How Competition to Attract Businesses Leads to Economic Losses for Cities and States

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A firm announces a plan to build a new facility, but where? Local and state development officials compete to attract the firm with ever-more-generous tax breaks and subsidies. This scene plays out again and again – even though research shows that incentives do not substantially influence firm behavior, even in the face of media exposes about wasteful giveaways. Why? Governments hope to encourage jobs and business profits, and hubris leads officials to believe "this time will be different," even if incentives have not worked before.

But something more pervasive is also at work. My research with Stephen Ellis demonstrates the role of "business climate" in driving economic development professionals and government officials to engage in an incentives arms race. Officials feel they must offer incentives, because failing to compete to attract businesses will be interpreted as evidence that their locality is not business-friendly. States and localities will therefore continue to compete, to the point of giving away more than the value of the new firm or facility. Can American citizens find ways to prevent the negative effects of this no-win arms race?

Pressures to Signal a "Good Business Climate"

"Business climate" is a broad concept invoked to indicate how pro-business a community is. A good business climate is believed to influence firm decisions over the longer term. Many economic development officials emphasize that offering incentives is a way to grab the attention of firms that may want to grow in their locality in the future. In this way of thinking, offering big tax breaks or subsidies is simply the unavoidable cost of promoting local development – just like the cost of advertising analogous to firms promoting certain brands or products.

Consider Alabama's perception of the marketing value it gets in return for giving huge subsidies to attract a new Mercedes-Benz plant, incentives totaling more than $168,000 per new job. "It's an attention grabber," explained one development advisor, who argues that the fiscal cost is not the point. According to Governor Jim Folsum, the Mercedes deal was a symbolic way to "break through old stereotypes and announce to the corporate world that Alabama is open for business."

The corporate world is not the only audience. Politicians who want to appear to be "doing something" to create jobs use incentives to send a pro-business signal to voters as well as firms. Each locality's desire to demonstrate a superior business climate fuels the incentives arms race.

How the Incentives Competition Creates Losses for all Localities

A simple formal model can be used to show why it is that, when many localities compete to offer incentives for a new business facility, the economic consequences are likely to be perverse for all. In our model, the firm's choice among identical localities is solely driven by the value of incentives offered. Because the leaders in each locality will offer incentives to avoid sending a discouraging signal about their business climate, everybody jumps into the competition – and the incentives escalate until the firm gets pay-offs equal in value to *all* of the economic benefits the new firm will create for its lucky home locality.

In short, localities are compelled to compete and offer overly generous incentives, not because they stand to gain anything economically, but because they can't afford to send a negative signal about their business climate. "You can't say no, but you can't afford to say yes" is how Stephen Goldsmith, Mayor of Indianapolis, aptly summed up the situation.

Can America Limit This Damaging Competition?

This is a good example of what scholars call a "prisoner's dilemma." It would be better if all localities could cooperate. But they cannot cooperate voluntarily, and any locality that refuses to offer incentives gets a reputation for a bad business climate. It is too costly to refuse to compete, and it hard to see how cooperation could be orchestrated or enforced.

- At the state or regional level, we might imagine a world in which a steady flow of new business facilities are built, and each place waits in line for "its turn" to attract a firm with good community conditions and some small subsidies. But how could this happen? Localities would have to keep any new ones from jumping into the competition, and every state or city would have to take the long-run view. None of this is realistic in an economy with booms and busts, and politicians who are elected for just a few years.

- National solutions are equally unlikely. The federal government would violate the U.S. Constitution if it tried to prevent states and cities and towns from offering incentives to promote commerce. Theoretically, a federal tax could be levied on locally offered incentives to attract business, but it would have to be set at the politically unrealistic rate of 100%; otherwise, businesses would still want to shop for the best incentive deal.

In practice, state and local economic development professionals will continue to compete to send highly visible signals about their community as a "great place for business." The only hope is to limit the all-around damage with decision-making processes that minimize the chances that a locality can be lured into bad deals or pay too much to attract a business. Possible steps include:

- Requiring comprehensive analyses to spell out the full cost of each project, including costs for new public services and stress to the environment, as well as the price of incentives.

- Designing incentives to include independently verifiable requirements that firms actually generate the promised jobs and economic growth – or else pay back some of the subsidies.

- Getting citizens much more involved, by vetting proposed deals in a public forum where officials would have to spell out expected gains in jobs and growth. Officials would be more accountable to voters if the deal turns out to be nothing more than a costly give-away.

Although pressures to engage in the incentives arms-race will persist, good governance and citizen engagement can help to mitigate the potential pitfalls for every U.S. community and state.

Read more in Cynthia Rogers and Stephen Ellis, "Local Economic Development as a Prisoners' Dilemma." *Review of Regional Studies* 30, no. 3 (200): 315-330.