

# Effects of Using Subsidies in Economic Development

## Introduction

Democracy for East Tennessee is a progressive, nonpartisan, organization working to promote government of the people, by the people and for the people. Motivated by the concern that tax subsidies to external businesses to influence their location decision is unfair to existing businesses and regional taxpayers, not providing equal treatment under the law, DFET conducted an internet information search on subsidies.

Government intervention in the private sector to expand the regional economy is the mission of economic development. Economic development interventions have used a variety of tools; one which has widespread use in state and local governments is subsidy of private businesses. The subsidies (often called incentives) are treated by governments as though they are necessary causative factors in companies' decisions to locate within the governed region.

## Results

Internet searches resulted in the following anecdotal evidence relevant to the necessity of and the effects of subsidies.

- HIP Healthcare's CEO said it was nice to receive the \$10M grants but that they were not a factor in their business decision to relocate.
- Pfizer executives explained why the city's \$46M subsidy did not drive their decision to expand in NYC.
- American Express says it would have stayed downtown even without a \$25M retention grant.
- In Ft. Worth, Texas, Cabellas, a mega 1.7B sales chain store, received tax benefits of \$30-40M based on promises of drawing 4.5M crowds to town. It didn't happen, so the taxes were shifted to the local citizens.
- In Pittsburgh, late 1990s, a store investment of \$70M was made, but projections of property taxes and sales taxes were too high. The store closed, leaving the city and taxpayers with the bill.
- United Airlines used \$320M of taxpayer money to build an advanced aircraft maintenance center at Indianapolis International Airport. They left, leaving the city and state governments with a bill and a special facility with no new tenants in sight.
- Two University of Iowa professors estimated the national loss of city and state tax revenue through incentives at \$30-50B annually.
- Past Treasury Secretary, Paul O'Neill said, "As a businessman I never made an investment decision based on the tax code. If you give money away, I will take it, but good business people don't do things because of inducements."
- Michael Bloomberg, current NY City Mayor and business financial expert, stated that "Any company that makes a decision about where they are going to be based on the tax rate, is a company that won't be around very long"

The search also found a more organized literature review which was done and reported in book form in 2004. The Economic Policy Institute published the book *Rethinking Growth Strategies* ([http://www.epinet.org/content.cfm/books\\_rethinking\\_growth](http://www.epinet.org/content.cfm/books_rethinking_growth)) by economist Robert Lynch, which is a comprehensive investigation of economic growth literature; hundreds of reports of survey research, economic studies and the representative firm. Some major results are listed below:

- "A review of the hundreds of ----studies that have evaluated the effects of state and local tax cuts and incentives also makes clear that these strategies are unlikely to stimulate economic activity and create jobs in a cost effective manner."
- "But state and local taxes (of corporations) are not typically a significant cost of doing business. Indeed, the cost of taxes pale in comparison to many other location specific costs including qualified workers, proximity to customers, and quality public services--"

- “The literature on the effects of state and local public services indicates that state and local spending may stimulate growth and create jobs.”
- “Research, in fact, substantiates that public investment plays a positive role in helping lower costs for firms.”

## Conclusions

- Subsidy is not a causative factor in new business location and is frequently unnecessary.
- There is compelling evidence that subsidies are frequently the cause of losses, which revert to taxpayers.
- Based on the considerable evidence found; subsidies of private business are not an effective tool in economic development..
- Government expenditures on regional public services of value to citizens and businesses are a valuable alternative to subsidies of particular private companies.

## Recommendations

- Eliminate subsidy as a tool for economic development. Seek companies who are willing to pay their own way.
- Spend revenue on improving the regional services of value to businesses and citizens.
- Government officials at all levels involved in economic development policy decisions apply the findings of *Rethinking Growth Strategies*. It may be downloaded and printed free from the website identified above. A summary of the book is attached below.

