

AN INTERSTATE COMPACT TO PHASE OUT COMPANY GIVEAWAYS

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Chair Kaiser, Vice Chair Washington, and members of the House Ways and Means 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 problems associated with economic development subsidies and the possible solutions available for Maryland.

Today, I will illustrate why economic development subsidies remain a problem despite growing agreement that they should be phased out and how an interstate compact offers an opportunity for a cooperative solution.

Academic research shows that economic development subsidies generally don't achieve their stated goals.¹ That is, they don't result in broad improvements in local and state welfare (although they obviously benefit the companies receiving them). This occurs for several reasons:²

1. The taxes needed to fund economic development subsidies create a negative economic effect that can reduce—or even exceed—the stimulating effect of the subsidy.
2. Subsidies disrupt the normal workings of a healthy market and cause economic waste by
 - a. protecting the privileged company from competition, enabling less efficient production,
 - b. encouraging companies to take excessively risky bets or providing incentives for investment and production that are suboptimal, and
 - c. encouraging companies to spend resources on lobbying rather than on focusing on customers.
3. On a national level, subsidies for economic development are, at their very best, a zero-sum game. Gains in one location are offset by losses elsewhere, meaning that the strategy fails improve economic outcomes for all Americans.

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

2. See the attached recent research paper 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).

Despite these economic problems, political-economic analysis implies that governments continue to pursue economic development subsidies because the subsidies appear to be beneficial for the policymakers who support them:³

1. Academic research has shown that politicians seem to benefit by being seen as “doing something” to improve the local economy.⁴ That is, good intentions and the short-run goal of good optics appear to matter more (especially with regard to reelection campaigns) than the real long-run economic effects (which are hard to accurately measure).⁵
2. Most nonacademic studies of economic development subsidies use a “benefits-only” analysis that ignores costs, including the economic impact of the taxes needed to fund the subsidies, creating a culture of misinformation regarding the expected effect of the subsidies.
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, while the difficulty of organizing many dispersed taxpayers inhibits their ability to mount an effective protest.
4. The pressure to offer subsidies is particularly difficult to resist when politicians in other cities and states engage in the practice, creating a prisoner’s dilemma where a policymaker feels compelled to support offering subsidies, even if it doesn’t seem right.

There is reason for optimism today. The interstate compact that HB 525 would create offers a path out of this self-destructive vicious cycle.⁶ As part of the Constitution, and therefore carrying the weight of federal law, an interstate compact provides a credible way for policymakers to commit to a given course of action. The confidence this provides is critical, since it removes the perceived vulnerability that comes from unilaterally exiting an arms race—even when the arms race causes more harm than benefit.

With the security offered by a compact, forward-thinking policymakers will be able to shift the paradigm to one where states create economic development by fully focusing on becoming great places to live, rather than wasting time courting corporations’ affection.⁷

Thank you for the opportunity to speak to you today. I look forward to your questions.

Most sincerely,

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ATTACHMENTS (2)

Matthew D. Mitchell et al., “The Economics of a Targeted Economic Development Subsidy” (Mercatus Research).

Michael D. Farren, “Using an Interstate Compact to Solve the Problems with Economic Development Subsidies” (Testimony).

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

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

5. However, when taxpayers and voters are informed of the tradeoffs required by subsidies—higher taxes and reduced public services, their approval evaporates: “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.

6. Michael D. Farren and Anne Philpot, *With Amazon HQ2, the Losers Are the Winners: Why Economic Development Subsidies Hurt More than They Help* (Arlington, VA: Mercatus Center at George Mason University, 2018), 19.

7. Michael D. Farren and Andrea O’Sullivan, “Want to Attract the Next HQ2? Become the Best Place to Live,” *The Bridge*, December 6, 2018.