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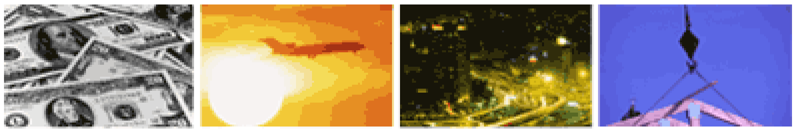

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Incentives: Pro And Con

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Pro: Incentives — An Effective Tool for Economic Development

By Mark Sweeney

When discussing incentives, it is important to distinguish between location advantages, location assets and incentives.

The role of incentives in economic development generates a lot of discussion, with various parties arguing for and against their use by governments and their agencies. These discussions are often characterized by a noteworthy lack of understanding of what incentives are and how they work. In fact, there is often confusion around what constitutes an incentive as well as how they are designed and executed. There is a tendency in the debate to frame a narrow choice of either spending on assets or spending on incentives. In addition to the misunderstandings, there are perceived winners and losers with incentives.

However, properly designed and executed, incentives are not part of a zero-sum game and by their nature are expected to create an increase in wealth for a specific area. That area can range from a hemisphere (trade agreements) to a neighborhood (target enterprise zones).

Why Incentives?

Governments of all sizes, in all places, and over hundreds of years, have used incentives to promote economic activity for the purpose of increasing the wealth and quality of life of its citizens. It is important for incentive policy makers to start with the understanding that this is a tool to achieve those strategic community goals, and design them so that the public benefits of the incentive outweigh the costs.

It is generally accepted public policy that governments have a role in promoting and maintaining a sound economic structure. Most states have an explicit state Supreme Court ruling confirming that economic development is a legitimate role of government. Once that position is understood and accepted, then the debate comes to what should governments do in that regard.

Most locations recognize that sustaining economic activity is a function of a large number of factors. One goal is to promote new investment and employment and in order to do this, policy makers must understand how investment location decisions are made. Once that is understood, then the means to influence those decisions becomes clear, and incentives are one tool to achieve that goal.

What Is An Incentive?

One challenge in discussing incentives is determining what an incentive is. It is important to make a distinction between location advantages, location assets and incentives. A useful definition for economic development incentives would be a deliberate policy or set of policies designed to make a location more attractive to particular investment decision makers.

This definition distinguishes incentives as policy actions as opposed to inherent location advantages. It also distinguishes between location assets as a result of general public investment and actions to attract specific industries or companies. For example, proximity to the Atlantic Coast is a potential location advantage, the Port of Baltimore is a location asset, and reduced port fees for a company in conjunction with a location or expansion in the area is an incentive.

How And Why Do Incentives Work?

In order to see why incentives are valuable, it is important to understand how they work — how they generate benefits, and how they influence locations.

The ultimate goal of such policies is to increase the wealth of an area's citizens. For most incentives, benefits outweigh, often dwarf, the costs. This is due to the circulation of the new wealth that is attracted. This can be seen in increased investment and employment beyond that of the attracted activity. Multiplier effects will vary with activities and locations, but they are an important element in incentive policy. The U.S. automotive industry has one of the highest multipliers of any activity, and the affect of the auto plants of the past 20 years has dwarfed the stated value (an often inflated value) of the incentives. This result holds even for the narrow view of government revenues — as if the government is an investment house looking for a profitable return — government revenues from such mega activities far exceed the government expenditures.

Incentives are designed to influence location decisions. First recognize that investment has a choice with regard to location (free flow of capital). This is truer than ever on a global scale, and was a fundamental part of the founding structure of this country. Second, recognize that where you locate a facility has a significant effect on its success. Locations vary on a host of site-variable factors and the decision-maker has to identify those differences and understand how they will affect them. Incentives are part of this complex scenario and dynamic decision process. They affect the strategic and operational aspects of the project, typically with an emphasis on direct cost reduction.

Spending On Assets Vs. Spending On Incentives

One argument against incentives is that incentives are detrimental in that public resources should be focused on investing in location assets and not incentives. However, the line between incentives as benefits to a company versus investments as benefits to a community is blurring. The new emphasis on knowledge-worker activities has brought community and quality of life assets to the forefront of the incentive discussion. Considerable activity is likely to emerge in the development of quality of life assets in support of the attraction and development of knowledge worker firms. While most of these may not be direct grants to companies, they will likely share the characteristics of the more traditional infrastructure incentives such as a new interchange for an auto assembly plant, which certainly benefits the company but is a community asset.

