

# The Baiting Game

*Using economic incentives to attract new businesses  
isn't as simple as it may seem*



BY KARL RHODES



Critics of economic development incentives ranted and raved in 1992 when South Carolina put together a \$130 million package to persuade BMW to build a plant in Spartanburg County.

In the decade that followed, BMW silenced those critics by building a world-class facility and expanding it several times. The company's initial employment estimate was 1,900. But by 2001, the plant was providing jobs to more than 4,300 people and an annual economic impact estimated at \$4.1 billion, according to a study by the Moore School of Business at the University of South Carolina.

The BMW incentives "turned out to be chicken feed given the economic impact of the plant," says Ray Owens, a vice president and senior economist at the Federal Reserve Bank of Richmond. Unfortunately, "for every BMW, there are plenty of broken promises."

Even when economic development incentives are highly profitable for one state, offering them is bad public policy for the country as a whole, says Art Rolnick, director of research for the Federal Reserve Bank of Minneapolis. "You are misallocating resources. You are interfering with interstate commerce. It is economically inefficient," he says. "And sometimes you induce a company to take a second-best location."

Rolnick views incentives as a "negative-sum" baiting game that should be outlawed by Congress because it pits states against each other at the expense of the national economy. For every winner there is a loser, he contends, and corporate subsidies reduce state governments' ability to fund public goods, such as education and transportation.

But without those extra incentives, firms with "market power" tend to raise prices to pay for the inefficiencies of their existing locations, say some observers. Rolnick responds that antitrust laws — not incentives — should be used to prevent the inefficiencies of "market power," which he equates to "monopolistic situations." States should not subsidize monopolies, but they often do, he says. "The monopolies are the ones who are the most successful in using these subsidies."

Big-league sports franchises are a prime example, Rolnick says. "These guys have a monopoly in a unique way because they are a very special form of entertainment, and they have played the bidding wars to the hilt. Billions of public dollars have gone to these private companies because ... they can provide a very credible threat that 'if we go, you don't get anybody.'"

Some economic development officials agree with Rolnick's suggestion that Congress should outlaw incentives. "I would testify for that bill the minute they write it," says Aris Melissaratos, Maryland's secretary of Business and Economic Development. "I really don't like this continuing bidding war," he explains. "Even though ... in most cases it's a rational quantitative analysis of payback, some jurisdictions at times act irrationally and create a bidding war that just gets out of hand."

## Which Bait Works Best?

In North Carolina, the debate over tax credits for job creation intensified when Michael Luger, a University of North Carolina economist, published a study questioning the effectiveness of an economic incentive program called the Lee Act. Luger estimated that "only around 4 percent of the jobs claimed to be created with Lee Act incentives actually were induced."

North Carolina granted \$208 million of tax credits under the program in the years 1996 through 2001. Since then, North Carolina has scaled back some aspects of the Lee Act to free up funds to use in more targeted incentive programs, says Don Hobart, general counsel for the state's Department of Commerce. Hobart says tax credits under the Lee Act have been more effective than Luger's 4 percent figure would indicate, but he concedes that "tax

## Swapping Fish Stories

Virginia hooked a semiconductor manufacturer in February 2002. Cerxon Microtechnologies LLC was just a startup operation, but it seemed like a pretty big fish in the small pond of Henry County, where plant closings had pushed the unemployment rate up to 13 percent.

Cerxon garnered several hundred thousand dollars in state and local incentives because it promised to invest \$6.6 million and employ 250 people. Gov. Mark Warner hailed the Cerxon deal as "a tremendous win for Henry County and all of Southside Virginia."

The company relocated to the county from Camden, S.C., a city that apparently made no attempt to retain Cerxon. In sharp contrast, Virginia gave the company a \$200,000 grant from its Governor's Opportunity Fund, a \$100,000 grant from its Tobacco Commission, plus nearly \$1 million in loans and other incentives from Henry County.

"Oh my God!" exclaimed Daniel Young, director of grants and incentives for the South Carolina Department of Commerce, when he learned about the incentives Virginia paid to attract the company. "Camden was not real upset when that project left," he said. "To my knowledge, we did not counteroffer because I don't think [Cerxon] was really big enough. ... I believe it was a one- or two-person operation."

In Virginia, Cerxon employed a few people, but it never came close to generating 250 jobs or investing \$6.6 million. It went out of business in December 2003.

While Virginia was luring Cerxon away from South Carolina, the Palmetto State was wooing CropTech away from the Old Dominion. CropTech was a highly touted biotech company that planned to use genetically altered tobacco to manufacture pharmaceuticals. It grew up in Virginia Tech's Corporate Research Center, but it shopped around for a new location as it geared up for mass production.

