Borders War: Insights on Economic Development Incentives

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Disclaimer

The views expressed in this presentation are those of the presenter and not necessarily those of the Federal Reserve Bank of Kansas City or the Federal Reserve System.
Do Incentives Work?

• Generally, within a nation:
  – factors of production are highly mobile
  – trade barriers are non-existent or highly unrestrictive
  – factors of production, climatic conditions, and the general business environment tend to be similar

• Implies that small changes in industrial policy can potentially have large effects on firm location
What is the Question?

• Key question is not if they are successful in luring companies, but

• Are they a cost-effective strategy for achieving growth (e.g., jobs) – is it a sensible use of economic development dollars?
Questions further defined:

- Do business incentives cause states or localities to grow more rapidly than they would have otherwise?

- Are the costs justified?

- Who get the benefits?
Do Incentives Work?

• Consensus view: incentives matter, but not much (and not as much as thought)
  – often they are too small to matter much to firms (asymmetric information)
  – actual hires tends to be much less than announced hires
  – the *net* impact of the actual hires often is less than the number of actual hires
Net Impacts of Firm Locations

• Positive Spillovers
  – input-output linkages
  – agglomeration effects
    • labor pooling
    • knowledge spillovers
  – employment and income multipliers

• Negative Spillovers – “crowding out”
  – infrastructure congestion
  – wage and rent pressure
  – reduced supply of resources
  – perception that this might occur

Do Incentives Work?

• Also . . .
  – Redundancy
  – Jobs taken by emigrants
  – For tax incentives
    • Shift in the tax burden to other individuals and/or businesses (or spending cuts)
    • Complexity in the tax code
Economic Rationale for Incentives

• Infant Industry
• Improvement of Distressed Areas
• Leveling the Playing Field
Infant Industry Argument

- may be an emerging industry in which the region believes it may in the future have a comparative advantage

- Support may be offered to an emerging industry in which substantial agglomeration economies exist
Infant Industry Argument

• But . . .

  – governments have tended to be very unsuccessful at picking winners and losers.

  – may require continual support of industries in which the region has a comparative disadvantage
Improvement in Distressed Areas

• a way to stimulate economic activity in depressed areas

  – presumes that better alternatives are not available.

  – efforts to improve the quality of the labor force and the level and quality of public infrastructure are likely to have much stronger long-term effects.

  – People prosperity vs. place prosperity
Leveling the Playing Field?

- distortions may offset existing distortions

- but there may be a race to the bottom
Competition

• Firms may play one region against another (asymmetric information)

• A gain in one region often means a loss for others (a zero-sum game)

• Incentives offered by multiple jurisdictions are likely to cancel each other out (a negative sum game)
Economic Development Policy
What Makes Sense?

• General business environment that is conducive to business
• Quality of life
• Workforce development efforts
• Retention and expansion
• Bids for incentives?
Closing Thought

GDP Growth in the U.S. and EU
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