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The Political Economy of Targeted Economic Development Incentives*

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Abstract: The use of targeted economic development incentives—or selective financial and regulatory incentives to encourage particular firms to relocate or expand—has proliferated in recent decades. However, the relationship between these targeted incentives and another approach to economic development, economic freedom, has not been studied. This article reviews several new studies assessing this relationship, and provides a review of academic literature evaluating how targeted incentives affect communities as a whole, including those firms and industries not receiving subsidies from government. It concludes by discussing areas for future work.

Keywords: economic development incentives, tax increment financing, business subsidies, local economic development, deal-closing funds, targeted economic development incentives, economic freedom, subsidies, economic growth.

JEL Codes: F43, H11, H25

1. INTRODUCTION

Policymakers at all levels of government seem to be keenly interested in policies that might boost economic growth for their constituents. Increasingly, they have turned to targeted economic development incentives to achieve this end (Bartik, 2017).[1] In recent years, states and localities have spent approximately $70 billion per year on targeted incentives (Good Jobs First, 2017). Given the ubiquitous use of these incentives to spur economic development, ascertaining the relationship between targeted incentives and another possible strategy for economic development—economic freedom—is an important (and relatively unexplored) line of research.

Questions about government involvement in the economy are often framed in terms of government size and scope, often looking at the *level* or extent of government spending, taxation,

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[1] Bartik reports that the use of business incentives like property tax abatements and job creation tax credits targeted to particular "new or expanding businesses" has, "more than tripled since 1990."

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and regulation. The economic freedom literature exemplifies this approach. But this way of framing the question obscures another important dimension: the variance in government involvement across firms, industries, or locales. Governments do not just establish levels of spending, taxation, and regulation. They also use a "targeted approach" to economic development that selectively favors particular firms and industries with benefits like targeted tax relief, cash subsidies, regulatory dispensations, and in-kind donations of land and other valuable goods and services. Instead of using lower taxes or reduced regulation across-the-board (or economic freedom) to encourage development, politicians select firms to receive these benefits.

In this special issue, the authors explore the relationship between economic freedom and targeted economic development. What is economic freedom, and how do targeted economic development incentives affect it? Does economic freedom causally determine differences in targeted taxation and spending? Or do targeted incentives causally determine economic freedom? And, finally, what are the economic effects of targeted economic development incentives?

2. ECONOMIC FREEDOM

Since at least Adam Smith, economists have emphasized that institutions—"the rules of the game in a society," as Douglas North (North, 1990, p. 3) defined them—shape human activities and economic outcomes. Smith (1776) argued that the market institution, what he termed "a system of natural liberty," channels private self-interest toward the public good.[2] In recent decades, "New Institutional Economics" has returned to this theme, exploring how varying institutional arrangements affect economic performance (North, 1990; Rodrik, Subramanian, and Trebbi, 2004; Acemoglu and Robinson, 2012). In one important strand of this literature, economists rely on measured economic freedom as one way to empirically test the institutional hypothesis.

The first *Economic Freedom of the World* (EFW) Index was produced by Gwartney, Block, and Lawson (1996). Since then, it has become a regular publication of the Fraser Institute, with Gwartney, Lawson, and Hall authoring the latest reports. Economic freedom is rooted in classical liberalism, and emphasizes the importance of "personal choice, voluntary exchange, freedom to enter markets and compete, and security of the person and privately-owned property" (Gwartney, Lawson, and Hall, 2017). The international index attempts to measure these concepts with publicly-available data. Higher economic freedom scores are assigned to, "nations with more secure property, freer trade, more stable money and prices, less government spending, and fewer regulations." (Hall and Lawson, 2014). In a broad survey looking at 198 empirical papers that use the EFW index as an independent variable, Hall and Lawson (2014) find more than two-thirds of these studies show economic freedom correlates with "good" outcomes—such as faster economic growth, higher living standards, longer life span, and greater happiness—while fewer than 4 percent find the EFW index to be associated with "bad" outcomes—including war, human rights violations, and income inequality. In a survey focused on the relationship between economic freedom and growth, Doucouliagos and Ulubasoglu find that, "regardless of the sample of countries, the measure of economic freedom and the level of aggregation, there is a solid finding of a direct positive association between economic freedom and economic growth." (Doucouliagos and Ulubasogul, 2006, p. 78).

