

## Are States Giving Away the Store?

by Adam M. Zaretsky

"Creating jobs" has become the rallying cry of the '90s. Nearly every state's department of economic development spends countless hours trying to figure out how to attract job-creating firms. As competition among the states for high-profile companies has increased, especially over the past 10-12 years, the stakes have grown as states try to outbid each other to secure the valued prize. The most recent example of this occurred in the battle for a Mercedes-Benz factory, which will open in Vance, Ala. (near Tuscaloosa) sometime in 1997.

Alabama offered Mercedes-Benz a package valued at more than the cost of the plant itself. To lure the \$300 million plant, with about 1,500 jobs, the state promised to buy the site for \$30 million and lease it to Mercedes for \$100. Surrounding communities will contribute an additional \$5 million each, and the University of Alabama will offer German language and culture classes to the children of plant employees. On top of this, the state will provide a package of tax breaks valued at more than \$300 million, which will, among other things, allow the plant to be paid for with

money that would have been paid to the state.<sup>1</sup>

The competition for the plant had been narrowed to Alabama, North Carolina and South Carolina, all of which seemed in a dead heat. Alabama's incentive package was slightly richer, but, according to Andreas Renschler, president of the Mercedes subsidiary that will run the U.S. venture, "Whether you get \$10 million more or less in one state doesn't make any difference."<sup>2</sup> A natural question to ask, therefore, is whether packages of this nature are worth it for the state. Are the returns from such offerings enough to offset the costs imposed on the citizens and businesses of the state, who, in the end, have to make up for the lost revenue? Is it wise for states that probably can least afford it to make such offers, or are they just giving away the store?

### A Plethora of Incentives

The sheer size of Alabama's incentive package has led to widespread concern that the bidding has become destructively competitive. What started out as tax incentives to lure new business has accelerated to include worker training, apprenticeship programs, infrastructure improvements and even state screening of applicants. To win a BMW plant, for example, South Carolina agreed to screen all job applicants, then train the

plant's entire work force through the state's technical schools.<sup>3</sup> South Carolina even raised private funds—about \$3 million—to pay the expenses of workers flown to Germany for first-hand training. North Carolina offers a similar employee training incentive to any manufacturer that adds six or more new workers.

Infrastructure improvements have generally been broader in their appeal. Before Atlanta's expansion in the mid- to late '80s, for example, the city spent heavily to develop Hartsfield International Airport, which has allowed the area to attract the corporate headquarters of many companies, such as United Parcel Service, Saab and Holiday Inns. This development was also instrumental in Atlanta's becoming the host city for the 1996 Summer Olympics. Closer to home, Tennessee invested heavily in telecommunications technology in the late 1970s: Local phone companies were allowed to raise rates aggressively if they funneled the new revenue into state-of-the-art digital switches and fiber-optic lines. This made Tennessee one of the country's leading states in telecommunications technology, and attracted firms such as Federal Express and Ingram Industries, which sells commercial CD-ROMs.

Gov. Jim Edgar of Illinois, however, believes, as do

many others, states have gone too far, and, by their excessive competitiveness, have encouraged firms to squeeze the last dime out of a government before committing to a state. At the August 1993 meeting of the National Governors' Association, he proposed a set of guidelines that limits how much states would give away in tax breaks and subsidies.<sup>4</sup> Briefly, Gov. Edgar proposed that states take a broad view of being friendly to business, one that goes beyond tax incentives to include quality education and transportation systems. States should invest in communities and people rather than individual businesses so that the fortune of a community is not tied up in one enterprise. In addition, companies should be held accountable for not living up to their end of a bargain after being showered with subsidies.<sup>5</sup> This last provision, sometimes known as a clawback, has been implemented in some states or explicitly written into contracts in others.

Many of the incentives mentioned above were tailored to suit the needs of the targeted firm and not necessarily part of a basic package of incentives. Once a state offers a particular incentive to a firm, however, it would be hardpressed to withhold it from another. The table at right lists the major provisions offered by each of the Eighth Federal Reserve District states to any prospective business.

### The Importance of Direct Local Participation

While municipalities cannot offer incentives that are comparable to what states can offer, their direct participation in the negotiations is usually seen as critical. In some instances, local authorities performed most of the work, with the state providing support as needed.

