

## **MICHIGAN SOAR FUNDING FOR ECONOMIC STIMULUS: EVEN THOUGH THE TRAIN HAS LEFT THE STATION, IT'S NOT TOO LATE TO CHANGE TRACKS**

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Michigan House Appropriations Committee

February 23, 2022

Chair Albert, Majority Vice Chair Whiteford, Minority Vice Chair Tate, and members of the House Appropriations 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 comment on Michigan's attempts to stimulate economic growth, especially the use of corporate subsidies such as those enabled by Legislative Transfer Request (LTR) 2022-1.<sup>1</sup>

The key takeaways of my testimony are as follows:

- House Bill 4082 (HB 4082), with its requirement that the Senate and House appropriations committees approve subsidy spending requests, is an ingenious solution to the “blank check” problem commonly seen with economic development subsidies.
- \$1.1 billion in subsidies have already been approved for the General Motors (GM) and Ultium Cells manufacturing plants for which LTR 2022-1 would provide an additional \$666 million.
- The purpose of HB 4082 was to provide legislators with the ability to reduce or deny subsidies for such projects, and policymakers should carefully weigh that option in this case.

### **LEGISLATIVE TRANSFER REQUEST 2022-1**

LTR 2022-1 is necessitated by the December 2021 enactment of House Bill 4082, which prohibits the State Administrative Board from transferring any funds appropriated by the legislature for one purpose to a state department, board, commission, officer, or institution for another purpose.<sup>2</sup> The effect of this additional check on administrative spending is that the \$1 billion the legislature has appropriated for the Strategic Outreach and Attraction Reserve (SOAR) Fund cannot be used by the Michigan Strategic Fund (MSF) to offer economic development subsidies through the Critical Industry Program (CIP) or

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1. Memorandum from Cory Savino, Transfer Coordinator, Senate Fiscal Agency, to Members of the Senate Appropriations Committee, (Jan. 27, 2022) (<https://www.senate.michigan.gov/SFA/StateBudget/LegisTransfer2022-1.pdf>).

2. H.B. 4082, 101st Leg., Reg. Sess. (Mich. 2021).

the Michigan Strategic Site Readiness Program (MSSRP) without direct approval from the Senate and House appropriations committees.<sup>3</sup>

HB 4082 is among the cleverest statutes regarding economic development subsidies that I have recently seen. State legislatures across the country have faced a repeating problem wherein they are asked to write what amounts to a blank check—approving billions in taxpayer funding for “transformative projects” without knowing who the recipient is or what the subsidized project would be.<sup>4</sup> But Michigan has set an example worth emulating in other states, because HB 4082 provides elected representatives the ability to specifically consider each proposed use of previously appropriated funds. This double-check ensures that appropriating legislations’ original intent is maintained and allows consideration of whether a better use of appropriated funds has since emerged.

### SUMMARY OF PROPOSED SUBSIDIES FOR GM AND ULTIUM CELLS

LTR 2022-1 would transfer \$666 million from the \$1 billion appropriated for the SOAR Fund to CIP and MSSRP to subsidize the construction of a new GM electric vehicle manufacturing facility and an Ultium Cells battery cell manufacturing facility. This is likely the exact sort of project that Michigan legislators had in mind when they approved the relevant pieces of legislation in December 2021.

However, policymakers might get sticker shock if they realize that the total subsidy for the project is \$1.8 billion, not the \$824 million that was previously announced.<sup>5</sup> The increase is in large part due to the Lansing Board of Water and Light’s approval of a \$937 million subsidy, which was achieved by reducing the electricity rate that Ultium will pay.<sup>6</sup>

It seems that the originally agreed upon subsidy amounts have suffered from scope creep. What the committee is being asked to approve today is not a \$666 million subsidy for GM and Ultium, but an additional \$666 million *on top of* the \$1.13 billion already approved for this project.

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3. Rick Yuille and Ben Gielczyk, *Strategic Outreach and Attraction Reserve Fund and Critical Industry and Michigan Strategic Site Readiness Programs* (Lansing, MI: House Fiscal Agency, 2021).

4. Kansas provides the most recent example of a state legislature appropriating billions for projects whose approval and spending decisions will be made by administrative officials. I provided neutral written testimony on the bill in question, which is provided in the attachments. Michael D. Farren, “Kansas Is Going down Wrong Path in Sweetening a Subsidy When Company Has Likely Made Its Decision,” *Topeka Capital-Journal*, February 16, 2022; Katie Bernard, “‘Mystery’ Factory Would Cost Kansas Taxpayers \$1.3 Billion. Is the State Overpaying?,” *Kansas City Star*, February 9, 2022.

