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COMPETITION BETWEEN STATES AND PROVINCES FOR NEW INVESTMENT: THE EFFECT OF CROSS BORDER INCENTIVES ON PLANT LOCATION

Grahame Richards

Thank you very much, and good morning everybody. My presentation today is going to be about Ontario's experience with investment incentives and plant location in the past five years. I will present the case that direct financial incentives are not cost effective, in our experience. By direct incentives I mean those offered as inducements to manufacturers and service companies to locate their operations in specific states or provinces or cities, not the business climate improvements like lowering corporate tax rates, generally, that would benefit all companies.

First, I would like to place the subject of incentives in context. The competition to attract investment is becoming increasingly intense. We figure we compete with one thousand five hundred sub-national jurisdictions for investment. There was an advertisement that was placed in Fortune Magazine by the Philippines in 1995. It proclaimed, "To attract companies like yours we have felled mountains, razed jungles, filled swamps, moved rivers, relocated towns, all to make it easier for you and your business to do business here."¹ We have not gone to such lengths in North America to the present. But in the past decade, many governments in both the U.S. and Canada have increased the range and value of incentives to attract business.

Advocates for publicly funded incentives argue that they are investments rather than giveaways. The critics contend that incentives have only a marginal impact on the location decision and waste taxpayers' funds. In 1996, the newly elected government in Ontario decided to stop offering direct incentives to businesses and to instead focus on improving the business climate generally for all business. Our experience since then has convinced me and


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us that a good business case far outweighs incentives in influencing investment location decisions.

In my presentation today, I will give you some background on the types of investment incentives and recent trends in North America, and discuss whether direct incentives really work by examining the actual evidence. The evidence suggests they do not, yet most investment promotion agencies, except mine, seem to like incentives, and I will offer explanations as to why I think they do this. I will also discuss the downside of incentives, and there are many, and I will talk about Ontario's experience with investment incentives. I noted before that we stopped offering direct incentives in 1996. The results have been positive for us, as I will show you, and that has led us to conclude that the future, with respect to investment incentives, is right here in Ontario.

There are many types of incentives, some arguably more beneficial than others. According to those who have studied the issue, no federal law in the U.S. prevents a state from offering any incentive of any kind to anyone to induce investment in that state. However, some constitutional lawyers, I understand, argue that if incentives are provided in a discriminatory manner or if they distort interstate commerce, the U.S. Supreme Court could declare them illegal under the Commerce Clause, Article I, Section VIII of the U.S. Constitution. Incentives have not, however, been seriously challenged in the courts in the U.S., as we understand it.

The incentives offered by states, provinces and individual cities can be broken down into several types. These include: tax incentives, financial incentives, infrastructure assistance, building roads, offering free buildings, fast-tracking permits, subsidizing fees, subsidizing utility rates, providing protection from environmental liability, employee training and intangible in-kind services, such as liaison services with municipalities. These incentives are quite widely offered.

Most states have increased almost all types of tax and financial incentives over the last decade. This increase in aggressive competition has been called "The new economic war between the states."² A 1996 KPMG (Klynveld Peat Marwick Goerdeler) study found that the median amount spent by U.S. state and a local government to lure companies to relocate was five million

dollars. The incentives paid for major automobile super deals are even more costly. Alabama paid a package worth two hundred fifty-three million dollars or two hundred thousand dollars per job for a new three hundred million dollar Mercedes assembly plant.

Over the last year or so, however, the incentives battles between states and cities may be taming a bit as a result of good economic times. Probably about thirty-five states indicate they are not going to increase or enhance existing incentives. Two states, Arizona and New York, have decreased the incentives they offer, according to a 1999 survey by the Council of State Governments.

The number of states offering tax incentives has increased over the decade. That is also the case for all types of financial incentives; it gives you some indication of how competitive the incentives game has been in the U.S. both in scale and scope.

The proliferation of incentives begs the question -- do they work? The reality is that empirical studies show that most tax and financial incentives do not work. Even if they do attract some investment, they are not cost effective. There is no statistical evidence we could find that incentives are truly effective. A review of business location studies over a twenty-year period for the Federal Reserve Board in New England concluded that tax-based incentives were ineffective.