In Illinois, for example, state and local officials joined forces to bring the Diamond-Star Automotive Plant, a Chrysler/Mitsubishi joint venture, to the Bloomington/Normal area of McLean County. Diamond-Star's search began in 1984, and the announcement was made in April 1986. State officials negotiated with local officials to develop a package that was acceptable to Diamond-Star but not too costly to the local governments. The final package included enterprise zones, a metro zone (an agreement between Bloomington and Normal to share costs and revenues), and the "Build Illinois" program. These incentives were not the overriding factor in Diamond-Star's decision to chose Bloomington/Normal; however, the firm did assume that its negotiations with state and local governments would yield some type of package.<sup>6</sup>

St. Louis, without assistance from the state of Missouri, offered about \$70 million to Trans World Airlines to entice it to

relocate its headquarters from New York. The deal—\$25 million in cash and \$40 million in a bond issue—gave TWA some of the cash necessary for it to emerge from bankruptcy. In addition, the city forgave \$5.3 million owed in back lease payments.<sup>7</sup> In exchange, the airline turned over its gate leases, jetways, baggage systems and associated property at Lambert-St. Louis International Airport to the city, which rents them back to TWA. Also, the city has the right to reassign gates to other airlines should TWA's departures fall below a certain level.

Sometimes, last-minute offers can change what some communities consider a done deal. In late 1992, for example, officials in Jackson, Tenn., were ready to announce that International Paper Co. would build a new plant, bringing nearly 400 jobs into the area. At the same time, Jackson officials were negotiating with the James River Corp. for a new plant. At the 11th hour, Kentucky offered both companies a package that they apparently couldn't resist, and both opened new plants in Bowling Green, Kentucky. Jackson offered International Paper \$500,000 for employee training; Kentucky gave the company \$39 million in training and other incentives. James River received the same deal. This included \$180,000 per year as a rebate of the personal income taxes paid by the firms' employees, and a 100 percent credit against the companies' corporate income taxes.

Tennessee could not match these incentives, especially since the firms were asking the state to abate taxes that do not exist there (Tennessee does not impose a personal income tax on earnings).

In the this case, the firms were offered corporate income tax credits equal to the company's annual debt service costs under the Kentucky Rural Economic Development Authority (KREDA).

If the tax liability would ever reach the amount of credits allowed, an assessment fee for the difference, up to 6 percent of gross wages, could be taken directly from employee withholdings. Employees could recoup the assessments through personal income tax credits. This benefit, which would grow as the cost of labor increases, not only eliminated Tennessee's advantage of not having an income tax, but made the lack of such a tax a liability.<sup>8</sup> This example illustrates how easy it has become for states to start a bidding war over firms, and how firms have now come to expect these attractive offers.

### Can States Recoup Their Investments?

One obvious question is whether it is worth the expense states have incurred to lure firms in hopes of creating new jobs. Departments of economic development or independent consultants brought in from local universities have typically been assigned the task of forecasting the potential number of jobs that might be

created, including those at the support services and suppliers necessary to keep the primary concern in operation, and the potential increase in revenue these additional workers will generate through income and sales taxes. Of course, such reports should be read with a wary eye, as the incentives to either inflate or deflate the results often depend on the author's affiliation or source of funding. In addition, not all effects can be reliably quantified, usually because broad assumptions that are not always verifiable must be made.

To fully evaluate the effectiveness of such incentives, enough time must elapse so that the benefits to the state can start accruing. As with many projects, state development packages are usually backloaded in terms of the benefits to the state, with the costs occurring primarily at the beginning of the project. Many of the previously cited examples are therefore too new to observe reasonable returns. The Honda Motor Company in Marysville, Ohio, however, began development in 1977; thus, the state has had more than 15 years to observe the firm's impact.

As the sidebar on the following page illustrates, the returns on Ohio's investments have more than exceeded expectations. This conclusion, however, may not hold for other projects and other states. Alabama's incentive package to Mercedes, for example, dwarfs what Ohio put into Honda. To

make the comparison relevant, Ohio's expenditures should be stated in 1993 dollars. The equivalent of Ohio's investments in Honda between 1977 and 1990 in 1993 dollars is slightly more than \$131 million. Thus, in inflation-adjusted terms, Mercedes' package of more than \$300 million is slightly more than double the amount Ohio invested in Honda. It may therefore be difficult for Alabama to recoup the cost of this incentive package.