5. Ryan Jeltema, “Michigan Approves \$824 Million in Incentives for GM’s Electric Vehicle, Battery Plants,” *Associated Press*, January 25, 2022.

6. The reduction in electricity rates appears to be greater than 50 percent. Despite advisements to the contrary, this portion of the subsidy will be funded through an implicitly higher rate of electricity paid by the 50,000 residential customers served by the Lansing Board of Water and Light. Memorandum from Josh Hundt, Exec. Vice President & Chief Bus. Dev. Officer, Mich. Econ. Dev. Corp., Stacy Bowerman, Senior Vice President of Bus. Dev. Projects and Services, Mich. Econ. Dev. Corp., & Eric Wilford, Senior Bus. Dev. Project Manager, Mich. Econ. Dev. Corp., to Mich. Strategic Fund (Jan. 25, 2022) (<https://www.michiganbusiness.org/4905b0/globalassets/documents/msf-board/msf-board-packets/msf-board-packet-january-25-2022.pdf>); Luisa Wiewgorra, “BWL Will Negotiate Discounted Electric Rates for Possible GM Battery Plant,” *FOX 47 News*, December 15, 2021.

TABLE 1. BREAKDOWN OF SUBSIDIES FOR GENERAL MOTORS AND ULTIUM CELLS

General Motors	
CIP grant from SOAR Fund	\$600.0 million
Industrial Facilities Exemption	\$23.1 million
State Education Tax abatement	\$5.5 million
<i>General Motors subtotal</i>	<i>\$628.6 million</i>
Ultium Cells	
Infrastructure upgrades from SOAR Fund	\$66.1 million
Reduced electricity rate	\$937.0 million
Renaissance Zone tax abatement	\$158.4 million
Industrial Facilities Exemption	\$4.6 million
<i>Ultium Cells subtotal</i>	<i>\$1.2 billion</i>
<b>Grand total</b>	<b>\$1.8 billion</b>

Source: Memorandum from Josh Hundt, Exec. Vice President & Chief Bus. Dev. Officer, Mich. Econ. Dev. Corp., Stacy Bowerman, Senior Vice President of Bus. Dev. Projects and Services, Mich. Econ. Dev. Corp., & Eric Wilford, Senior Bus. Dev. Project Manager, Mich. Econ. Dev. Corp., to Mich. Strategic Fund (Jan. 25, 2022) (<https://www.michiganbusiness.org/4905b0/globalassets/documents/msf-board/msf-board-packets/msf-board-packet-january-25-2022.pdf>).

### OPTIONS AVAILABLE TO MICHIGAN LEGISLATORS

This committee should ask itself two main questions as it considers LTR 2022-1:

- Is it fair to ask taxpayers to contribute another \$666 million to this project, given that the price tag is already 37 percent greater than the publicly announced \$824 million?
- What effect will the additional \$666 million have? If those subsidies were reduced—or even denied—what effect would that have on the corporations’ decision of where to locate the facilities?

Alas, economics can help to answer only the second question. However, there is good reason to believe reducing the SOAR funding for GM and Ultium is unlikely to sway their decision of where to locate the factories, meaning that legislators can drive a harder bargain in order to save their constituents some money.

It is particularly important to identify who would benefit from the SOAR funding up for approval. More than 90 percent of the \$666 million of requested SOAR funding would go to GM, not Ultium. GM already operates a manufacturing plant on the site in question and has ample room to expand operations, meaning that the subsidy is highly unlikely to change GM’s decision of where to locate its new plant. Furthermore, GM will enjoy a downstream benefit from Ultium’s subsidies because the co-location of the facilities will reduce the cost of shipping the battery cells destined for GM’s electric vehicles.

It is possible that the subsidies are a bigger motivator in Ultium’s location decision because it does not already have existing operations on the site in question, but the \$66.1 million in infrastructure development that SOAR funding would provide is unlikely to sway Ultium’s final decision when it already has approval for subsidies worth \$1.1 billion.

Furthermore, the MSF and the Michigan Economic Development Corporation (MEDC) apparently failed to even negotiate with GM and Ultium as to the size of the subsidies. The MSF and MEDC's own request to the Michigan legislature for SOAR funding notes only the amount that GM and Ultium requested, not whether the initial request was challenged and negotiated to a lower amount to protect Michigan taxpayers from overpaying. This is important, because a large enough overpayment would swamp any potential benefits of the project, leading to a net negative economic impact.

It is important that legislators recognize that the appropriations authority they clawed back with HB 4802 gives them the ability to reject MSF and MEDC's request outright or to reduce the subsidy amounts provided, thereby preserving the capacity to fund additional projects in the future.

Thank you for the opportunity to address the committee today. I am happy to answer any questions you may have.

