MERCATUS CENTER
George Mason University

TESTIMONY

# ENDING NONDISCLOSURE AGREEMENTS WOULD REDUCE SUBSIDY WASTE

**Michael D. Farren, PE, PhD**
*Research Fellow, Mercatus Center at George Mason University*

Illinois General Assembly, House Revenue and Finance Committee

April 1, 2021

Chairperson Zalewski, Vice Chairperson Tarver, Spokesperson Reick, and members of the House Revenue and Finance 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 partial solution offered by HB 22.

States and cities spend an estimated *$95 billion* annually on economic development subsidies.[1] Most academic research finds that these subsidies fail to improve economic outcomes, and they may even *reduce* economic growth, especially at the local level.[2] States and cities find themselves trapped in a prisoner's dilemma—an unproductive competition caused by restrictions on cooperation—wasting ever-larger shares of their tax revenues on subsidies.[3]

Corporations seeking subsidies usually demand confidentiality in negotiations with government officials.[4] This arrangement enables corporations to play local governments against each other to extract the highest possible value of subsidies, at great cost to taxpayers. Furthermore, public services become underfunded when the demand for services increases while tax collections decrease.

HB 22's ban on local officials' ability to sign nondisclosure agreements (NDAs) associated with economic development subsidies offers a partial solution to the larger problem. Ending NDAs would likely reduce subsidy expenditures and improve local policymakers' accountability to residents and taxpayers.

1. Michael D. Farren and Matthew D. Mitchell, "An Interstate Compact to End the Economic Development Subsidy Arms Race" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 23, 2020), 21.
2. Matthew D. Mitchell et al., *The Economics of a Targeted Economic Development Subsidy* (Arlington, VA: Mercatus Center at George Mason University, 2019).
3. Farren and Mitchell, "An Interstate Compact to End the Economic Development Subsidy Arms Race," 13.
4. Steve Miller, *Invisible Incentives: How Secrecy Impedes Evaluation and Accountability of Economic Development Subsidies November* (Gainesville, FL: National Freedom of Information Coalition, November 2020).

That said, I would like to highlight three ways how the proposed legislation could be made more effective at achieving its goal of reducing local government spending on subsidies:

1. Close legal loopholes by expanding the legislation to apply to private individuals and organizations conducting subsidy negotiations on behalf of local governments.
2. Combine HB 22 with other proposed legislation, such as HB 211, to restrict local governments from using subsidies to poach jobs from each other.
3. Preempt local governments' ability to use economic development subsidies altogether.

## LOOPHOLES IN NONDISCLOSURE REQUIREMENTS

Many local government officials already face requirements that subsidy negotiations be subject to sunshine laws, open meetings regulations, or Freedom of Information Act (FOIA) requests. Signing NDAs is a primary way that officials get around these transparency mandates.[5] Because HB 22 would limit local officials' ability to engage in these backroom deals, it would likely reduce the public funds wasted on subsidies.

However, some local (and state) governments have already employed another tactic to ensure that their subsidy negotiations remain hidden from public knowledge: they use private individuals and organizations, such as a local chamber of commerce, as a third party to negotiate on their behalf.[6] Because these agents are not public officials, their communications with subsidy-seeking corporations are not subject to sunshine laws, open meetings regulations, or FOIA requests.

In order to avoid this obvious loophole, Illinois legislators should consider how to expand HB 22's application to *any* agent operating on behalf of local officials (with or without the local officials' explicit authorization). These private agents' actions and speech should arguably be considered equivalent to the actions and speech of any public official, and their failure to abide by the same regulations could be subjected to the same legal repercussions.

Also, local officials consistently tie up FOIA requests with legal challenges, in spite of open-records requirements.[7] To address this problem, policymakers may also consider expanding the legislation's scope by limiting local officials' ability to challenge FOIA-style requests regarding economic development subsidies.

## ENDING INTRASTATE JOB POACHING

The purpose of HB 22—to reduce the wastefulness of locally provided subsidies—is complementary to the purpose of HB 211, which would prohibit local officials from using subsidies to poach companies (and their jobs) from other jurisdictions.[8] Combining the two bills seems natural, since both appear intended to restrict the most egregious economic development subsidies.

Although the interstate subsidy competition receives most of the attention in the news media, local governments' use of subsidies to encourage "jurisdiction jumping" might be an even larger problem. The most infamous case of this behavior was seen in the Kansas City area, where from 2011 through 2019, Kansas and Missouri together paid $335 million to motivate 116 companies to cross State Line

---

5. Martin Austermuhle, "Amazon Insists on Silence from Twenty HQ2 Finalists," WAMU, January 30, 2018.
6. Sarah Holder, "What Did Cities Actually Offer Amazon?," *CityLab*, May 29, 2018.
7. John Pletz and A.D. Quig, "Inside Chicago's Doomed Amazon HQ2 Pitch," *Crain's Chicago Business*, March 6, 2020.
8. H.B. 211, 102nd Gen. Assemb., Reg. Sess. (Ill. 2021).

