Targeted Business Incentives are Not Good Public Policy

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SUMMARY

Targeted state incentives do not provide a net economic gain. Incentives merely redistribute jobs and investment from one business to another and from one region to another. Price adjustments in free competitive markets lead to maximum efficiency in the use of resources and maximum benefit for all. Targeted incentives destroy the efficiency of the free market by favoring inefficient businesses while disfavoring efficient ones. Once this process of incentive price subsidy begins a number of perverse market consequences result:

One, the subsidy distorts the rate of return that businesses use to judge the profitability of investment alternatives.

Two, the subsidy is designed to create "more jobs"; however, the subsidy will act to squeeze more socially beneficial investments out of the market if incentives are continued into periods of relatively full employment.

Three, this type of public intervention in the economy is self-defeating for creating the conditions of self-renewing profit reinvestment into the local economy. Rather than creating private capital market mechanisms for investing, the public dollars become the mechanism for making capital investments.

Four, political favoritism is an inherent byproduct of targeted incentives. The power to give the incentive is the same as the power to deny a similar incentive to someone else.

Fifth, tax incentives given to outside companies place North Carolina companies at a competitive disadvantage, both in terms of selling goods, and gaining access to capital.

ARGUMENT FROM ECONOMICS

Some North Carolinians have advocated a larger governmental role in promoting the state or particular regions of the state to outside industry. Others have proposed a smaller governmental role, or a different one. Policymakers and economic developers have disagreed about the importance of various factors in fostering the creation, expansion, and relocation of businesses. These factors might include wage rates, availability of labor and capital, tax rates, skill levels, transportation options, and access to consumer markets.

The relatively recent government policy of providing cash or other direct, targeted incentives to individual companies--incentives not available to all firms, but only to particular ones selected through governmental rather than market means--represents a distinct break from North Carolina's past economic development policy.

The use of tax revenues on a selective basis to promote the private purposes of individual firms, however, is directly opposite to the pursuit of the common good. This practice relies upon the unreasonable assumption that governments can best judge which businesses will contribute the most value to an economy, because the government is taking money away from some firms, workers and consumers--through taxation--and giving it to others. This "opportunity cost," is rarely factored into the equation which government uses to justify its policy. Their focus is merely on the jobs or economic opportunities that appear to be created, not whether there is a net expansion of jobs or economic opportunities once the clear opportunity cost of the policy is subtracted.

Cash and other targeted state incentives have not provided a net economic gain in any jurisdiction. Instead, academic studies examining the subject have found that such incentives bear no statistically significant relationship to measures of state economic performance or well-being. A comprehensive study is by Margery Marzahn Ambrosius, "The Effectiveness of State Economic Development Policies: A Time-Series Analysis" 42 Western Political Quarterly 283 (Spring 1989) viz.

> "In no case, however, does any one of these economic development policies demonstrate an unequivocally positive, measurable overall impact on either of the indicators of state economic health.
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> "By using methodology which has not previously been used to analyze the effectiveness of state economic development policies, considerable support is thus given to previous findings that these policies have no beneficial effect on state economies. In fifteen of the sixteen analyses, these policies have no demonstrable positive effect on the economic health of the adopting states, as measured by per capita manufacturing value added or by the unemployment rate."

This means that such incentives merely redistribute jobs and growth from one area to another, or from one firm to another, or even from one individual to another.

It is not enough for a government to intend for a tax-funded subsidy to benefit the economy as a whole rather than simply the firm to which it is given. If intention alone is allowed to define "public purpose", then it has no meaningful definition. If the constitutional test for "public purpose" is anything more than an inkblot, then it must be based on a reasonable expectation of net social benefit. Such an expectation is inherently impossible with regard to incentive practices.

How profits may be used in society to achieve a public purpose was analyzed by Thomas Aquinas. Aquinas began his analysis by reviewing the philosophical debate over the activity of trading and the behavior of the individual trader.

The resolution for Aquinas lay in determining whether profits were subsequently used to promote the public good. Aquinas developed a three part categorization of the use of profits which would be used to guide judgments about the use of profits. If the trader pursues an "honorable" purpose with the profits, then profits are justified. The three allowable purposes for profits were self-support, charity, or providing the public with goods.

Adam Smith, The Wealth of Nations, made the link between profits and the public good. Smith described a society that relied upon competitive market transactions between sovereign individuals to achieve greater prosperity for the entire nation rather than a society that relied upon government-directed economic policy.

The branch of economic theory employed by Smith eventually became known as "general equilibrium welfare economics."

Smith contended that every individual would endeavor to employ capital in support of domestic industry for practical reasons.

> A "statesman who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it." Id at 423.

One of the leading scholars in welfare economic theory was J. De V. Graaf, who described what transactions occur in the free market to bring all the actors to market welfare maximization.

What Graff suggested was that marginal equivalences, achieved through price adjustments in the freely competitive markets, would eventually lead to both maximum efficiency in the use of resources, and maximum welfare of the participants, given an existing distribution of income.

The key economic piece of information that all consumers and firms regard in making their decisions is price. It is the price of goods and services, freely determined in the market exchanges between sovereign consumers and profit maximizing firms that allows the adjustments of marginal rates of transformation of resources into finished products, and then the consumption of products into consumer satisfaction.

In the absence of government intervention in market exchanges, or monopoly power in production, economic welfare theory predicts that participants in the free market price system will seek and find maximum welfare for all.

Industrial recruitment incentives acts as a price subsidy to a specific firm selected by the government over any other firm that may also make an investment under conditions of consumer sovereignty and free market exchanges. When government intervenes in the market, as in the case of industrial recruitment incentives, the ratio of net return to capital is not the same for all savers and investors.

