DEVELOPMENT SUBSIDIES

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Good afternoon, Chairman Almy, Vice Chairman Ames, and members of the New Hampshire House of Representatives Ways and Means Committee:

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 opportunity for states to create a cooperative solution using an interstate compact. I'm happy to contribute toward the conversation regarding HB 1132.

My testimony today has three main points:

1. Economic development subsidies generally fail to achieve their goals. That is,
    a. they generally don't lead to broad improvements in economic outcomes for the states and cities that use them,
    b. they aren't as important as many people believe in terms of swaying companies' decisions of where to locate, and
    c. they can actually *reduce* economic development.
2. An interstate compact could provide a tailor-made solution to the counterproductive subsidy arms race confronting policymakers.
3. Any interstate compact will need to include a number of specific elements that guarantee credibility and enforceability to ensure its long-term success.

UNDERSTANDING THE PROBLEMS WITH ECONOMIC DEVELOPMENT SUBSIDIES

Economic development subsidies have a long history and, unfortunately, they're as American as apple pie.[1] In fact, the Boston Tea Party was a protest against one of these subsidies—a tax break for the

1. As early as 1661, Virginia subsidized woolen cloth producers with bounties of tobacco. David E. Pinsky, "State Constitutional Limitations on Public Industrial Financing: An Historical and Economic Approach," *University of Pennsylvania Law Review* 111, no. 3 (1963): 266.

East India Company that effectively gave the crown-chartered firm a monopoly on tea trade in the New World.[2]

Opposition to favoritism is still alive in some states today: In 2011, 17 business leaders in the Kansas City area wrote a letter to the governors of Kansas and Missouri asking for a cease fire to the "border war" between the two states.[3] Unfortunately for the taxpayers of both states, at the time, the states were not able to come to an agreement and so the border war continued.

Between 2011 and 2018 Kansas and Missouri paid a combined *$335 million* to subsidize the movement of around 12,000 jobs from one state to the other, with most companies moving only *five to seven* miles.[4] Shortly after the letter was sent, Sean O'Byrne, vice president of the Downtown Council of Kansas City, voiced his doubts regarding the policy in an interview with the *New York Times*: "I just shake my head every time it happens, it just gives me a sick feeling in the pit of my stomach. It sounds like I'm talking myself out of a job, but there ought to be a law against what I'm doing."[5]

DEFINING ECONOMIC DEVELOPMENT SUBSIDIES

Deciding what constitutes an economic development subsidy can sometimes be difficult. It's obvious that cash handouts are subsidies, but this limited classification isn't sufficient for two reasons: First, few economic development programs actually provide cash payments, and even when they do, the subsidy is framed as something else. For example, most of Wisconsin's recent subsidies for Foxconn Technology Group are characterized as corporate income tax credits. But because manufacturing firms are excluded from the state's corporate income tax, the tax credits are equivalent to a cash handout.[6]

Second, many economic development policies create fungible economic benefits that are, *in effect*, subsidies. For example, when a government provides a corporation with publicly owned assets, specialized infrastructure, loans, or loan guarantees it displaces some of the resources that the corporation would otherwise have had to spend on the project. Because of these factors, defining an economic development subsidy as *any government-granted privilege that creates exclusive economic benefits for the recipients* captures the broad universe of such policies.[7]

WHY ECONOMIC DEVELOPMENT SUBSIDIES DON'T WORK

Economic development subsidies suffer from multiple problems that ensure that they typically don't work as advertised. That is, they usually fail to promote net economic development in the jurisdictions that pay for them. In fact, they may actually depress local economic development. Moreover, there's good reason to believe that, regardless of their local effect, they tend to depress economic development at the national level.

Subsidies Don't Work

A large body of academic research finds that, while subsidies may benefit the firms, activities, industries, or regions that are privileged, most are not associated with measurable improvements in the

2. Matthew D. Mitchell, *The Pathology of Privilege: The Economic Consequences of Government Favoritism* (Arlington, VA: Mercatus Center at George Mason University, 2015), 9–10.
3. "K.C. Business Leaders Demand Cease-Fire on Wasteful Job Poaching," Good Jobs First, accessed January 22, 2020, https://www.goodjobsfirst.org/kc-business-leaders-demand-cease-fire-wasteful-job-poaching; "The New Border War," *Economist*, March 22, 2014.
4. Shayndi Raice, "Tired of Fighting for Business, Missouri and Kansas Near Cease-Fire over Incentives," *Wall Street Journal*, June 25, 2019.
5. Louise Story, "As Companies Seek Tax Deals, Governments Pay High Price," *New York Times*, December 1, 2012.
6. 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).
7. Mitchell et al., "The Economics of a Targeted Economic Development Subsidy."

