

RESEARCH SUMMARY

How to Combat Economic Development Subsidies: Strengthen Anti-Aid Provisions in State Constitutions

States and localities spend about \$49 billion per year on targeted economic development subsidies, according to a recent study. This amounts to almost one-third of state and local business tax revenue. This spending occurs in spite of the fact that public aid—whether in the form of subsidies, tax privileges, or regulatory breaks—is almost never the decisive factor in attracting new businesses to a region. Indeed, history shows such aid is more likely to depress economic development than to encourage it. Moreover, subsidies tend to invite public corruption, undermine economic freedom, and crowd out public expenditures.

In “[Outlawing Favoritism: The Economics, History, and Law of Anti-Aid Provisions in State Constitutions](#),” Matthew D. Mitchell, Jonathan Riches, Veronica Thorson, and Anne Philpot examine the salient aspects of anti-aid provisions. These are state constitutional provisions, found in 45 states, that prohibit targeted subsidies to private firms or individuals. The history of such provisions suggests that lawmakers were once better attuned to the problems of subsidies. Unfortunately, these provisions have been undermined over the years and now must be reinvigorated to protect state taxpayers, consumers, and unsubsidized businesses.

THE COST OF SUBSIDIES IS TOO HIGH

Over the long run, subsidies undermine both fiscal and economic health. Subsidies tend to do the following:

- Cause states to raise taxes, reduce government services, or both.
- Benefit the wealthy and well connected at the expense of the poor and politically unorganized.
- Encourage firms to ignore their customers and market signals, resulting in lower-quality products and services.

EARLY ECONOMIC SUBSIDIES BANKRUPTED THE STATES

In the early days of the United States, American governments resisted the British tradition of subsidies, tax privileges, and regulatory protections. However, this attitude changed in the 1820s when states began funding large infrastructure projects such as railroads and the Erie Canal. As a result, between the years 1810 and 1840, state debt per capita rose by 144 percent.

The unsustainable nature of these investments was laid bare by the financial panic of 1837 and the recession that followed. By 1842, eight states and one territory had defaulted on their debts. Following the federal government’s refusal to bail them out, several states began to right their own ships through the adoption of constitutional amendments forbidding fiscal mischief. In many states, anti-aid provisions were an import aspect of these reforms.

For a time, these provisions worked. But after a few decades, local governments—which were not constrained by the initial anti-aid provisions—began to offer their own targeted subsidies. This practice precipitated another fiscal crisis in the 1870s and, in many places, another round of reforms applying anti-aid provisions to local governments.

These reforms, too, seemed to work for a time. Courts routinely struck down state and local subsidies, state and local fiscal conditions improved, borrowing costs fell, and the nation entered a prolonged period of economic growth. In time, however, legislatures and courts would again circumvent these rules by justifying public aid for projects with an extremely broad interpretation of what constitutes a “public purpose.”

CONSTITUTIONAL ANTI-AID PROVISIONS CAN STILL BLOCK SUBSIDIES TODAY

More recently, some courts have begun to take anti-aid provisions seriously again. The nation’s experience with these provisions suggests that the most effective anti-aid provisions require the following three criteria to be satisfied for every expenditure of public funds:

- 1) The public expenditure should be primarily for a public purpose.
- 2) The government should maintain sufficient control over the expenditure to ensure that its public purpose is accomplished.
- 3) The public should receive adequate consideration for its expenses.

KEY TAKEAWAY

The economic case for targeted subsidies is weak. The balance of the evidence suggests that they are more likely to undermine economic development than to enhance it. Nearly every state constitution includes a provision that, upon its plain reading, would seem to ban targeted subsidies to private industry. Though these provisions have been weakened through broad judicial interpretations, courts have once again begun to take them more seriously. History suggests that these provisions can be made more effective, but the details matter.