#### **ATTACHMENT**

Michael D. Farren, "Helping Kansas Get the Best out of a Bad Deal: Megasubsidies for a Mystery Company" (Testimony before the Kansas House Commerce, Labor, and Economic Development Committee, Mercatus Center at George Mason University, Arlington, VA, January 31, 2022).

## HELPING KANSAS GET THE BEST OUT OF A BAD DEAL: MEGASUBSIDIES FOR A MYSTERY COMPANY

**Michael D. Farren, PE, PhD**

*Senior Research Fellow, Mercatus Center at George Mason University*

Kansas Legislature, House Commerce, Labor, and Economic Development Committee

January 31, 2022

Chair Tarwater, Vice Chair Long, Ranking Member Clayton, and members of the House Commerce, Labor, and Economic Development 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 unintended, but foreseeable, adverse effects of economic development subsidies, such as those proposed in Senate Bill (SB) 347.

An estimated *\$95 billion* is spent annually by state and local governments on economic development subsidies.<sup>1</sup> These subsidies remain a tenacious problem, despite increasing efforts to phase them out.<sup>2</sup>

Academic research consistently shows that economic development subsidies fail to achieve their stated goals.<sup>3</sup> 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.<sup>4</sup> This failure occurs for several reasons:

1. The higher-than-necessary taxes that pay for economic development subsidies create a negative economic effect that can reduce—or even exceed—the stimulating effect of the subsidy.<sup>5</sup>
2. The average granted 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.<sup>6</sup>

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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 2020), 21.

2. A coalition of state policymakers has been working to increase interstate cooperation on economic development subsidies, starting with 6 states in 2019 and growing to 15 states by 2021. “Coalition to Phase Out Corporate Tax Giveaways,” Coalition to Phase Out Corporate Tax Giveaways, accessed February 5, 2020, <https://endtaxgiveaways.org/>.

3. Matthew D. Mitchell, “Florida Man Seeks a Quarter of a Billion Dollars That Won't Help State,” *Medium*, October 30, 2015.

4. 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).

5. Mitchell et al., “The Economics of a Targeted Economic Development Subsidy,” 18.

6. Farren and Mitchell, “An Interstate Compact to End the Economic Development Subsidy Arms Race,” 7.

3. Subsidies disrupt the normal workings of a healthy market, causing economic waste by
  - a. protecting privileged companies from competition, reducing their motivation to adopt the most efficient production techniques;
  - b. encouraging companies to make excessively risky bets, in effect using taxpayer dollars to underwrite gambles that investors wouldn't fund; and
  - c. motivating investment and production decisions that are suboptimal, often because they are politically motivated rather than customer focused.<sup>7</sup>

Making matters worse, subsidies cause slower *national* economic growth.<sup>8</sup> This occurs even in the small number of situations when a subsidy does sway a corporation's location or expansion decision. When a subsidy "works," it has motivated a suboptimal economic decision that leads to an inefficient use of resources—getting *less* bang for the same buck.

An extreme example would be subsidizing the construction of indoor ski slopes on the flatlands of Kansas to compete with Colorado.<sup>9</sup> Doing so is *technically* feasible—after all, New Jersey just opened the first indoor ski facility in the United States.<sup>10</sup> But, as your mother probably warned you, "Just because New Jersey is doing it doesn't mean it's a good idea."

Despite these harmful economic outcomes—and they are harmful indeed, because slowing economic growth impoverishes future generations—political-economic analysis suggests that the inertia of this policy is difficult to overcome. Superficially, these subsidy deals seem to benefit the policymakers who support them, and the subsidies are supported by powerful special interest groups.<sup>11</sup> Here are some of the barriers blocking a change toward policies that would promote faster economic growth:

1. Academic research has shown that politicians appear to benefit when they are seen as "doing something" to improve the local economy.<sup>12</sup> That is, expressed good intentions and the media attention from ribbon-cutting ceremonies appears to matter more (especially with regard to reelection campaigns) than the real adverse long-term economic effects of these policies.<sup>13</sup>

(Reassuringly, when taxpayers and voters are reminded of the tradeoffs required by subsidies—higher taxes and reduced public services—their approval of these policies disappears).<sup>14</sup>

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.<sup>15</sup>

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7. Mitchell et al., "The Economics of a Targeted Economic Development Subsidy," 24.

8. Farren and Mitchell, "An Interstate Compact to End the Economic Development Subsidy Arms Race," 9.

9. 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.

10. Brian Pinelli, "New Jersey's Indoor Ski Area Aims to Attract 250K New Skiers in First Year," *POWDER Magazine*, February 5, 2020.

11. Mitchell et al., "The Economics of a Targeted Economic Development Subsidy," 32.

12. Nathan M. Jensen and Edmund J. Malesky, *Incentives to Pander: How Politicians Use Corporate Welfare for Political Gain* (Cambridge: Cambridge University Press, 2018).