The Foreign Investment Advisory Service, (FAIS), the joint service of the World Bank and the IFC, International Finance Corporation, has helped more than one hundred seventeen countries attract investment. In May 1999 they concluded, "In our experience most incentive schemes are simply not effective. They attract very little additional investment and they have costs. They are a drain on treasuries and sometimes counter-productive because they make investment procedures too complex.... In fact, a significant number of multi-nationals make investment decisions in complete disregard of tax and fiscal incentives. They take into account only what they consider to be more basic factors. Of course, after a positive internal decision, they will bargain as hard as possible for any incentives that are available."³

Most surveys of decision-makers conclude that incentives rank only fourth or fifth among the top location decision-making criteria, after factors such as labor skills, business costs, infrastructure and the quality of life. In the 1999 survey of one hundred eighteen foreign-owned firms by the University of North Carolina, respondents ranked tax incentives eighth and government financing tenth out of eleven location decision factors.4

In survey after survey incentives ranked low on the list of site-location criteria. A recent Conway Data local survey of real estate development organizations ranked the availability of financial incentives fifth after labor, operating costs, business climate and infrastructure.5 Another recent example is America on Line's (AOL) five hundred twenty million dollar technology center in Virginia. AOL, apparently, accepted a much lower incentive package, twenty-two million, than the forty million dollars it was offered by Smyrna, Georgia. According to AOL quote, "Incentives were important, but not a determining factor," end of quote.6 In other words, the business case far outweighed incentives in the final decision.

Why then do most directors of foreign investment promotion agencies like incentives so much? Why is it that the first thing that a site location consultant asks us is: what are your incentives? The FIAS has several explanations.

First, government officials who believe in the effectiveness of incentives base it on their daily experience with investors who bargain hard to get whatever incentives are available.

Second, incentives may be used as a signaling device. If a jurisdiction want to change its image to one that is pro-business, investor friendly, the announcement of a set of incentives can form a useful part of the public relations package. Whether incentives are the most cost effective way to do it is a different question.

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Third, the awarding of incentives provides a photo opportunity for politicians. Most officials who claim incentives are effective are the ones that grant them. They have a job to do and they naturally want all the tools they can to get it done. Most of my staff would agree with that.

Finally, those who claim that incentives are effective often rely on cost-benefit data prepared by consultants hired by the firm involved, and these consultants benefit from incentives. In many cases the site-location consultant's final pay will depend on the amount of incentives they extract from a jurisdiction.

There are substantial political pressures on policy makers to allocate resources to incentives, despite the evidence they do not work. The University of North Carolina study identified several of these:

Perceptions tend to offset reality in public policy making. The publicity suggesting that incentives attracted projects like the BMW plant to South Carolina outweighed the reality that they were only marginal factors.

Politicians are often under pressure to, quote, "Do something now"; that is, to create jobs and attract investment, regardless of the long-term consequences. They fear criticism from the public or special interest groups for not doing enough to entice projects to their states, especially when they're on the short list of a site selector.

There is a "follow-the-herd" mentality in economic development policy. Economic development officials fear they will be at a competitive disadvantage if they fail to offer incentives and, although some policy makers admit incentives may not be effective, they do not wish to be the first to disarm economically.

There are many downsides to incentives. It is clear that incentives do not make a bad location a good one. However, states that cannot offer a good business case still attempt to compensate by offering generous incentives that are costly to taxpayers. That, in our opinion, takes dollars away from infrastructure improvements and skills training. Incentives can reduce long-term competitiveness.

Incentives provided to foreign investors also raise questions of inequity. They are clearly unfair to local companies. Why should local companies, who may need assistance from the state, be excluded?
Incentives tend to be "upwardly re-distributive". They tend the use tax revenues from small businesses and individuals to induce large companies to make decisions they could well afford without financial assistance.

Studies have found that whatever immediate, often marginal, impact incentives might have, they wear off rather quickly, especially if the recipients move on to a cheaper jurisdiction in a few years.