broader communities that pay for them.[8] Perhaps unsurprisingly, the peer-reviewed academic research on subsidies generally contradicts the favorable findings of private consultant studies. One important reason for the discrepancy is that the consultant studies rarely include the effect of economic harm done by the taxes that fund the subsidy. In essence, they use a "benefits only" approach, rather than a full-fledged cost-benefit analysis.[9]

Furthermore, in the large majority of cases, economic development subsides don't actually sway a company's decision of where to locate, whether to expand, or whether to stay put. This may sound counterintuitive, but it has been documented in a large number of academic studies. Timothy Bartik, one of the leading scholars of economic development, surveyed the body of research on this question and concluded that the typical subsidy materially affects a company's decision of where to locate or whether to expand in about 2 to 25 percent of cases.[10] In other words, in over 75 percent of cases, a granted economic development subsidy was not the deciding factor in the company's final decision. In those situations, the subsidy represents a complete waste of public resources.

Subsidies May Depress Local Economic Development

Even worse, a subsidy can actually *depress* local economic development. One reason for this is that subsidies must be funded by taxes and taxes tend to discourage economic activity. Recent research suggests that state governments that provide more and larger subsidies tend to have higher taxes.[11] It is difficult, however, to disentangle cause and effect.[12] It may be that the cost of subsidies is passed onto state residents; or it may be that states with high tax burdens must make up for these burdens with more subsidies.[13] Other research by Bartik—again summarizing the broader body of academic literature—finds that cities and states with higher tax rates tend to experience lower levels of economic activity.[14] It is possible that the higher taxes needed to pay for the subsidies—which are ostensibly intended to spur economic development—may have a *larger* negative effect than the presumed positive effect of the subsidy.[15]

Alternatively, policymakers may pay for subsidies by reducing public services such as education, public safety, or infrastructure. Indeed, research by University of the South professor Jia Wang suggests that spending on public goods generally decreases after subsidies have been granted.[16] Reducing the public services provided to residents would, in general, reduce the local quality of life, a factor known to affect firm location decisions.[17] This suggests that even if policymakers avoid raising taxes to pay for subsidies,

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8. Matthew D. Mitchell, "Florida Man Seeks a Quarter of a Billion Dollars That Won't Help State," *Medium*, October 30, 2015.
9. Mitchell et al., "The Economics of a Targeted Economic Development Subsidy."
10. Timothy J. Bartik, "'But for' Percentages for Economic Development Incentives: What Percentage Estimates Are Plausible Based on the Research Literature?" (Upjohn Institute Working Paper No. 18-289, W.E. Upjohn Institute, Kalamazoo, Michigan, July 1, 2018).
11. Peter Calcagno and Frank Hefner, "Targeted Economic Incentives: An Analysis of State Fiscal Policy and Regulatory Conditions," *Review of Regional Studies* 48, no. 1 (2018): 71–91
12. Matthew D. Mitchell, Daniel Sutter, and Scott Eastman, "The Political Economy of Targeted Economic Development Incentives," *Review of Regional Studies* 48, no. 1 (2018): 1–9.
13. John Dove and Daniel Sutter find that states that spend more on targeted subsidies tend to experience lower levels of measured economic freedom. John Dove and Daniel Sutter, "Is There a Tradeoff between Economic Development Incentives and Economic Freedom? Evidence from the US States," *Review of Regional Studies* 48, no. 1 (2018): 55–69.
14. This effect is substantially stronger at the municipal level compared to the metropolitan and state levels, meaning that higher taxes to fund subsidies from local governments cause more associated economic loss. Timothy J. Bartik, *Who Benefits from State and Local Economic Development Policies?* (Kalamazoo, MI: W.E. Upjohn Institute, 1991); Timothy J. Bartik, "What Works to Help Manufacturing-Intensive Local Economies?" (Upjohn Institute Technical Report No. 18-035, W.E. Upjohn Institute, Kalamazoo, MI, May 1, 2018).
15. This is precisely what my coauthors and I find in our recent analysis of Wisconsin's Foxconn subsidies. Mitchell et al., "The Economics of a Targeted Economic Development Subsidy."
16. Jia Wang, "Do Economic Development Incentives Crowd Out Public Expenditures in U.S. States?," *B.E. Journal of Economic Analysis & Policy* 16, no. 1 (2015): 513–38.
17. Paul D. Gottlieb, "Residential Amenities, Firm Location and Economic Development," *Urban Studies* 32, no. 9 (1995): 1413–36.

local companies may still face increased costs and the community may experience slower economic growth as a result.