[2] See, for instance, Smith's famous quote, "it is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest."

Beginning in 2002, the *Fraser Institute* has produced a regular economic freedom index at the subnational level for North America, including Canada, the United States, and Mexico (Stansel, Torra, and McMahon, 2017). Several studies in this special edition (Dove and Sutter, 2017; Calcagno and Hefner, 2018) use this *Economic Freedom of North America* (EFNA) index to quantify varying levels of economic freedom across U.S. States. EFNA measures economic freedom across three categories of government policy: government spending, taxes, and labor market freedom (Stansel, Torra, and McMahon, 2016).[3] Much like the EFW index, EFNA's measure of economic freedom across U.S. states has been found to have a positive, and statistically significant association with various measures of well-being, including: economic growth (Compton, Giedeman, and Hoover, 2011), income levels (Karabegovic et al., 2003), employment growth (Garrett and Rhine, 2011), employment-to-population ratios (Heller and Stephenson, 2014), firm growth rates (Campbell, Fayman, and Heriot, 2011), firm creation (Campbell and Rogers, 2007; Campbell et al., 2012), the growth rate in the number of proprietorships (Goetz and Rupasingha, 2009), and the growth rate of sole proprietorships (Kreft and Sobel, 2005).

This line of literature suggests that measured economic freedom does have a positive relationship with various measures of economic well-being. In the next section we turn to another strategy for economic development, targeted economic development incentives.

3. WHAT THE LITERATURE SAYS ABOUT THE EFFECTS OF TARGETED ECONOMIC DEVELOPMENT INCENTIVES

While both theoretical and empirical evidence suggest that there is a positive association between economic freedom and prosperity at the state level, the academic literature finds that targeted incentives are less effective in promoting broad-based prosperity. For one thing, targeted incentives entail an opportunity cost. Incentives direct taxpayer dollars to particular firms and industries which might have been used to provide public goods or to lower tax rates for all (Wang, 2016; Dove and Sutter, 2017). While targeted tax cuts and subsidies might spur economic activity among privileged firms, they discourage economic activity elsewhere in the economy by necessitating higher tax rates—and therefore higher deadweight losses—born by firms and customers in non-privileged sectors. In fact, a well-known theory in modern public finance holds that uneven taxation of otherwise similar activities entails larger deadweight loss than broader taxation with lower rates (Rosen and Gayer, 2013).

Furthermore, when targeted incentives entail outright subsidies, they encourage investments in which marginal costs exceed marginal benefits, resulting in "too much" of the subsidized activity (Mitchell, Horpedahl, and Gonzalez, forthcoming). Subsidies also insulate privileged firms from competition, making them less efficient and less accountable to consumer demands (Leibenstein, 1966). The very possibility of selective privileges encourages firms to inefficiently spend resources seeking privilege from policymakers (Tullock, 1967; Krueger, 1974).

Targeted tax cuts and regulatory relief may be the inevitable outcome of economic principle meeting the incentives of real world democratic politics. Across-the-board tax and regulatory cuts themselves represent a public good for businesses. All taxpayers benefit from a

[3] The ten variables include: General Consumption Expenditures by Government as a Percentage of Income, Transfers and Subsidies as a Percentage of Income, Insurance and Retirement Payments as a Percentage of Income, Income and Payroll Tax Revenue as a Percentage of Income, Top Marginal Income Tax Rate and the Income Threshold at Which It Applies, Property Tax and Other Taxes as a Percentage of Income, Sales Tax Revenue as a Percentage of Income, Minimum Wage Legislation, Government Employment as a Percentage of Total State/Provincial Employment, and Union Density.

reduction in rates or elimination of a regulation, regardless of whether they contributed to the political effort or not. Lobbying for lower tax rates is a voluntary contribution to the provision of a public good, and should be underprovided relative to the optimal for businesses as a whole. Targeted exemption from taxes and regulations, by contrast, are excludable, allowing politicians to provide relief only for the firms they select, whether due to contributions or other political considerations. Once the option of targeted relief becomes available, why should we expect businesses to lobby for the public good instead of the private good? Businesses could further leave the tax and regulatory burden for their rivals unaffected by lobbying only for targeted relief, creating a competitive advantage.