Road, which bisects Kansas City.[9] Though the states have since declared a shaky ceasefire, local governments continue to poach from each other, straining the truce.[10] This beggar-thy-neighbor approach is widespread, occurring even between small municipalities, and causes even greater harm to overall economic growth than state-level subsidies.

## PREEMPTING LOCAL GOVERNMENT SUBSIDIES ALTOGETHER

Academic research finds that the higher taxes needed to fund economic development subsidies result in slower economic growth across the economy in question. That tradeoff is part of the reason why research doesn't find broadly beneficial results associated with subsidies.[11] But the effect is much more severe—5 to 10 times larger—for smaller municipalities.[12] This finding suggests that if subsidies are going to be an element of economic development efforts, it might be better to manage them solely at the state level by preempting local officials' ability to offer them. This approach would provide a more holistic solution to local subsidies than either HB 22 or HB 211.

## CONCLUSION

Subsidy competitions for economic development often place policymakers between a rock and a hard place, and they may feel no other option than to sign an NDA to remain in the competition. For those policymakers, HB 22 would likely be a relief.

Still, HB 22's effectiveness would be limited without expanding its application to anyone acting as an agent on behalf of local governments. Furthermore, reducing the expenditures wasted on subsidies could also be achieved by preempting local officials' ability to poach jobs from other jurisdictions or even preempting local officials' ability to provide subsidies altogether.

Regardless of the particular approach, the large body of academic research agrees that phasing out economic development subsidies would lead to greater economic growth.

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

## ATTACHMENTS (3)

Matthew D. Mitchell et al., "Targeted Economic Development Subsidies Don't Work: Negligible Community Benefits and Economic Development" (Research Summary).

Michael D. Farren and Matthew D. Mitchell, "Targeted Economic Development Subsidies Don't Work. An Interstate Compact Could End Them" (Policy Spotlight).

Michael D. Farren and Matthew D. Mitchell, "Interstate Compacts against Economic Development Subsidies: How to Stop the Economic Race to the Bottom" (Research Summary).

---

9. Shayndi Raice, "Tired of Fighting for Business, Missouri and Kansas Near Cease-Fire over Incentives," *Wall Street Journal*, June 25, 2019.
10. Miranda Davis, "Kansas, Missouri Won't Identify Exceptions to Border War Truce," *Kansas City Business Journal*, February 18, 2020; Patrick Tuohey, "Is the Missouri-Kansas Border War Truce Already Falling Apart?," *The Hill*, December 9, 2019.
11. Mitchell et al., *The Economics of a Targeted Economic Development Subsidy*.
12. Timothy J. Bartik, *Who Benefits from State and Local Economic Development Policies?* (Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 1991), 43.

MERCATUS CENTER
George Mason University

RESEARCH SUMMARY

# Targeted Economic Development Subsidies Don't Work: Negligible Community Benefits and Economic Development

Many government officials consider targeted economic development subsidies key to economic development. In a recent survey of 110 mayors, for example, more than 8 out of 10 said targeted incentives are a good idea. In reality, economic development subsidies only help their corporate recipients and the politicians that supply them. Other companies, local residents, and the economy at large are harmed.

In "The Economics of a Targeted Economic Development Subsidy," Matthew D. Mitchell, Michael D. Farren, Jeremy Horpedahl, and Olivia Gonzalez provide a comprehensive analysis of the effects of economic development subsidies. Their estimates are based, in part, on the broad body of peer-reviewed academic research that finds that subsidies have little to no effect on where companies choose to invest. This means that the expected gross benefits of such subsidies should be substantially reduced. Furthermore, the authors incorporate the economic impact of the higher taxes needed to pay for the subsidies. They find that in the case of Wisconsin's subsidies to Foxconn, the net effect of the subsidies will likely *reduce* future economic activity in Wisconsin by $370 million to $19.2 billion.

## FOXCONN IN WISCONSIN: A CASE STUDY OF SUBSIDY FAILURE

In 2017, Wisconsin struck a deal with Taiwanese company Foxconn to manufacture large LCD screens within the state. Foxconn was supposed to make a $10 billion investment and create up to 13,000 jobs. In return, Wisconsin would do the following:

- Provide up to $3.6 billion to Foxconn in tax breaks and other subsidies
- Exempt Foxconn from certain environmental regulations
- Provide billions more in local government, utility, and infrastructure subsidies

Just two years after the deal, Foxconn is already reneging on its commitments and is building a much smaller $2 billion to $3 billion facility that will employ far fewer workers. This should be no surprise, given a recent Wisconsin state audit finding that, on average, subsidized firms create only 34 percent of the jobs they promise.