***Rethinking Growth Strategies***, an economic research summary book by economist Robert Lynch, published in 2004 by the **Economic Policy Institute** was quoted and recommended above. Excerpts are printed below for your convenience, the entire book may be downloaded free from the publisher’s website at:

([http://www.epinet.org/content.cfm/books\\_rethinking\\_growth](http://www.epinet.org/content.cfm/books_rethinking_growth))

### Executive summary

Creating jobs and growing the economy are top priorities for state and local officials. Their tools of choice to achieve these goals may, however, be the least effective among those available to them. Too often public officeholders first embrace lowering taxes and creating tax incentives as their chief economic development tools, with public investment usually ranking as a distant third option. *An analysis of the relevant research literature, however, finds little grounds to support tax cuts and incentives—especially when they occur at the expense of public investment—as the best means to expand employment and spur growth.*

It is commonly thought that firms will migrate to a particular state for the purpose of reducing costs, since lower costs may result in higher profits for business owners. But state and local taxes are not typically a significant cost of doing business. All state and local taxes combined make up but a small share of business costs and reduce profits only to a limited extent. Indeed, the costs of taxes pale in comparison to many other location-specific costs, and numerous location factors—including qualified workers, proximity to customers, and quality public

services—can be more critical than taxes. The availability of these vital location factors depends in large part on each state and locality's commitment to public investment—and their ability to pay for it. Research, in fact, substantiates that public investment plays a positive role in helping lower costs for firms.

Ultimately, the proof of the power of tax cuts and incentives to attract or retain business and create jobs lies in how firms respond to them. On this score, the evidence fails to support the claim that growing the economy requires shrinking the public sector and reducing taxes. In particular, there is little evidence that state and local tax cuts—when paid for by reducing public services—stimulate economic activity or create jobs. There is evidence, however, that increases in taxes, when used to expand the quantity and quality of public services, can promote economic development and employment growth.

There are five main types of arguments given for cutting taxes and offering tax incentives at the state and local level; these arguments raise issues such as the tax burden, the supply-side effects, the demand-side effects, the business-climate impacts, and the competitiveness implications of taxation. These kinds of arguments have been repeated so frequently that they are often accepted uncritically. Almost any time a tax increase on individuals or businesses is proposed, politicians or special interest groups invoke one or more of these arguments to assert that the proposed tax increase will seriously damage the economy and cause a significant loss of jobs. While not totally without merit, these five arguments overstate the case for reducing taxes, as well as ignore counter evidence and disregard the economic impacts of the spending alterations that governments take in response to tax changes. The significant weaknesses in these arguments show them to be less than persuasive as justifications for state and local tax cuts.

A review of the hundreds of survey, econometric, and representative firm studies that have evaluated the effects of state and local tax cuts and incentives also makes clear that these strategies are unlikely to stimulate economic activity and create jobs in a cost-effective manner. A close examination of the recent econometric literature on the effects of tax cuts (analyzed in detail in Chapter 4) demonstrates how these kinds of studies have been misused to justify tax cuts on economic grounds. In particular, this literature review points out that some recent econometric studies find that state and local taxes have either a positive or no effect on economic activity, and most of the studies that suggest taxes have a small negative effect on economic activity do so only when public spending is held constant as taxes increase—a circumstance that is highly uncommon in the real world. Moreover, even the small negative effects of state and local taxes that some econometric studies find are likely somewhat exaggerated and do not support the notion that state and local tax cuts and incentives can be counted on to create numerous jobs or to do so in a cost-effective way. The bottom line is that state and local taxes, at their current low levels, may be largely irrelevant to business investment decisions.

The literature on the effects of state and local public services indicates that state and local spending may stimulate economic growth and create jobs. In addition, the studies that have examined the net effects of simultaneously changing taxes and public spending—arguably those studies that provide the best "real world" measure of the effect of state and local tax cuts—generally find that raising taxes and using the additional revenues to pay for more public services enhances economic growth and expands employment.

It follows that, if taxes are not a decisive factor and public spending can be a positive force, then the use of tax cuts to create jobs can carry uneconomical "costs per job." Even with optimistic assumptions, for each private-sector job created by state and local tax cuts, governments may lose between \$39,000 and \$78,000 or more in tax revenue annually. This substantial revenue loss forces governments to lay off public employees in numbers that probably exceed the number of jobs created in the private sector. The net effect of tax cuts is thus likely to be a loss of

employment. In addition, the public would lose the value of the public services that would no longer be provided. So, while access to jobs is clearly a vital concern in today's economy, public officials and voters should focus not solely on faith in tax cuts but on the best ways to get employment results. In the end, any jobs that might be gained by cutting taxes can be more than offset by the jobs lost as a result of cuts in public services.