But political realities also create the potential for the influence of politics over economic decisions. Targeted policies reward small, highly-organized interest groups with concentrated benefits paid for by taxpayers, consumers, and other competitors. Relative to the beneficiaries, the groups that pay for these targeted benefits are unorganized and diffuse, and so tend to find it costlier to resist these policies, even if the total costs exceed the total benefits (Olson, 1965). Because the benefits of targeted incentives are immediate while the costs are often shifted into the future, incentives also encourage intertemporal cost-shifting.[4] The result can be more crony capitalism in the economy.

Mitchell, Horpedahl, and Gonzalez (forthcoming) conduct an extensive review of 90 peer reviewed studies that empirically assess the effect of targeted economic development incentives on a variety of economic variables. They distinguish between those studies that take a narrow-scope approach, or "assess the effect of incentives on the favored firm or region," and those that take a broad-scope approach, or "assess the effect of incentives on the community at-large." This distinction is important because the stated aim of targeted incentives is to promote economic development for the entire community that funds the project, not just for the targeted firm or region. Of 32 studies that examine the effects of targeted incentives broadly, only 3 (9 percent) find positive effects while 6 (18 percent) find negative effects for the community at-large. The rest either find no statistically significant effect or mixed results.[5] Among the 58 studies that take a narrow approach to assessing targeted incentives, 38 (66 percent) find privileged firms and regions benefit from targeted incentives while the rest find insignificant, mixed, or even negative results.

3.1 Economic Freedom and its Relationship with Targeted Economic Development Incentives

As Dove and Sutter (2017) point out in their article, the relationship between targeted economic development incentives and economic freedom is, at first, ambiguous. Targeted incentives do spell relief from the "higher taxes and stricter regulations" that are negatively associated with economic freedom, albeit in a "piecemeal" fashion for particular firms and industries. But targeted incentives, since they are not economy wide, might encourage policymakers to "increase spending and raise tax rates to recoup exempted tax revenue." So it is unclear whether targeted incentives are "a form of government-constraining competition or an example of unhealthy crony capitalism."

[4] For an explanation of how political incentives encourage the use of policies that appear to demonstrate immediate benefits, but push costs off into the future, see Buchanan and Wagner (1977).

[5] The 90 peer reviewed studies excluded economic development programs at the federal level, and were published between the years of 1990 and 2016.

The articles in this special edition all explore some aspect of this relationship. Each study in this special edition was presented at the 56th Annual Meeting of the Southern Regional Science Association in Memphis, Tennessee, in sessions titled "Targeted Economic Development Incentives, Economic Freedom, and Prosperity." These sessions sought to explore the relationship between economic freedom and targeted economic development strategies that employ tax exemptions or breaks, subsidies, and other forms of selective incentives to attract and retain businesses.

Three take a case study approach, looking to see whether targeted incentive programs at the state level benefit the economy as a whole. Two others look at the relationship between targeted incentives and economic freedom directly, and another assesses the effect of incentives on various measures of income inequality in the U.S. The mix of case studies and examinations across states highlights the complementary nature of these research methods. Case studies can examine individual programs in great detail, but have difficulty resolving questions about the generalizability or external validity of results. Studies across states can address generalizability, but good case studies inform researchers about program characteristics that wider studies may not consider.

3.2 Case Studies

Each of the state based case studies—for Missouri, Arkansas, and Florida—suggest that targeted incentives fail to provide widespread benefits. Paul Byrne (2018) looks at Tax Increment Financing (TIF) in Missouri, assessing whether the number of jobs reported by TIF proponents correlates with Bureau of Labor Statistics (BLS) data on actual employment. He finds no relationship between the jobs numbers reported by economic developers and BLS local employment data. Furthermore, he finds that when TIF is used to retain jobs, the number of reported retained jobs is negatively related to municipal employment, suggesting jobs retained as part of the TIF came at the expense of jobs elsewhere in the community.

Jacob Bundrick and Thomas Snyder (2018) look at the effects of Arkansas's Quick Action Closing Fund (QACF), which allows Arkansas's governor to use funds to close deals with firms looking to locate in the state. They find that subsidies positively correlate with private employment and establishments within the county in which they are issued. But, these subsidies negatively correlate with private employment and establishments in bordering counties, and the two effects roughly offset one another. When fiscal costs are considered, QACF subsidies have no relationship with county-level private employment and have a large, negative relationship with county-level private establishments.

