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TESTIMONY

AN INTERSTATE COMPACT TO PHASE OUT CORPORATE GIVEAWAYS

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

Connecticut General Assembly, Finance, Revenue and Bonding Committee

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Co-Chairs Fonfara and Scanlon, Representative Elliott, and members of the Finance, Revenue and Bonding 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 possible solutions available for Connecticut.

An estimated *$95 billion* is spent annually by state and local governments on economic development subsidies.[1] These subsidies remain a tenacious problem, even as support grows for phasing them out. My research suggests that an interstate compact offers an opportunity for a cooperative solution.

Academic research consistently shows that economic development subsidies fail to achieve their stated goals.[2] That is, they do not result in broad improvements in local and state welfare, nor are they likely to sway corporations' decisions of where to locate or expand.[3] This failure occurs for several reasons:

1. The taxes or diverted funding that pays for economic development subsidies create a negative economic effect that can reduce—or even exceed—the stimulating effect of the subsidy.[4]
2. The average accepted subsidy is likely to change only one out of every eight corporate location or expansion decisions. This means that almost 90 percent of subsidy spending is completely wasted, failing in its primary goal.[5]

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, "Florida Man Seeks a Quarter of a Billion Dollars That Won't Help State," *Medium*, October 30, 2015.
3. See the attached research summary and the paper it references for a more complete listing of why economic development subsidies fail to create the economic development they promise. 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).
4. Mitchell et al., "The Economics of a Targeted Economic Development Subsidy," 18.
5. Farren and Mitchell, "An Interstate Compact to End the Economic Development Subsidy Arms Race," 7.

For more information or to meet with the scholar, contact
Mercatus Outreach, 703-993-4930, mercatusoutreach@mercatus.gmu.edu
Mercatus Center at George Mason University, 3434 Washington Blvd., 4th Floor, Arlington, Virginia 22201

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3. Subsidies disrupt the normal workings of a healthy market and cause economic waste by
    a. protecting privileged companies from competition, enabling less efficient production,
    b. encouraging companies to make excessively risky bets,
    c. motivating investment and production decisions that are suboptimal, and
    d. inducing companies to pursue politically derived profits rather than focus on satisfying customers.[6]

Making matters worse, the subsidies used in this interstate arms race cause slower *national* economic growth.[7] This occurs even in the small number of situations when a subsidy does sway a corporation's location or expansion decision. When the subsidy "works," it has motivated a suboptimal economic decision that will result in an inefficient use of resources. An extreme example would be subsidizing Florida orange growers to move to Connecticut—doing so is technically feasible, but obviously not a wise decision.[8]

Despite these adverse economic outcomes, political-economic analysis suggests that governments continue to pursue economic development subsidies because the subsidies appear to be beneficial for the policymakers who support them:[9]

1. Academic research has shown that politicians seem to benefit by being seen as "doing something" to improve the local economy.[10] That is, good intentions and the short-term goal of good optics appear to matter more (especially with regard to reelection campaigns) than the real long-term economic effects (which are hard to accurately measure).[11] However, when taxpayers and voters are informed of the tradeoffs required by subsidies—higher taxes and reduced public services—their approval of these policies disappears.[12]
2. Most nonacademic studies of economic development subsidies use a "benefits-only" analysis that ignores costs (especially the economic impact of the taxes needed to fund the subsidies) creating a culture of misinformation regarding the expected effect of the subsidies.[13]
3. The uneven distribution of benefits (which are concentrated on the subsidy recipients) and costs (which are spread out across all other taxpayers) means that the recipients have a strong incentive to lobby for their subsidies, whereas the many dispersed taxpayers have difficulty mounting an effective protest.[14]
4. The pressure to offer subsidies is particularly difficult to resist when politicians in other cities and states engage in the practice, creating a prisoner's dilemma where a policymaker feels compelled to support offering subsidies, even if doing so doesn't seem right.[15]

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6. Mitchell et al., "The Economics of a Targeted Economic Development Subsidy," 24.
7. Farren and Mitchell, "An Interstate Compact to End the Economic Development Subsidy Arms Race," 9.
8. This insight is not new. As Adam Smith observed almost 250 years ago in *The Wealth of Nations*, "By means of glasses, hotbeds, and hotwalls, very good grapes can be raised in Scotland, and very good wine too can be made of them at about thirty times the expense for which at least equally good can be brought from foreign countries." Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (n.p.: Simon & Brown, 2012), book IV, chap. II, para. 15.
9. Mitchell et al., "The Economics of a Targeted Economic Development Subsidy," 32.
10 Nathan M. Jensen and Edmund J. Malesky, *Incentives to Pander: How Politicians Use Corporate Welfare for Political Gain* (Cambridge: Cambridge University Press, 2018).
11. Farren and Mitchell, "An Interstate Compact to End the Economic Development Subsidy Arms Race," 12.
12. "When you start to show voters not just the incentives, but also what the alternatives are that their money could be used for—whether tax cuts or more spending on education—political support for these incentives falls dramatically." Richard Florida, "Why Do Politicians Waste So Much Money on Corporate Incentives?," *CityLab*, May 24, 2018.
13. Farren and Mitchell, "An Interstate Compact to End the Economic Development Subsidy Arms Race," 11.
14. Mitchell et al., "The Economics of a Targeted Economic Development Subsidy," 32.
15. Farren and Mitchell, "An Interstate Compact to End the Economic Development Subsidy Arms Race," 13.

There is reason for optimism today. The interstate compact proposed in HB 6176 offers a path out of this self-destructive cycle. The ability of states to enact legislation to enter into a compact is enshrined in the US Constitution, and compacts provide a credible way for policymakers to commit to cooperation. The confidence such a commitment provides is critical because it removes the perceived vulnerability that comes from unilaterally exiting an arms race—even when the arms race causes more harm than benefit.[16]

With the security offered by a compact, forward-thinking policymakers will be able to shift the paradigm to one where states create economic development by fully focusing on becoming great places to live, rather than wasting time courting corporations' affection.[17]

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

ATTACHMENTS (3)

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).

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

16. Farren and Mitchell.
17. Michael D. Farren and Andrea O'Sullivan, "Want to Attract the Next HQ2? Become the Best Place to Live," *The Bridge*, December 6, 2018.

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.

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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.

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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.

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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.

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- *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.