Meanwhile, there are other issues besides the dollar amounts to consider. The Marysville region of Ohio has today become quite dependent on Honda for its fiscal stability. Union County's dependence on 65 percent of its revenue from one source could expose it to severe hardship should Honda decide to relocate. This is one concern Gov. Edgar expressed at the National Governors' Association meeting. Moreover, some suggest that Honda might still have entered the Ohio market even if this package had not been offered. It appears that the *offering* of tax abatements was probably more important than their actual value.<sup>9</sup>

These are some of the lessons other states are taking to heart when they devise a program intended to lure business. In particular, states are trying hard not to place all their eggs in one basket. States are also trying to protect their investments in a firm, primarily through clawbacks.

### When the Firm Wants To Leave

When General Motors announced in late 1991 that it would close more than 20 plants and lay off almost 75,000 workers, towns across the United States and Canada held their breaths. As GM began announcing its plant closures, one choice was narrowed to either the Arlington, Texas, or Ypsilanti, Michigan, plant, since both were producing similar autos.<sup>10</sup> When GM finally decided to close the Ypsilanti plant, the town promptly sued, arguing that the plant was obligated to remain open because GM had sought and received tax breaks in exchange for jobs: The auto maker had applied for and received tax breaks in 1984 and 1988 on \$250 million of investments, saving 50 percent on its tax bill.

A lower-court ruling held that GM was bound by oral promises that led the town to grant the tax abatements. The state appeals court overturned this ruling, stating that just because a corporation solicits a tax abatement using assurances of jobs as a carrot does not imply evidence of a promise. Thus, municipalities will have to be more specific in stating what they might consider a premature withdrawal from a region and design agreements that heavily penalize a firm for leaving.

Some states, like Louisiana, Ohio and Texas, and some

localities have already passed laws requiring companies to compensate municipalities for financial incentives if they move prematurely. Other communities have written these requirements into contracts signed by firms. Arlington, Texas, for example, the site of the other plant, signed a 10-year contract with GM in 1991 under which the city can seek to recover all abated taxes if GM closes the plant within five years.

This represents but one kind of clawback. In general, the idea is to introduce an explicit *quid pro quo* into the development process. Essentially, the firm is given an incentive package on the written understanding that it will create and maintain a certain number of jobs over some stated period of time; otherwise, it must make a compensating payment to the state.

The first major legal clawback battle in the United States occurred in New York between the city of Yonkers and Otis Elevator. The city sold to Otis for a half-million dollars a parcel of land valued at \$16 million. Some years later, Otis was taken over by another firm, which announced it would close the technologically obsolete Yonkers plant and transfer investment out of state. Yonkers sued seeking a prorated clawback for its investment in the plant. Unfortunately, because the city had not stipulated in writing a length of time it expected the firm to remain in Yonkers, it lost the case.<sup>11</sup>

Another case involved Duluth, Minn., and the Triangle Corporation, which in exchange for incentives agreed to a limited clawback clause prohibiting the transfer of any equipment purchased with publicly issued bonds. When Triangle began transferring jobs and equipment, the city sued and won an injunction that was later upheld by the state's Supreme Court. This was the first case that resulted in a favorable verdict for the locality, demonstrating that communities fare much better when they specify a financial recovery procedure before a plant shuts down or scales back.<sup>12</sup>

Some clawback programs have taken unique forms. Under a loan-grant convertibility program, for example, the state agrees to lend a firm money with the provision that if a certain number of jobs within a designated period are created, the loan will be converted into a grant. If the total number of jobs is not created, a prorated portion of the financial assistance must be repaid. For instance, if 70 percent of the total jobs were created, then 30 percent of the loan must be repaid.

While clawbacks seem like a reasonable means for states and communities to protect themselves from abuses of their generosity, a serious problem arises when trying to define job creation. Should all jobs be counted, or only those jobs that were created because of the financial assistance offered? How long

must a job be retained to qualify as job retention? Should only certain levels or types of jobs be included, or should jobs be weighted by their pay? Should jobs filled by workers from underrepresented groups count differently? How much time should the firm be given to create these jobs?

In addition to addressing the issues, communities must also make allowances for contingencies that are beyond a firm's control, such as business cycles and market changes. Because of these problems, officials have often been hesitant to include clawback provisions in their incentive packages or to enforce them when they are included. To add to the confusion, clawbacks can also become bargaining tools as regions compete with one another for firms—a region that does not insist on clawbacks has a clear advantage over one that does.