An alternative to targeted incentives are uniform policies designed to promote growth. Hai Guo and Shaoming Cheng (2018) look at the impact of taxes and expenditures on the stock of small businesses in Florida. In a panel analysis of 66 Florida counties, they find that local sales tax rates significantly reduce the number of small businesses, while greater economic environment spending increases the small business stock. Low tax burdens and the right kind of government spending can spur entrepreneurship and business formation. Their analysis includes three types of spending—transportation, physical environment, and economic environment—and only the economic environment category correlates with more small businesses.

3.3 Targeted Incentives, Economic Freedom, and Income Inequality

Three studies address broader issues relating to economic freedom and income inequality, using the entire U.S. as the sample. Peter Calcagno and Frank Hefner (2018) look at data across states to see if economic incentives seem to be used to offset otherwise negative economic conditions. They find that states with higher unemployment rates, states with spending that exceeds revenues, and states with higher individual income tax burdens are more likely to offer particular firms targeted subsidies. Their results might explain the insignificant effects of incentives on growth: the weakest economies are using the incentives most intensively.

John Dove and Daniel Sutter (2018) take the reverse approach from Calcagno and Hefner, and try to understand whether targeted economic development incentives can explain economic freedom. In other words, they examine whether there is a tradeoff between economic development incentives and economic freedom. They find an economically and statistically significant negative relationship between incentives and economic freedom, suggesting that incentives reduce economic freedom.

Both Calcagno and Hefner, as well as Dove and Sutter, show the difficulty in disentangling the direction of causality in this relationship. While both show a negative relationship between targeted incentives and economic freedom, it is difficult to know whether states resort to targeted incentives because of poor tax, spending, and regulatory climates (i.e. low economic freedom), or whether targeted incentives to favored firms increase tax burdens for others, thereby reducing measured economic freedom, or if the same political forces leading to high taxes and spending lead to use of dubious incentives as well.

Jia Wang, Stephen Ellis, and Cynthia Rogers (2018) explore whether economic development incentives worsen inequality. In other words, are targeted incentives part of the set of government policies which might worsen income inequality in the U.S. (Mankiw, 2013; Lindsey and Teles, 2017)? They use three measures of inequality, the Gini coefficient, the share of income in the top 1 percent, and the share of income within the top 10 percent, and data from 2000 to 2009 from the U.S. states, and find evidence of a "reverse-Robin-Hood effect," whereby income is redistributed from the bottom 90 percent of people to the top 10 percent of people. This study sheds a normative light on the use of targeted incentives, and suggests that targeted incentives are regressive.

4. FUTURE WORK

While Dove and Sutter (2018) and Calcagno and Hefner (2018) are among the first to analyze the relationship between targeted economic development incentives and economic freedom, future work is needed to further explore this relationship. Both have found negative correlations between the use of incentives and economic freedom, but we do not know whether the use of targeted incentives explains economic freedom scores, or whether low economic freedom (such as bad tax and regulatory climates) encourages policymakers to use incentives as a way to overcome the policy environment. Of significance, however, targeted incentives do not seem to be diffusing wide enough to substitute for across-the-board tax and regulatory reform.

More research is also needed to determine the effectiveness of targeted incentives, but from a broad-scope perspective that looks at the effect of incentives on a community *as a whole*. Most studies only take a narrow approach. Bundrick and Snyder (2018) and Byrne (2018) look at the effects of targeted economic development incentives broadly and find they do not produce the benefits intended (primarily, an increase in employment, business establishments, or both). Guo and Cheng (2018), who show that general economic development policies (i.e. not firm specific

incentives) have a positive effect on the stock of small businesses in Florida counties, provide evidence that economic development can be cultivated without targeting specific firms. And if more evidence accrues that targeted incentives fail to achieve their intended goals, research must continue to look into other motives for the use of targeted incentives. Some have already looked at the political incentives involved in deciding on targeted incentives (Jensen, Malesky, and Walsh, 2015), but more research should follow Wang, Ellis, and Rogers (2018) to see whether these policies are a vehicle to transfer income.

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