State and local tax cuts and incentives are probably not the best use of public revenues, even when the object is to encourage business firms to put more people to work. This finding confirms that state and local officials should take into account public-service as well as tax effects on the economy when considering fiscal policy designed to promote optimal job growth. Tax increases used to enhance public services can be the best way to spur the economy. By stimulating growth, generating jobs, and providing direct benefits to residents, improvements in state and local public services can be one of the most effective strategies to advance the quality of life of citizens.

## Introduction

- Over the past 35 years, nearly every state and local government has expanded its efforts to promote economic development. While the primary goals of these efforts are laudable—more jobs and faster economic growth—the techniques employed are too often of dubious value. Not only may these techniques be ineffective, but they may also undermine the ability of state and local governments to invest adequately in the public services and infrastructure that are necessary for long-term economic growth and development.
- Although state and local economic development strategies are numerous and varied, by far the most expensive techniques involve broad-based tax cuts and targeted business tax breaks. For seven consecutive years from 1995 to 2001 state governments cut taxes, with the total tax cuts amounting to over \$35 billion.<sup>1</sup> Much of this tax cutting was in the name of economic development. Perhaps more significantly, special state and local tax loopholes, tax credits, and tax abatements to business (generally referred to collectively as "tax expenditures") have grown dramatically over the past 35 years and now total billions of dollars annually. Data from eight states suggest that state and local business tax breaks and subsidies summed nationally to \$48.8 billion in 1996.<sup>2</sup> Tax expenditures now easily dwarf all the other money spent on state and local economic development programs.
- The record economic expansion that started in March 1991 and ended in March 2001 caused incomes to soar and allowed state and local revenues and spending to rise despite tax cuts. During the booming 1990s, state and local government spending (excluding federal grants-in-aid) more than kept pace with growth in the economy, increasing slightly from 9.8% of the gross domestic product (GDP) in 1991 to 10% of GDP in 2001.<sup>3</sup> However, the effects of these tax cuts, in combination with the slow economic growth of the recent past, are starting to catch up with state budgets, and in 2002 and 2003, most states cut spending on programs.<sup>4</sup> The pressure to cut state and local spending is likely to persist as long as these jurisdictions continue to face budget deficits, demands for additional tax cuts, and calls for a smaller role for government.
- The almost universal justification for tax cuts and business tax incentives is that they are the best ways to create jobs and spur growth. This assertion is made even when state and local governments must cut public services as a consequence of tax incentives and tax reductions. Taxes, and many of the government programs they pay for, are seen as burdens on the private sector and impediments to economic growth.

- But do tax cuts and incentives create jobs in a cost-effective manner? Conversely, do state and local public services undermine growth? A review of the available data strongly suggests that the answer to both of these questions is no. And while state and local tax cuts may in theory stimulate economic activity, in practice they are unlikely to do so. This means that state and local governments may be wasting billions of dollars annually on tax cut policies that are failing, while underfunding programs that can promote long-term growth and job creation.
- The following section discusses the five main arguments generally cited in support of cutting taxes and offering tax incentives at the state and local level. It also critically examines each of these tax cut arguments. This examination of the basic economic arguments for tax cuts is followed by a thorough review of the studies that have evaluated the effects of state and local tax cuts and incentives. The literature review includes survey research, the statistical and econometric studies, and the "representative firm approach" research. An analysis of this literature explains why state and local tax cuts and incentives are unlikely to stimulate economic activity and create jobs in a cost-effective manner. The literature on the effects of state and local public services, which indicates that state and local spending may stimulate economic growth and create jobs, is also discussed. Finally, the studies that have examined the net effects of simultaneously changing taxes and public spending are reviewed. These studies generally find that raising taxes and using the additional revenues to pay for more public services enhances economic growth.

## **About the Author**

Robert G. Lynch is an associate professor and chairman of the Department of Economics at Washington College, where he has taught since 1998. Previously, he taught at the State University of New York at Cortland, where he served as chair of the department of economics from 1991 to 1993. His areas of specialization include public policy, public finance, international economics, economic development, and comparative economics. In the past he has evaluated the adequacy and effectiveness of various state and local government economic policies, reviewed economic growth strategies, and analyzed the efficiency, fairness, and stability of state and local tax systems. Professor Lynch is also the author of several papers that have analyzed the effectiveness of state and local government economic policies in promoting economic development and creating jobs. He graduated with a B.A. degree in international and development economics from Georgetown University in 1979, earned a master's in economics from the State University of New York (SUNY) at Stony Brook in 1981, and received a Ph.D. in economics from SUNY Stony Brook in 1984.