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Are Economic Development Incentives Blessings in Disguise or Necessary Evils?

Thomas Bailey and Thomas Johnson

> In recent years, companies have been leveraging incentives from states and communities to minimize the cost of starting up operations; companies that seek partnerships with states and localities typically view incentives as a measure of commitment. Virginia, long a leader in economic development, is facing new challenges from competing states whose economic development policy includes the generous use of incentives.
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> ----Governor George Allen and Secretary of Commerce Robert T. Skunda. *Opportunity Virginia : A Strategic Plan for Jobs and Prosperity. 1994*.

Alabama offered Mercedes-Benz $253 million in incentives in return for the 1,500 people that the company is expected to employ. Scenarios similar to this one are repeated around the country. State and local governments, believing that businesses will bring increased economic activity into a community, offer incentives to entice the firms to locate in their area.

Virginia is no exception to this practice. Governor George Allen promised, and the General Assembly approved, $131 million in incentives for Disney's "America" to be built in Prince William County. But this project was abandoned because citizens wanted to preserve the Civil War battlefields in the area and because they were concerned with the potential for large increases in traffic in an already congested area.

Thomas Bailey was a graduate student and Thomas Johnson is a professor in the Department of Agricultural and Applied Economics at Virginia Tech.

Disney decided not to pursue the location. In mid-January 1995, Motorola announced plans to build a $1-billion-plus semiconductor plant that would employ as many as 5,000 people. After a 6-month search of more than 30 sites, Richmond, Virginia was chosen as the final site. Motorola was offered access to $85.6 million in incentives, $60 million of which will be from grants created specifically for the semiconductor industry.

What Are "Incentives"?

Economic development incentives are grants, loans, loan guarantees, tax credits, tax exemptions, and other tools used to partially or totally offset the costs of machinery, tools, buildings, land, and worker training. In addition to offsetting these costs, public funds may be used to build or expand infrastructure such as road and rail access, water and sewer facilities or to prepare sites or for combinations thereof.

State and local governments and public, quasi-public, and private organizations offer incentives of one type or another. Locally funded incentives include discounted or no-cost sites, lease packages for facilities or land, low or no interest rate loans, infrastructure improvements, site environmental and archeological audits, zoning variances, site preparation grants, employee relocation packages, utility cash grants, and more.

Incentives are also used to help existing firms expand operations in communities, to assist firms that may be threatening layoffs or closing, and to help new firms

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Virginia Tech

start-up. Virginia, like most states, provides an array of incentive programs at the state and local levels.

Incentive programs in Virginia

Most major state-level incentives used in Virginia are state funded except for the Real Property Tax Exemption and the Tangible Personal Property Tax Exemption (Table 1). These are incentives available for localities to use at their discretion. Enterprise zones, designated areas in which the businesses are exempt from certain state taxes, are created by the state. The localities within the 25 enterprise zones in Virginia can provide additional local level incentives. One of the newest programs, the Governor's Opportunity Fund, was created by the Allen administration to build roads, sewer lines, and other infrastructures. The funds are given at the Governor's discretion and the amount must be matched by local governments.

Disadvantages of Incentives

It is the squeaky wheel that gets the grease. Critics of incentives tend to be more vocal about the shortcomings of incentives than the proponents are about their values. All too often, states and communities give away too much and impoverish themselves. This situation leads to a decrease in the quality of services provided to the community and the firm it sought to attract. In turn, this situation may mean only poorer quality firms can be attracted to the area.

At the local level other problems with incentives can arise. Incentives are frequently given to the firms that may not be most appropriate for a community, such as firms that tend to relocate frequently. Mismatches such as this one can occur when state and local negotiators fail to communicate with each other. The lack of communication may occur because localities are acting without full knowledge, they lack the community resources to obtain more complete information, state programs are often rigid in their requirements, or some combination of these.

In practice, incentives are often given to large, profitable firms even though these firms would have little difficulty obtaining favorable and adequate financing from private financial markets. Small, capital-starved firms, which may add significantly to a community's economy, are often overlooked.

Advantages of Incentives

As with most things, it is easier to criticize than to praise, and thus, the positive aspects of incentives are frequently overlooked by their critics. One of the hardest to identify and measure advantages of incentives is the competition that they can generate. The competition among communities for firms can improve the overall business climate. An improved business climate increases the global competitiveness of firms and generates additional benefits for consumers and the locality where the firm is located.

Communities, if they have enough information on the impact that firms will have on their economies, are able to compete differentially for the firms that best meet their goals. Incentives provide communities with a tool for influencing their economic future. Without this tool the future of most communities would solely be in the hands of states and private firms.