Subsidies Reduce National Economic Development

The net effect of subsidies on local economic development may be uncertain, but it's a fair bet that subsidies reduce economic development at the national level. This is because subsidies waste national resources regardless of whether they enhance local development.

As I have noted, if a subsidy wasn't the deciding factor in a company's location or expansion decision, then the government has provided a taxpayer-financed handout for no gain. Furthermore, the taxes to fund the subsidy reduce long-run economic development.

However, the subsidy itself also gives the company a measure of protection from its unsubsidized competition. This sheltered status allows the company to not work quite as hard to please customers as it otherwise would have, and it allows the company to be less vigilant in controlling costs. To put it plainly, subsidies protect companies from the consequences of laziness.[18] Moreover, the very existence of the privilege encourages some firms to expend scarce resources seeking it and others to expend scarce resources opposing it. Both the inefficient production, as well as the resources spent to win the political protection from competition that enables it, reduce national economic development.[19]

Furthermore, 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.[20] The less efficient production leads to reduced national economic development *in addition to* the diminished economic development at the local level caused by the higher taxes to fund the subsidy and the resources wasted on currying political privilege.

WHY AN INTERSTATE COMPACT?

Why, then, do cities and states continue to offer subsidies? Despite misgivings, local leaders often feel compelled to offer subsidies out of fear that officials in other areas will "steal" the jobs that would have otherwise been created in their hometowns.

Moreover, despite the fact that the economic payoffs of subsidies are likely negative, the political payoffs seem to be positive. A recent survey found that 84 percent of mayors believe subsidies to be beneficial.[21] Furthermore, a recent book by Nathan Jensen and Ed Malesky shows that policymakers believe that offering subsidies improves their standing in the public eye.[22] Being able to point to a

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18. Mitchell, *The Pathology of Privilege*, 17; Harvey Leibenstein, "Allocative Efficiency vs. 'X-Efficiency,'" *American Economic Review* 56, no. 3 (1966): 392–415.
19. Economists call the socially wasteful efforts to curry favor or to protect against it rent-seeking. Gordon Tullock, "The Welfare Costs of Tariffs, Monopolies, and Theft," *Western Economic Journal [Economic Inquiry]* 5, no. 3 (1967): 224–32; Matthew D. Mitchell, "Rent Seeking at 52: An Introduction to a Special Issue of *Public Choice*," *Public Choice* 181, no. 1 (2019): 1–4.
20. An alternative way of thinking of this is that the company picked a less productive or more wasteful location to do business, rather than one that maximizes the value, net of cost, that it offers to customers. A more relatable example would be if people chose to live five miles farther away from their workplace because the cost of housing was subsidized at the new location. Although the effect on their household finances would be positive, the net effect on society would be negative for two main reasons: First, the cost of taxation to fund the subsidy reduces economic growth. Second, their decision to live farther away leads to a greater consumption of resources (e.g., fuel, productive time, or both) traveling to work each day, leaving less of those resources to be productively used in the economy.
21. Katherin Levine Einstein et al., *Menino Survey of Mayors: 2018 Results* (Boston, MA: Boston University Initiative on Cities, 2019).
22. Nathan M. Jensen and Edmund Malesky, *Incentives to Pander: How Politicians Use Corporate Welfare for Political Gain* (Cambridge: Cambridge University Press, 2018).

particular marquee business or project in the community and tell voters, "Look what I've done," seems to be a winning political strategy.[23]

This means meaning that policymakers face pressure to offer subsidies even if they're uncomfortable with the idea.[24] This is doubly true when politicians in other cities and states are publicly announcing their own subsidy offers. The misplaced fear of missing out on potential economic growth as well as the legitimate fear that rival politicians will criticize them for failing to do enough to promote jobs compels most politicians to join the subsidy arms race.