Virginia made an effort to retain the company, but its incentives paled in comparison to the multimillion-dollar package that South Carolina put together to attract CropTech to Berkeley County. At a press conference in May 2002, the chairman of the Charleston Regional Development Alliance raved about CropTech's potential. "The company's unique processes and creative approaches will provide top-quality jobs for area residents," he said, "and its research will help improve the lives of people around the world."

Things didn't pan out that way. Nearly one year later — on April Fools' Day — the headline in *The Post and Courier* told Chapter 11 of the CropTech story. "Berkeley may lose CropTech," it said. "Virginia firm files for bankruptcy." —KR

## The Big One That Got Away

Virginia officials put together a huge incentive package in the mid-1990s, when Motorola executives were looking to build a \$3 billion semiconductor plant west of Richmond. In addition to offering \$60 million for achieving production milestones, Virginia officials accelerated plans to extend Route 288 through rural Goochland and Powhatan counties. They also expedited \$12 million to jumpstart a new School of Engineering at Virginia Commonwealth University. Until Motorola came around, neither of those projects were high priorities for state funding.

Microelectronic engineering became a major focus of the new school, and Motorola engineers helped design the school's electrical engineering curriculum. Also, two community colleges in the Richmond area established specialized microelectronics technology programs to prepare thousands of employees to work at Motorola. The plant was delayed, but another semiconductor manufacturer, Infineon Technologies, built a plant on the east side of the city.

VCU graduated its first class of engineering students in 2000. By then, the \$323 million extension of Route 288 was under construction, but the Motorola site was sitting idle, and the community colleges were scaling back their microelectronics programs.

In 2002, Motorola abandoned plans to build its proposed plant.

Virginia never paid any production-milestone incentives to Motorola, but the phantom plant did have a big impact on the Richmond economy. Some residents complain that the project caused a misallocation of transportation



*Virginia's big semiconductor catch turned out to be Infineon Technologies. The company built this clean room and fabrication plant east of Richmond.*

and education resources, while others say things worked out for the best.

"I've always viewed Route 288 as a big benefit of Motorola," says Ray Owens, a senior economist at the Federal Reserve Bank of Richmond. "It was the missing link of Richmond's circumferential beltway."

Also, VCU's School of Engineering helped attract Infineon, which currently employs about 1,750 people, says Mark Kilduff, executive director of the Virginia Economic Development Partnership. The engineering school, he notes, "still is a great benefit to Infineon," and it has helped attract other high-tech companies to the Richmond region. —KR

incentives represent a blunt instrument for economic development from a state's perspective, whereas other programs are a lot more surgical."

The Tar Heel State has beefed up its One North Carolina Fund, which makes performance-based cash grants for industrial recruitment. The fund used to receive just \$1 million or \$2 million per year, but in 2001, the General Assembly made a one-time contribution of \$15 million. And now the Department of Commerce is seeking another \$20 million for the fund from the 2004 General Assembly.

Last year, North Carolina also established its Site Infrastructure Development Fund, which makes cash

grants for site improvements to companies that are relocating to or expanding within the state. The fund has received a one-time appropriation of \$24 million.

"Companies want money upfront now," says Daniel Young, director of grants and incentives for South Carolina's Department of Commerce. "They're all doing their 15-year models, and the more you put in upfront, the greater the impact. If you start spreading it out on taxes and soft money, and spreading that over years, you don't get the bang for the buck."

Most of South Carolina's hard-dollar incentives are grants to localities for infrastructure improvements. Young

refers to this deal-closing fund as the "checking account." Annual appropriations to that account have been about \$18 million for the "past six or eight years at least," he says.

Virginia is trying to increase its Governor's Opportunity Fund from \$17.5 million in the current two-year budget to \$23 million for the coming two years, says Mark Kilduff, executive director of Virginia's Economic Development Partnership. That pot of money attracts lots of attention, he says, but the vast majority of the state's economic development deals do not qualify for those funds.

A more common form of upfront assistance in Virginia is work-force training. "That program is meaningful to 99 percent of the companies we work with," Kilduff says, because it helps defray the costs of pre-employment training.

Maryland's secretary of Business and Economic Development also puts work-force training at the top of his list. "That is an incentive that I am very much in favor of because it enhances productivity of the worker and the enterprise," Melissaratos says. "It makes that enterprise more competitive, and the skill set is retained for the worker in case something at that company doesn't pan out."

Whether a state offers work-force training or tax credits or performance grants, it's important to keep incentives simple, says David Satterfield, executive director of West Virginia's Economic Development Office. In recent years, West Virginia has boiled its incentive programs down from 21 to four, and Satterfield is determined to make them "predictable, meaningful and based on common sense." Prospects should not need an army of tax lawyers to determine an incentive's true value, he says. "If they don't understand it, they won't appreciate it."

