

## Business Location Incentives are Ineffective – So Why Do They Persist in American States and Localities?

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At governors' websites, state economic development offices, and local council meetings, Americans often hear boasts about "economic development incentives" – or references to more technical versions such as "tax increment financing" or "industrial revenue bonds." Supposedly, these are economic development tools that channel government resources to private businesses in order to attract investment, encourage expansion, or retain a company threatening to relocate to another country or state. Such policies can range from tax holidays that provide firms with a reprieve from state and local taxes, to public financing for infrastructure improvements or grants to retrain workers.

The complex economic justifications for these business incentives warrant scrutiny. Supporters sometimes claim that granting benefits to individual private businesses will spill over to encourage broader economic development – an argument similar to those used to justify public financing for the Olympic Games or National Football League stadiums. Another line of reasoning is that the intense competition among countries, states and cities necessitates the use of incentives – to ensure that footloose local firms don't relocate. These justifications may seem reasonable, but academic research casts serious doubt on the effectiveness of economic development incentives, and my own work shows that they are often politically motivated.

### Economic Development Incentives are Ineffective – and Expensive

Numerous studies have attempted to evaluate the impact of economic development incentives on job creation and state and local tax bases. Despite tremendous variation in program types, a common pattern emerges: Studies of incentives, including my own work, find that two-thirds to three-fourth of incentives are redundant – in that they give businesses extra benefits to do things they would have done even without incentives. Most firms that receive these benefits had already chosen to relocate or expand, so the incentives as such were not decisive.

In some cases, incentives can swing investments from one community to another – if, for example, businesses are indifferent about several alternative locations. But even in such unusual situations, incentives are not optimal economic development tools.

### But Business Incentives are Smart Political Strategies

Research documenting the economic wastefulness of location incentives is not new. So the obvious question is this: if the ineffectiveness of these policies is so well known, why do legislators still enact them? My own research points to the political effects of these programs. In a series of surveys I carried out with co-authors, we examined how voters reward or punish politicians for using economic development incentives – and we found that deploying incentives was always a winning political strategy. If a company was already planning on moving into a politician's state, offering an incentive allowed the politician to take credit for the relocation. If the state didn't attract an investment, the politicians could minimize blame for losing it by showing that they had valiantly tried to keep or attract it. Either way, even if incentives had zero impact on firm decisions, politicians could use these policies to signal to voters that they were aggressively promoting job creation and local economic development. When businesses made decisions that boosted the local economy, the politicians could appear partly responsible.

In a study of local governments, we learned more about official use of business incentives for electoral gain. We found that directly elected mayors, as opposed to appointed city managers, offered larger incentives and engaged in much weaker oversight of business incentive programs. Elected mayors offered more money and conducted fewer and less rigorous cost-benefit analyses to investigate whether the incentives were

economically useful.

Political incentives are, in short, front and center in the business incentive game – but not, notably, incentives operating through campaign contributions or other indirect exchanges between business investors and politicians. When location incentives are deployed, the political game is very public, because office-seeking politicians are offering support to business in order to take visible credit for economic development.

## **Reform Depends on Making Costs and Trade-Offs Publicly Visible**

Our findings on the political logic of incentives highlight the difficulty of reform. To be sure, many states and cities *are* enacting greater oversight of these programs, assuring that issues such as conflict of interest or firms taking incentives and breaking agreements do not go unnoticed or without redress. These are important reform steps, but they do not get at the heart of the problem. The real issue is that many of these incentives go to firms that don't need the funds, and the incentives do not actually sway investment decisions. The status quo persists because politicians gain electorally from handing out incentive checks – and firms would be silly to not cash them.

In a series of follow-up surveys, my research colleague Edmund Malesky and I found that presenting voters with information about the tradeoffs between incentives and other government policies can affect the politics of incentives. If voters see incentives not as a costless economic development strategy, but as payoffs that come at the expense of school funding or lower taxes for everyone, then public support for these policies – and the politicians who push them – plummets.

In sum, the key to building public support for reform lies *not* in providing information on the excessive *use* of incentives, but in displaying their true *costs* to the communities these programs are supposed to benefit. Fortunately, the Government Accounting Standards Board – the organization which creates generally accepted accounting principles used by state and local governments – is pushing governments in this direction. The newly passed Rule #77 requires local governments to document the tax costs of incentives, making the pros and cons more transparent. Providing voters with meaningful information on the real costs of these programs – and the hard trade-offs they entail – is the first step towards meaningful reform.

**Read more in Nathan M. Jensen, "Job Creation and Firm-Specific Location Incentives." *Journal of Public Policy* (March 2016); 1-28; and Nathan M. Jensen, Edmund Malesky, Mariana Medina, and Ugur Ozdemir, "Pass the Bucks: Credit, Blame and the Global Competition for Investment." *International Studies Quarterly* 58, no. 3 (2014): 433-447.**