The Either/Or Position

There seems to be a long and consistent tendency to limit economic development focus and practice. This either /or approach is popular with politicians and pundits who are more interested in soundbite positioning as opposed to thoughtful, challenging policy decisions. This often occurs around elections with pronouncements about taking care of existing industry by rolling back incentives to new firms. More recently, it seems to have taken over the debate on incentives with the contention that governments should be investing in location assets and doing away with incentives.

This either/or approach is commonly heard in recent discussions of the shift to a knowledge economy. Old recruitment policies are abruptly abandoned in the search for positioning for knowledge-worker opportunities. Such pursuits may turn out to be wise forward thinking, but there are immediate needs and opportunities to be addressed while making the transition to the knowledge-worker world. There is no need to pit one approach against the other because the short-term transition of many locations will not allow for immediate needs to be ignored while long-term assets for knowledge economy opportunities are developed. For example, the rising ranks of unemployed workers need jobs now, not a generation from now when investments in higher education are realized.

Governments have always done both, investing in location assets while also developing incentives. In the context of overall fiscal policy, these two economic development needs need not be isolated into an either/or position. Rather, the developing shift to a knowledge-worker economy demands extraordinary policy efforts, including an increased spending on location assets. Do both.

The Fairness Assumption

When all is said and done, most of the arguments against incentives focus on tax policies that provide tax breaks to investing and employing companies. The criticism of tax incentives frequently has as an unstated assumption that the tax structure without the incentives is somehow sound, fair and optimally designed, and that incentive policy upsets that finely designed balance and creates unfair advantages. This could not be further from the truth. Fundamental state tax policy (not even considering incentives) is the result of intense lobbying and political maneuvering during many years and across virtually every interest group you can imagine — homeowners, renters, teachers, senior citizens, demographic minorities, small business, big business, agriculture, unions, truckers, railroads, environmentalists, etc. The end result of state income, sales and property tax policy is a code creating advantages for some, and disadvantages for others.

The criticism of negotiated property tax agreements will often point to the cost of the program as something given up by the community and unfair to other tax payers. The first assumption in this argument is that the company would come without the incentive. It cannot be assumed a project would come without the property tax incentive, particularly if it is a high impact incentive mitigating a major weakness. The second assumption behind this argument is that the tax climate is fairer without the incentive. The property tax treatment in the community may rely primarily on taxing factories and be grossly “unfair” to manufacturers and advantageous to homeowners. This concern about incentives is an attempt to preserve a status quo that is not so much fair as it is advantageous to one group and disadvantageous to others. Our experience shows that the development of major tax incentives such as payment-in-lieu property tax programs arise from an attempt to mitigate a weakness (major cost penalty) in the recruitment of capital-intensive industries.

National Policy

In the United States, the federal government sets many of the rules and boundaries for state policy and then states operate within those boundaries in ways that are best suited to their circumstances. An example is the federal Commerce Clause which provides limits on what states can do to affect interstate commerce. This structure does foster competition across states, but now competition typically includes non-U.S. locations as well, so the competitive position, and the role of incentives in enhancing that competitive position, is not just state vs. state, but state vs. another country.

Increased federal restraint of state and local government incentive activity will be difficult at best. Where does the federal government draw the line? For instance, should they rule that there be no job creation credits? If so, winners will be already healthy areas with low unemployment, while losers will be struggling areas with many of its citizens unemployed. Should the federal government dictate property tax policy? Does that mean every class of property is treated the same in every location? Should manufacturing areas have the same property tax policies as tourism areas that have low property taxes and high sales taxes?

The federal government fulfills its role as guardian of the overall boundaries, and did so recently with the *Cuno vs. DaimlerChrysler* case in the 6th U.S. Circuit Court of Appeals. But it is important to note that while the ruling held an investment tax credit violated the Commerce Clause (which will be argued in the U.S. Supreme Court this year); it also upheld the local property tax incentive. The end result will be that states will look to redesign some incentives in light of *Cuno*, but the case does not signify the end of incentives.

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