In this less-than-perfectly competitive market, the ideal theoretical benefits of welfare maximization predicted by economic theory fail to occur. Some firms benefit from the government intervention, while other firms do not. Some consumers benefit from the government intervention, while other, morally equivalent, citizens do not benefit. The government, not the autonomous workings of the free market, determines who will win and who will lose as a result of the use of the incentives.

Once the process of government incentive price subsidies begins, a number of perverse market adjustments and consequences result, none of which has a market-based resolution that would restore price as the key information variable. The process of private investment decision-making becomes more and more politicized and arbitrary. This is true even if the government officials who decide are paragons of virtue.

First, the price subsidy distorts the rate of return throughout the capital markets that all firms use to judge the profitability of investment alternatives. The government incentive acts to drop the real rate of return of the recipient firm, compared to the prevailing market rate of return for non-recipients, thus making socially inefficient investments possible and more likely to recur.

Second, in the absence of a market-derived, commonly observed rate of return, the socially optimal rate of investment does not equal the time preferences of consumers for present versus future rates of consumption. It becomes more rational for non-recipient firms, who are not initially blessed by government largesse, to begin searching for incentive handouts and focusing their attention on obtaining easy government revenues, not on obtaining more difficult market derived profits. The rate of investment declines for profitable enterprises that would be undertaken, thus adversely affecting consumption in future periods.

Government handouts serve not only to produce socially inefficient investments that would not otherwise be undertaken in the competitive market, but also serve to distort the rate of investment required to produce optimal levels of welfare in the future. This process eventually leaves the government as the dominant force in determining both the socially optimal rate of investment for the future and the type and location of investments that will occur.

Third, the government subsidy is designed, according to its proponents to create "more jobs." It is actually the derived stream of income from the "more jobs" that the proponents should be stressing, because it is income that allows consumption in the free market. This act of consumption is linked to welfare maximization of consumers.

The "more jobs" provided by incentives produces a stream of income that may or may not have been present in the economy prior to the incentive. If "more jobs" is created when "more jobs" is not required because of full employment, then the government incentive serves to squeeze other more socially beneficial investments and capital out of the market. Since “incentive” programs have a long gestational period, they invariably will carry over into periods of relatively full employment.

The government not only determines who wins and loses, but its action with the incentive has a secondary effect of squeezing other investment alternatives out of the market. It is not, then, rational for non-recipient firms to either commit capital to investments that would compete with the government subsidized investments, or to invest for future time periods, given capacity constraints in the labor market.

Fourth, while dropping the real rate of return for the recipient firms, the government lowers the risk of failure for the firm compared to the higher risk levels faced by non-recipient firms. The subsidized firm has a lower level of commitment to the success or failure of the investment because less of the firm's own capital is invested. The incentive acts as an insurance policy for the recipient firm. If and when things go bad, or if and when some other state offers a better incentive, the firm has less at risk in abandoning the project.

This type of government intervention becomes self-perpetuating. If it took a government subsidy to recruit the firm to the location, and that subsidy helps promote a lack of commitment to the investment, then it seems likely that it will take more incentives to keep the firm from leaving. Unless the government continually meets the competitive bids of other states, the firm, basing its decisions on the political process, and not the market rate of return or market rate of risk, will continually extract greater incentives from the government agent in order to stay. By this time it has a covey of lobbyists in state who will become adept at finding subsidies.

Fifth, over time, the price subsidy to the recipient firm distorts the adjustment relationship between returns to capital and returns to labor that are expected to occur in a competitive market. In perfect competitive equilibrium the marginal equivalency of profits to consumer satisfaction is reached after a series of price-based exchanges. By providing the incentive, the government allows higher nominal returns to be achieved by the firm, vis-a-vis non-recipient firms than is consistent with the payment of prevailing wages in the labor market, although the return appears lower when the government's subsidy is counted as part of the recipient firm's investment.

Given a highly automated or technologically advanced production process, the subsidized firm can match low-skilled, low-wage labor to the equipment, and take the incentive as unearned profits. The repeated use of the incentives over time by the government serves to erect a permanent barrier to the expected rise in wages that would occur in a competitive market by distorting the equilibrium of the adjustment process in returns to capital and labor. Not only does government intervention distort the competitive relationship between capital and labor, incentives act to make this discriminatory relationship a permanent feature of North Carolina's economic development process. In the words of Adam Smith, the government agent who attempts this feat has engaged in "folly" and "presumption". Supra at 423.

POLITICAL FAVORITISM IS AN INHERENT BYPRODUCT OF THE SYSTEM OF GOVERNMENT RECRUITMENT INCENTIVES

When government selects the recipients of incentives it overrides consumer sovereignty of free choice in the market place. The government substitutes its own judgement in place of the collective, autonomous, free decisions of the market on what type of goods and services should be produced. Any such judgment by the government is inherently arbitrary and capricious because it is not available to all those similarly situated.

The government has no way of determining the social advantages of its decision. But its decision creates winners and losers, many of whom cannot be identified in advance. The power to decide who gets the incentive is perfectly symmetrical to a power to deny an incentive, or to provide a disincentive to a private firm considering location in North Carolina.

A principle beneficial effect of the free market system is to minimize the need for politicized control over economic decisions thus preserving the character of American democracy. Francis Fukuyama, Trust (The Free Press, 1995).

Cash (and other targeted) incentives provided by government by private firms do not promote the common good. They do not serve a public purpose. They are exclusive emoluments or privileges which are inimical to constitutional government and to free markets.

SOURCE: The author submitted a version of this article as a brief in Maready v. City of Winston-Salem for the John Locke Foundation. The full text of the brief with bibliography may be found at www.paulstam.info/articles.php?a=incentive. Tom Vass, an investment banker from Raleigh, authored sections of it. His website may be found at www.corporateinvestment.net.