## THE PUBLIC DOES NOT WIN WITH ECONOMIC DEVELOPMENT SUBSIDIES

Despite their promises, subsidies are bad for the communities that provide them. Subsidies cause economic harm in the following ways:

- *Subsidized companies are made less efficient*. By allowing firms to shift costs onto taxpayers, subsidies allow firms to have higher production costs and to be less attentive to customer desires.

- *Entrepreneurs are encouraged to seek favors*. Subsidies encourage entrepreneurs to develop new ways to obtain political privilege rather than new ways to lower costs or enhance consumer welfare.
- *Nonsubsidized companies are harmed*. They are saddled with the tax cost of the subsidies given to their competitors.
- *Taxpayers foot the bill*. Scarce public resources, which could otherwise fund public services or tax cuts for all, are instead wasted encouraging business decisions that would likely be made anyway. These taxes, in turn, discourage other economic activity.
- *Communities are put at risk*. Subsidies can encourage overspecialization within a region, making communities more vulnerable to economic downturns.

## KEY TAKEAWAY

Economic subsidies rarely sway where a company chooses to invest. Instead, companies prefer locations that offer productive workers, efficient business logistics, and access to region-specific resources. Subsidies turn companies' attention away from satisfying consumers, cost taxpayers billions of dollars, and generally don't create the economic development they claim. Subsidies may harm the long-term health of the companies that receive them. And from a broader perspective, they are almost certainly harmful for economic development.

# 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 handout 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).

**ABOUT THE AUTHORS**

Michael D. Farren is a research fellow at the Mercatus Center at George Mason University. His research focuses on the effects of government favoritism toward particular businesses, industries, and occupations, specializing in labor, economic development, and transportation issues. Farren received his PhD in applied economics from Ohio State University and is also licensed as a professional engineer.

Matthew D. Mitchell is a senior research fellow and director of the Equity Initiative at the Mercatus Center at George Mason University. In his writing and research, he specializes in public choice economics and the economics of government favoritism toward particular businesses, industries, and occupations. Mitchell received his PhD and MA in economics from George Mason University and his BA in political science and BS in economics from Arizona State University.

MERCATUS CENTER
George Mason University

WWW.MERCATUS.ORG

MERCATUS CENTER
George Mason University

RESEARCH SUMMARY

# Interstate Compacts against Economic Development Subsidies: How to Stop the Economic Race to the Bottom

State and local policymakers use targeted economic development subsidies in an attempt to attract new businesses to their jurisdictions or to encourage already-established companies to expand or maintain their current operations. Unfortunately for policymakers and taxpayers, these subsidies are more likely to undermine economic development than to enhance it.

In "An Interstate Compact to End the Economic Development Subsidy Arms Race," Michael D. Farren and Matthew D. Mitchell examine subsidies such as cash handouts, income tax credits, and any government-granted privilege that creates exclusive economic benefits for the recipients. They explain why subsidies don't work and describe the economic problems they cause. The authors also explain why policymakers continue to offer subsidies. An interstate compact—an agreement not to offer subsidies—can stop this counterproductive economic race to the bottom.

## WHY SUBSIDIES DON'T WORK

- It is estimated that only one out of every eight subsidies influences a company's decision about where to locate, whether to expand, or whether to stay put. That means that most of the estimated $95 billion states and cities spend on subsidies every year is wasted.
- Subsidies must be funded by taxes—and higher taxes tend to discourage economic activity.
- Subsidies are also paid for by a reduction in spending on public services such as education, public safety, and infrastructure.
- Subsidies can also protect the subsidized company from competition. The company may not have to work quite as hard to create value for its customers or control costs as it would have without the subsidy.

## WHY POLICYMAKERS KEEP OFFERING THEM

- Many of the costs of subsidies (such as those listed above) are generally not considered, or are undercounted, before investment decisions are made.
- Taxpayers face greater difficulty in organizing to oppose subsidies than companies face in campaigning to maintain them.
- Politicians believe it is politically advantageous to offer subsidies, especially when politicians in other localities are doing so. A recent survey found that 84 percent of mayors believe it is beneficial to offer subsidies.

## INTERSTATE COMPACTS CAN MAKE THEM STOP

- States and cities can enter into agreements with each other to refrain from offering subsidies that seek to poach companies from one another.
- Such agreements, outlined in a clause in the US Constitution, are known as interstate compacts and carry the weight of law.
- During the past several years there have already been multiple attempts to develop an interstate compact to address the problems of economic development subsidies.
- Interstate compacts allow the states to work together to solve common policy problems without intervention by the federal government.

## AN INTERSTATE COMPACT WOULD DO MORE TO ENCOURAGE ECONOMIC GROWTH THAN ALL THE SUBSIDIES COMBINED

The money currently wasted on subsidies could be used to improve critical public services and provide tax reductions for all households and business. This change would do more to improve economic growth than the trillions of dollars that politicians have wasted on subsidies, trying to convince voters that they are doing something to improve the economy.