



POLICY SPOTLIGHT

Targeted Economic Development Subsidies Don't Work.
An Interstate Compact Could End Them.

MICHAEL D. FARREN AND MATTHEW D. MITCHELL | AUGUST 2020

State and local policymakers are projecting substantially reduced tax revenues as a result of the economic downturn caused by the COVID-19 pandemic. Declining revenues and depressed economic activity create a strong temptation for these policymakers to use subsidies to attract new businesses or to encourage already-established companies to expand or maintain their current operations. Subsidies will not, however, boost state revenues or revive moribund economies.

Targeted economic development subsidies usually fail to promote economic development in the jurisdictions that pay for them and are likely to further depress tax revenues. Despite the fact that they don't work, policymakers face strong incentives to continue offering subsidies, perpetuating a mutually destructive subsidy war with other states and localities. One way to resolve this dilemma is through an interstate compact by which states would agree to mutually disarm in the subsidy war.

SUBSIDIES CAUSE ECONOMIC PROBLEMS

Subsidies include cash handouts, tax credits, and any government-granted privilege that creates exclusive economic benefits for the recipients.

Subsidies don't work as advertised. In the large majority of cases, subsidies don't actually sway a company's decision about where to locate, whether to expand, or whether to maintain operations. In those situations, the subsidy represents a complete waste of public resources—a taxpayer-financed hand-out for no gain.

Subsidies reduce funds for other programs. Tax dollars spent on subsidies aren't available to shore up public pension programs, which would improve future

government finances by reducing borrowing costs. Similarly, funds spent on subsidies can't provide wider tax relief or improved public services, both of which are more likely to assist long-run economic development. If the subsidies are paid for in higher taxes, then this also discourages economic activity.

Subsidies give favored companies a degree of protection from unsubsidized competitors. This sheltered status allows a company to not work quite as hard to satisfy its customers as it otherwise would have. Subsidized companies also tend to be less vigilant in controlling costs. In effect, subsidies protect companies from the consequences of laziness. This, in turn, reduces long-run economic development.

POLITICIANS CONTINUE TO DISPENSE SUBSIDIES

Despite their economic costs, subsidies have clear political benefits. A subsidy allows a local leader to send voters a highly visible signal that he or she is committed to improving the local economy and is taking steps to do so. When some politicians start using subsidies, those in other cities and states feel pressured to follow suit. As Jim Edgar, former governor of Illinois, put it, “If you’ve got some states doing it, it’s hard for the others not to do it. It’s like unilaterally disarming.”

Fortunately for state and local government leaders, there is a multilateral solution that can help end the subsidy arms race.

INTERSTATE COMPACTS CAN END THIS ECONOMIC RACE TO THE BOTTOM

An interstate compact offers a way for states to credibly commit to work together to end the subsidy war. A well-structured compact can allow policymakers to escape the economic race to the bottom without having to be the first to disarm. The idea has momentum—nearly one-third of states have already introduced interstate compact legislation to move toward multilateral disarmament.

At a time when state and local governments face reduced revenues and potential cuts for critical services, the funds wasted on targeted economic development subsidies represent the lowest-hanging fruit that could be repurposed to better uses. Moreover, getting rid of subsidies would also lead to improved

economic development, increasing tax revenues in the future.

An interstate compact would help state and local policymakers focus on policies that truly help attract businesses and create good jobs in their communities. In the process, it would also help the United States recover more quickly from the coronavirus-induced economic downturn.

FURTHER READING

Michael D. Farren and Matthew D. Mitchell, “An Interstate Compact to Stop the Economic Subsidy Arms Race” (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 2020).

Michael D. Farren and John Mozena, “Federal Pandemic Relief Could End the Interstate Economic Development Arms Race” (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, May 2020).

Michael D. Farren, “An Interstate Compact to Phase Out Corporate Giveaways” (Testimony before the Illinois General Assembly, House Revenue & Finance Committee, Mercatus Center at George Mason University, Arlington, VA, February 7, 2020).

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).

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