Another advantage is that incentives provide firms with a measure of community commitment. If a community is willing to work with a firm to provide necessary training and infrastructure, a firm is more likely to see the community as a partner -- not merely as a tax collector. When the first firm that sees the community as a partner has located in an area, it is often easier to attract subsequent firms. Oftentimes, other firms are attracted by having the necessary infrastructures already in place so that their start-up time and costs can be reduced. The initial firm begins the process of rural economic development, which, in a growing community, can be expanded further as additional firms enter the area or existing firms expand.

When economic development groups organize to attract firms to a community, vast amounts of information are gathered about the community. Without such information being brought to the attention of firms, many communities would be overlooked, since firms would not be aware of the positive aspects these communities have to offer. This information is also useful to the community in developing policies for attracting businesses, for planning improvements to the community, and for helping the community leaders track the progress of the community.

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Allocating Incentive Packages

Do incentives significantly influence the decisions of firms? Research suggests that most firms are more sensitive to market access than to the costs of land or taxes. The savings to a firm from a typical incentive package are often small. However, the cost to the state or locality providing the incentive can be substantial.

Basic firms are those firms that bring outside dollars into the community, not just cause dollars to change hands within the community. Because outside dollars increase the economic activity of a community through their multiplier effect, firms that generate these outside dollars are commonly the focus of incentive programs. However, some non-basic firms -- firms providing products or services to the community, but not bringing in outside dollars -- may be very effective at keeping economic activity in the local economy by purchasing local products and increasing local income. These non-basic firms, by increasing the multipliers of basic firms, may do as much for the local economy as basic firms and should not be overlooked.

Incentive programs need to be designed to allow localities to achieve their objectives. But, negotiation for firms normally occurs at the state level with limited input from the local government and the majority of the funding for incentives often comes from state governments rather than local governments. For example, the state may focus its effort on larger firms, while the community may not be as concerned with the number of people that will be employed as it is with the longevity of the firm in the community or the kinds of jobs available to the residents (Cox and Bailey).

Though numerous state and local programs exist (Table 1), Virginia lacks a well-defined set of guidelines for implementing these programs. There is no guarantee that the most desirable firms are the ones receiving assistance or that the state or locality is not giving away too much. Several guidelines could help the situation.

1. Maximize local input at all stages of recruitment and allocation of investments.
2. Include local input on state-level decisions.
3. Keep all parties well informed.
4. Do not encourage "bidding wars" between localities within the state.
5. Provide incentives only for environmentally friendly industries with pay scales above local averages.
6. Provide incentives to industries whose job-skill requirements are consistent with local labor.
7. Insist on "claw back" provisions that require firms receiving incentives to repay the incentive money if minimum performance standards are not met.
8. Provide incentives that build local capacity by investing in the people (for example, educational training), so that the benefits stay in the community even if the firm leaves.
9. Allocate some portion of the amount used for attracting new firms to an area to assist existing area businesses in expansion efforts.

Conclusions

Incentives are no panacea. "Good" incentives provide competition among communities, if the communities are operating with full information. Incentives can help to create a better overall business environment if they are used to encourage competition among firms. And, communities can use incentives to help shape the kind of growth and development they want. On the other hand, incentives can be "bad" if they are not targeted toward firms that best meet the community's goals or if the incentives are too large for the community to support -- such as the promise of infrastructure that is beyond the tax base of the community.

Communities need to take a more active part in negotiating incentive programs. Community leaders may know how they want their community to develop; however, they may be hampered by a lack of information and resources to accomplish their goals. Since the state often controls funds and programs, it needs to avoid "fueling" competition between communities for state funds.

When offering an incentive package to a firm, the state or community needs to look at ways to make their dollar investment go as far as possible. Enticing a food processing plant into an agricultural region will probably result in less spent on infrastructure and worker training than would be spent by inviting a "high-tech" industry into the same locality.

Economic development incentives seem to be here to stay for the foreseeable future. The future of many communities is very dependent on them. They can repress and impoverish or they can empower and vitalize. Community and state leaders have a responsibility to develop a sound strategy for their use, and to apply this strategy consistently.

Additional reading

1. Recently completed research at Virginia Tech:

Bailey, Thomas. "An Analysis of Firm Desirability Among Virginia's Counties and Cities." Unpublished MS Thesis. Virginia Tech, 1996.

Cox, Anna. "Proactive Industrial Targeting: An Application of the Analytical Hierarchy Process." Unpublished MS Thesis. Virginia Tech, 1996.

2. The benefits associated with incentive programs can be investigated further in :

Bartik, Timothy J. *Who Benefits From State and Local Economic Development Policies.* W. E. Upjohn Institute for Employment Research. Kalamazoo, Mich. 1991.