13. Farren and Mitchell, "An Interstate Compact to End the Economic Development Subsidy Arms Race," 12.

14. "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.

15. Farren and Mitchell, "An Interstate Compact to End the Economic Development Subsidy Arms Race," 11.

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.<sup>16</sup>
4. The pressure to offer subsidies is particularly difficult to resist when politicians in other cities and states engage in the practice, creating something like an arms race, where policymakers feel compelled to support offering subsidies, even if doing so doesn't seem right.<sup>17</sup>

Despite megasubsidy deals being announced seemingly every day in recent weeks, there remains reason for optimism.<sup>18</sup> Over the past few years, 15 states have introduced legislation to create an interstate compact that offers a path out of what has become an economic arms race. 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 across state lines. The confidence such a commitment provides is critical because it removes the misapprehension that comes from a unilateral exit—even when the arms race leads to self-destruction, as each state keeps shooting itself in the foot over and over again.<sup>19</sup>

With the security offered by a compact, forward-thinking policymakers would be able to shift the economic development paradigm to one where states encourage growth by fully focusing on becoming great places to live, rather than wasting time courting corporations' (transient) affection.<sup>20</sup>

### SENATE BILL 347

Regarding SB 347, economic research and my extensive experience studying deals like this offer a few key insights.

1. The suggestion that the collection of amendments offered by the Senate to the enabling legislation is a “deal killer”—as stated by Lieutenant Governor Toland—is unlikely to be correct.<sup>21</sup> Academic research illustrates how nearly 90 percent of subsidies are wasted because companies would have made the same decision without the subsidy.<sup>22</sup>

The subsidy package as currently constructed seems likely to eliminate any state tax liability for the company targeted by SB 347. The findings of peer-reviewed research suggest that adding *even more* icing to the cake Kansas is offering by making the tax credits refundable is highly unlikely to meaningfully sway the targeted company's final decision.

2. Previous similarly sized subsidy deals from other states have enabled companies to receive tax credits equivalent to the value of the state income taxes their employees pay (which some argue, incorrectly, doesn't cost the state anything). However, I have never seen a state take on the *direct responsibility* of reimbursing a company's payroll expenses.

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16. Mitchell et al., “The Economics of a Targeted Economic Development Subsidy,” 32.

17. Farren and Mitchell, “An Interstate Compact to End the Economic Development Subsidy Arms Race,” 13.

18. Reid Wilson, “States Dole Out Mega-Subsidies in Bid to Lure Companies,” *The Hill*, January 28, 2022.

19. Farren and Mitchell, “An Interstate Compact to End the Economic Development Subsidy Arms Race.”

20. Michael D. Farren and Andrea O'Sullivan, “Want to Attract the Next HQ? Become the Best Place to Live,” *The Bridge*, December 6, 2018.

21. Katie Bernard and Kevin Hardy, “KS Senate Approves Incentives for Mystery Company—along with ‘Deal Killer’ Changes,” *Kansas City Star*, January 27, 2022.

22. Farren and Mitchell, “An Interstate Compact to End the Economic Development Subsidy Arms Race,” 7.

Payroll expenses are typically the largest cost companies face, and refundable tax credits connected to payroll reimbursement could lead to much higher subsidy payouts than currently anticipated. Kansas could be setting a dangerous precedent that will exacerbate future subsidy deals across the country, as well as ensuring that this particular deal never pays off for the state.

3. The one economically justifiable subsidy in this legislation is the reimbursement of training costs for new employees.

Current federal tax code forbids companies from counting employee training costs as a tax-deductible expense if that training prepares workers for a new kind of job. My previous research explains how this inability to properly deduct a critical cost of doing business reduces individual opportunity and economic growth.<sup>23</sup>

It's difficult to say what the correct reimbursement of training costs should be, at least for the purpose of maximizing economic efficiency. But it is safe to say that economic development subsidies that are directed toward building workers' skills (which increases economic productivity) are much, much more effective at creating long-run economic growth than corporate handouts.

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).

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23. Michael D. Farren, "Tax Reform 2.0: Solving the 'Skills Gap' with One Weird Trick," *The Hill*, August 24, 2018; Michael D. Farren, "Bridging the Skills Gap" (Testimony before the House Small Business Committee, Subcommittee on Economic Growth, Tax, and Capital Access, Mercatus Center at George Mason University, Arlington, VA, September 7, 2017).

# 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 hand-out 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

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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.

## **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.

## RESEARCH SUMMARY

## Targeted Economic Development Subsidies Don't Work: Negligible Community Benefits and Economic Development

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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 renegeing 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.

- *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.