Thankfully, there's been some progress made in addressing this problem. Kansas and Missouri made headlines in mid-2019 when they agreed to end their subsidy arms race.[25] However, they have not found a complete and final solution: the agreement only covers the Kansas City region, there are no restrictions on local governments continuing to offer subsidies, and either state could exit the agreement without penalty or advance notice.[26]

This offers a good example of why a more comprehensive and durable agreement, like an interstate compact, may offer a better resolution. A compact allows states to credibly commit to a given course of action and to be sure that their compact partners will be held to their own promises.

A PRIMER ON INTERSTATE COMPACTS

Interstate compacts aren't well known, even though they're part of the original US Constitution. However, there are currently more than 200 compacts and most states are members to dozens of such agreements.[27] Interstate compacts allow the states to work together to solve common policy problems without intervention by the federal government.

Their constitutional nature means that compacts carry the weight of federal law, meaning they offer a credible way for states to commit to a given course of action. But compacts can also be flexible. For example, the recent Enhanced Nurse Licensure Compact repealed and replaced the original Nurse Licensure Compact to motivate greater participation in the compact.[28]

During the compact drafting process states can decide what enforcement mechanisms to put into place and what penalties should befall states that violate the compact. The only limits on what can be put into the compact are what measures the states themselves want to agree to, what Congress will consent to (according to the Supreme Court, congressional consent is required in cases where the compact intrudes on the authority that the states delegated to the federal government in the Constitution), and what the Constitution itself permits (for example, states could not enter into a compact that abridges rights guaranteed by the Fourteenth Amendment).

CRITICAL ELEMENTS FOR AN ECONOMIC DEVELOPMENT INTERSTATE COMPACT

New Hampshire's interest in convening a committee to study how a compact can be used to mutually solve the problem of economic development subsides is a step in the right direction. I would

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23. Richard Florida, "Why Do Politicians Waste So Much Money on Corporate Incentives?," *CityLab*, May 24, 2018.
24. Intriguingly, the apparent support that politicians earn with voters when providing subsidies evaporates when the costs of the subsidies are presented in the form of tradeoffs, like increased taxes or reduced education spending. Matthew D. Mitchell, Nathan Jensen, and Edmund Malesky, "Why Do Politicians Push for Corporate Welfare?," *The Bridge*, July 27, 2018.
25. "The Kansas-Missouri Subsidy Armistice," *Wall Street Journal*, August 14, 2019; S. B. 182, 100th Gen. Assemb., 1st Reg. Sess. (Mo. 2019); State of Kansas, Governor Laura Kelly, Exec. Order No. 19-09, August 2, 2019, 19.
26. A similar agreement between New York City, New Jersey, and Connecticut in 1991 was short-lived. Joseph F. Zimmerman, *Interstate Economic Relations* (Albany, NY: State University of New York Press, 2004), 151.
27. National Center for Interstate Compacts, *Interstate Compact Fact Sheet*, n.d.
28. James Puente, "The Enhanced Nurse Licensure Compact," *American Nurse Today* 12, no. 10 (2017): 50–53.

recommend that the committee discuss several particular elements of such a compact, because they will be critical to creating an effective solution to the problem.

1. Defining a subsidy: an interstate compact will have to explicitly define what constitutes a subsidy, as discussed earlier.
2. Compact enactment and administration: a compact will also have to determine how and when the compact takes effect, how the compact will be enforced, and how (or if) states are able to exit the compact.
3. Dispute resolution: a compact will need mechanisms to flag violations, create procedures for dispute resolution, and set penalties for states that breach the compact.
4. Reforms: a compact should also have a mechanism or advisory body to identify deficiencies in the compact in order to propose appropriate reforms.

CONCLUSION

The problem of economic development subsides existed before the American founding and unfortunately has worsened in recent decades.[29] The broad body of academic research clearly shows that, contrary to the claims made by consultants, instead of enhancing economic development, subsidies are more likely to reduce it.

There is widespread public misunderstanding of subsidies, and as a result, policymakers face strong incentives to continue offering them. This divergence between what is economically efficient and what is politically expedient keeps policymakers trapped in a self-destructive subsidy war.

An interstate compact offers a politically feasible long-term solution.[30] Policymakers would be wise to explore the opportunity, because real economic development depends on it.

29. Timothy J. Bartik, *A New Panel Database on Business Incentives for Economic Development Offered by State and Local Governments in the United States* (Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 2017).
30. An alternate solution would be to enforce the state constitutional provisions that are already law (but which have faded into obscurity and disuse). 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).