During most of the 1990s, Washington, D.C., refused to play the baiting game, and schools of companies swam across the Potomac River to Northern Virginia. "Five or six years ago, the city was really an economic desert," says Chris Bender, a spokesman for the Office of the Deputy Mayor for Plan-

ning and Economic Development. “The businesses that were here were categorically fleeing for more fertile ground. There just was no support.”

The District became more business friendly in the late 1990s, Bender says, following the election of Mayor Anthony Williams and the designation of enterprise zones covering two-thirds of the city. Since then, the District has experienced an “economic renaissance,” Bender says. “We were rated No. 1 in foreign real estate investment in the world in 2002. Our office vacancy rates are the lowest in the country despite the highest rents.”

Many law firms, associations, and multinational corporations want a presence in Washington, D.C., but the city still struggles to attract and retain an adequate retail tax base. Bender says a new shopping center in the low-income Brentwood area is one of the District’s top incentive success stories. With significant assistance from the city, Rhode Island Place has attracted the District’s first Home Depot and a Giant Food, the only grocery store in the Brentwood area.

Washington, D.C., is saddled with a high percentage of federal property that doesn’t generate any tax revenue, Bender explains. So city officials have to find creative ways to capitalize on the remaining real estate. “We do that by getting businesses here, and that takes incentives,” he says. “We do need incentives. There’s no question about that.” (For more on Washington, D.C.’s commercial real estate market, see the cover story from the Fall 2003 issue of *Region Focus* titled “Building in Uncle Sam’s Backyard.”)

West Virginia’s economic development officials take a similar view. The Mountain State has upped its ante on incentives since Gov. Bob Wise took office in 2001. Most notably, West Virginia has raised \$225 million for a new economic development grant program.

“I look at [incentives] like my retirement plan,” Satterfield says. “I’m putting money away and investing it hoping that there’s going to be a gain.” People investing in West Virginia are hoping to increase the value of their companies in much the same way.

“They expect the state to bring something to the dance.”

### No Fishing Allowed?

Rolnick, the economist at the Federal Reserve Bank of Minneapolis, admits that government officials have little choice but to offer incentives. “Here in the Twin Cities ... if somebody comes after 3M or General Mills or the Minnesota Twins ... you, as a mayor or a governor, have to respond.” But Congress should end this baiting game by taxing the value that private companies receive from any preferential treatment, he says. “The federal government would tax that income at a confiscatory rate.”

In 1999, Minnesota Congressman David Minge introduced the Distorting Subsidies Limitation Act, which would have placed a steep federal excise tax on incentives — not the 100 percent tax that Rolnick advocated, but a substantial tax nonetheless. The legislation never received a full hearing, Rolnick says. “The economics of it are pretty clear,” he says. But “there are huge conflicts of interest here. In the current system, politicians are allowed to give away goodies, and if you end the bidding wars, they can’t give away goodies.”

At the Federal Reserve Bank of Richmond, Owens is not quite that cynical. “If the world were a perfectly competitive place, incentive programs would be silly,” he agrees. “But these programs are designed by people existing in the real world — not the perfect world of principles [of economics] textbooks.”

It would be impossible to equalize what every state has to offer, adds Kilduff at the Virginia Economic Development Partnership. “Would every state and every locality have to have the same tax rates?” he asks. “Would every community have to have an interstate? Would every community have to have a university?”

To evaluate a particular proposal to eliminate incentives, you would have to look at how incentives are defined, says Hobart at the North Carolina Department of Commerce. “Is it truly preferential treatment? Or is just smart public policy?”

Hobart suggests that most wealthy states would gladly quit the baiting game while they are ahead. “Any state that already has a great quality of life and a solid, well-developed infrastructure for transportation and education would have no problem eliminating pure economic development incentive dollars from all states,” he predicts.

Not necessarily, says Kilduff. He asks: How would the United States stop foreign governments from baiting their hooks with incentives?

Rolnick says international trade agreements should include subsidy restrictions. “It is the federal government’s responsibility to negotiate good trade agreements,” he says. “Just as we don’t want trade barriers, we don’t want subsidy wars.” And besides, “most of the subsidy wars are internal,” he contends. “Minneapolis and St. Paul go after each other’s companies, and from the state’s point of view, that’s crazy.”

That logic also applies to neighboring states, says Maryland’s Melissaratos. “This is a pretty small planet, and I hate to see us fighting for jobs with Virginia. We need to face the global competition together.” **RF**

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