3. Criticisms can be further explored through the following sources :

Bingham and Hill, eds. *Financing Economic Development : An Institutional Response.* Sage Publications. London, England. 1990.

Shaffer, Ron. *Community Economics : Economic Structure and Change in Smaller Communities.* Iowa State University Press. Ames, Iowa. 1989.

4. Tools for measuring the impacts of incentive programs can be found in:

Hustedde, Ronald J., Ron Shaffer, and Glen Pulver. *Community Economic Analysis: A How To Manual.* North Central Regional Center for Rural Development. December 1993.

For a copy contact:
North Central Regional Center for Rural Development, 216 East Hall, Iowa State University, Ames, IA 50011, (515) 294-8321, FAX: (515) 294-2303

Holland, Dave. *Economic Impacts - What and Impact Statement Says.* Western Rural Development Center. March, 1994.

For of copy of this or any other *Coping With Growth* publication contact:

Western Rural Development Center, Oregon State University, Ballard Extension Hall 307, Corvallis, OR 97331-3607, (503) 737-3621, FAX: (503) 737-1579

NOTICES

**At the printer a REAP Report, *The Right to Farm Legislation and County Zoning Ordinances*, by Kathryne Piepenhagen and David Kenyon. This report reviews county zoning ordinances in 23 counties after the Right to Farm Law changed in 1995. Contact the REAP office for copies.

**November 15 REAP will sponsor a conference, *Virginia Farmers Adjusting to the 1996 Farm Bill*, in Williamsburg on ways to make better marketing decisions and to prepare better long range plans after the passage of the 1996 Farm Bill. The emphasis will be on grain and oilseed crops, plus livestock and dairy, and cotton, peanuts, and tobacco. However, the luncheon speaker will be discussing the relationship between the farmer, his local community, and the Fund for Rural America and Rural Communities Action Plan provisions of the Farm Bill. More details will be forthcoming. Contact the REAP office if you want to attend.

**REAP is cosponsor of *Tobacco and Health Symposium: Both Sides of the Coin* to be held September 24-26 in Roanoke. Contact the REAP office for more details.

**HOW TO REACH US: REAP, Department of Agricultural and Applied Economics, 0401, Virginia Tech, Blacksburg, VA 24061; telephone (540) 231-9443; fax (540) 231-7471; email *reap01@vt.edu* or on the WWW *http://www.reap.vt.edu/reap/reap.htm.*

Table 1. State-level incentives programs in Virginia

Type of Incentive Program	Type of Incentive	Targets	Funding Purpose
Financing Programs			
Community Development Block Grants	Grant	Low income	Infrastructure, Site development, building construction or renovation
Governor's Opportunity Fund	Grant	No specific target	No specific funding purpose
Industrial Development Bonds	Bond	Industry or firm specific	Building construction or renovation, Equipment or tools
Small Business Financing	Bond and Loan Guaranty	Industry or firm specific	Building construction or renovation, Equipment or tools
Solar Photovoltaic Manufacturing Grants	Grant	Industry or firm specific	No specific funding purpose
Southwest Virginia Economic Development Grant Fund	Grant	Specific region	Infrastructure, Site development
Tax Increment Financing	Tax Increment	Distressed area	No specific funding purpose
Virginia Business Modernization Program	Grant and Loan	Industry or firm specific	No specific funding purpose
Virginia Coalfield Economic Development Authority	Grant and Loan	Specific region	Infrastructure, Site development, Building construction or renovation, Land acquisition, Machinery and tools
Virginia Economic Development Revolving Loan Fund	Loan	Specific region, Low income	Building construction or renovation, Equipment or tools
Virginia Revolving Loan Fund	Loan	Specific region	No specific funding purpose
Infrastructure Programs			
Industrial Access Road Program	Grant	No specific target	Infrastructure
Rail Industrial Access Program	Grant	No specific target	Infrastructure
Shell Building Initiative	Loan	No specific target	Building construction or renovation
Tax Credits and Exemptions			
Corporate Income Tax Credit	Tax Credit	Distressed area	No specific funding purpose
Enterprise Zones	Tax Credit and Exemption	Distressed area, Low income	No specific funding purpose
Major Business Facility Job Tax Credit	Tax Credit	No specific target	No specific funding purpose
Real Property Tax Exemptions	Tax Credit and Exemption	No specific target	No specific funding purpose
Recycling Income Tax Credit	Tax Exemption	No specific target	No specific funding purpose
Sales and Use Tax Exemptions	Tax Exemption	No specific target	No specific funding purpose
Tangible Personal Property Tax Exemption	Tax Exemption	No specific target	No specific funding purpose
Training Programs			
Customized Industrial Training	Grant	No specific target	Labor training

**Virginia Polytechnic Institute
and State University
Department of Agricultural and
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