### Can Government and Business Cooperate?

These issues will be debated for as long as firms seek concessions that they can use to pit states against each other. At the regional level, it is important for each community to do its best to attract companies that provide the most stable jobs. On an aggregate level, though, this type of interstate bidding war seems almost futile since any relocation or expansion in the United States benefits the nation as a

whole. In some respects, this is the underlying message of Gov. Edgar's address.

Nevertheless, as long as states continue to compete with each other, more and bigger packages will be negotiated until some threshold is reached, beyond which states will simply refuse to go. Some feel that Alabama reached this threshold with its Mercedes package. If so, future packages may include incentives that do not cause a direct burden on the taxpayers of the state. Whatever the next step, states are finding that attracting and retaining jobs can be a costly adventure.

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## **ENDNOTES**

1. Cooper and Ruffenach, p. A2.
2. Woodruff and Templeman, p. 139.
3. The following information about the Southeast can be found in Foust and Mallory, p. 101.
4. These guidelines, while adopted by the Association, will probably have minimal effect because states, especially poorer ones, typically feel they must do whatever it takes to attract new jobs.
5. See Dionne, E.J., Jr.
6. See Lind and Elder, pp. 21-23. The "Build Illinois" program is a state program that funneled money to the municipality to provide land, roads, sewer facilities and worker-training programs.
7. See Miller.
8. See Lewis, p. 19.
9. See Marvel and Shkurti, p. 61. The distribution of taxes abated, about \$8.5 million over 10 years, and other incentives, totaling about \$27 million over 10 years, lends support to this argument.
10. Most of the following information is from Miller and Felsenthal.
11. See Peters, p. 330.

12. *Ibid*, p. 331.

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4...These guidelines, while adopted by the Association, will probably have minimal effect because states, especially poorer ones, typically feel they must do whatever it takes to attract new jobs.

5...Dionne, E.J., Jr.

6...See Lind and Elder, pp. 21-23. The "Build Illinois" program is a state program to develop the infrastructure necessary for the smooth operation of business. For example, this plant had a high demand for water and sewer facilities, as well as heavy-duty roads into the plant, which would have been too costly for the locality. This program funneled money from the state to the municipality to provide land, roads, sewer facilities and worker-training programs.

7...See Miller.

8...See Lewis, p. 19.

9...See Marvel and Shkurti, p. 61. The distribution of taxes abated, about \$8.5 million over 10 years, and other incentives, totaling about \$27 million over 10 years, lends support to this argument.

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(Sidebar)

## The Rise of Honda In Ohio

Honda initially built a motorcycle assembly plant which opened in 1979.<sup>1</sup> Ohio gave Honda about \$15 million in incentives and an option to purchase adjacent state-owned property. In 1980, Honda acted on the option and announced it would build a \$250 million automobile plant projected to employ 2,000 workers. This time, Ohio offered about \$45 million in incentives. Production of Honda's Accord began in 1982. In 1984, Honda announced it would build a plastics and an engine plant and spend \$240 million expanding the auto plant. In 1987, expansions of the engine and research and development plants and a second auto plant were announced. In total, Honda had invested more than \$2 billion in Ohio by 1990 and employed more than 8,200 workers in its factories. The state and local governments had contributed more than \$90 million in incentives and rebates.

Honda created prosperity in Ohio beyond even its own projections. Much of this fortune can be attributed to the unforeseen success of Honda's Accord in American markets. Based on the expansions in the 1980s, the state and Honda had projected the creation of about 5,800 jobs. In fact, almost 10,000 jobs were created, which reduced the state's average cost per job

created from an estimated \$4,200 to about \$2,500. This additional job creation translated into greater-than-anticipated income tax revenues. By 1990, Ohio was receiving \$7.2 million income tax dollars from Honda employees alone? estimates were for only \$5.1 million.<sup>2</sup> In addition, between 1980 and 1990, Honda of America in Union County, Ohio, paid slightly more than \$27 million in property taxes and had about \$8.5 million abated. In other words, Honda was responsible for only 76 percent of its total property tax bill to the county, but this amount was still nearly 65 percent of all property taxes collected by the county. Clearly this was a good deal for the state, the county and Honda.

1.....Most of the following information can be found in Marvel and Shkurti. Numbers cited come directly from tables and other data cited in the article.

2.....These figures assume an annual wage of \$30,000 in 1988 and an estimate of taxes in Ohio.

See footnote b of Table 3 in Marvel and Shkurti, p. 56.