Let me now talk about Ontario's experience with incentives. Ontario, as you know, has one of the most advanced and dynamic economies in the world. Much of that dynamism is linked to international investment. About twenty percent of the Ontario Gross Domestic Product (GDP), which stood at two hundred forty-five billion dollars in 1998, is generated by the local operations of multi-national corporations, so we welcome foreign direct investment.

In 1996, the newly elected government decided to stop offering direct subsidies to individual businesses and to focus instead on improving the business climate for all. The government believes that free markets work best when they are not distorted.

For your information, Ontario municipalities are not permitted by statute to offer tax breaks or financial incentives. Other provinces in Canada do offer some incentives, but not as much, generally, as U.S. states. The federal government and its agencies like the Atlantic Canada Opportunities Agency and provinces like Quebec have significant incentive programs. Ontario does, therefore, face internal competition for investment in Canada. However, generally speaking, we have such a good business case to offer that we have lost only three or four percent of projects to other provinces due to incentives offered in recent years.

In 1994 the provinces signed an 'Agreement on Internal Trade'. It included a code of conduct on incentives to prevent provinces from poaching: giving incentives to companies to relocate from one province to another. However, there are no sanctions specified for those who violate the code.

Ontario also faces stiff competition from U.S. states. Regardless of the competition, the Ontario government is focused on improving the business climate and continually lowering the cost of business for all, rather than playing the direct-incentives game.
When we stopped offering incentives in 1996, we also launched an aggressive program of marketing and business climate improvements. The government's overall program included: lowering taxes, both corporate and personal, balancing the budget, reducing debt, streamlining labor laws, increasing government efficiency, reducing red tape, investing in areas such as research and development (available to all companies), education and skills training (offered to all), investing in healthcare and technology. As well, the government is renewing the province's physical infrastructure through a recently announced twenty billion dollar (Canadian) program called "Superbuild".

The government has cut both personal and corporate taxes substantially and continues to do so. Ontario's corporate tax rate will be reduced to eight percent by 2005. That will make the combined federal and provincial corporate taxes thirty point one percent in 2005, as compared to forty point five percent combined federal and state tax in Ohio, for instance. That is not including future tax cuts announced by President Bush.

While Ontario does not provide any direct financial assistance or subsidies to investors, the package does include research and development tax credits, skills training programs and investment marketing services.

Ontario, we believe, has a compelling business case to offer companies. Its package includes a highly educated and available workforce, competitive business costs, a low-cost healthcare system, good infrastructure, a pro-business government and an excellent quality of life. Canada, as we repeatedly like to point out, has ranked first on the United Nations (UN) Human Development Index for the past seven years.

Most companies use financial models to compare short listed location sites. In these models, the net present value of Ontario-based operations compare very favorably against those in competing U.S. states or cities.

Ontario's biggest investment goes into healthcare and education. This translates into benefits for business: access to a skilled workforce and substantially lower health insurance costs. U.S. manufacturers pay, on average, more than three thousand one hundred U.S. dollars per employee for the kind of healthcare coverage provided in our publicly supported system, whereas Ontario employers pay about five hundred and forty U.S. dollars in employer health tax.
A key area in which the government has invested resources is education. Consequently, Ontario boasts a highly educated workforce. Ontario's system of seventeen universities and twenty-five colleges is one of the most highly developed anywhere. In the Toronto area, the Toronto University complex, for example, is second to only to Boston in engineering and science graduates.

Consulting firms such as Price Waterhouse Coopers and Arthur Anderson have been engaged by us to develop net-present-value models for us in our selling efforts for both call centers and auto parts manufacturers. These compare operating costs between Ontario and competing U.S. locations. Ontario locations invariably turn out to have lower operating costs under various scenarios, such as Windsor, Ontario on this slide. These models have been far more persuasive to investment decision-makers than any incentive we might have offered. These models do not run on just sixty-five cent dollars (one Canadian dollar equal to sixty five U.S. cents). We run them on whatever factor the investors want to plug in, generally up to seventy-five and eighty cent dollars.

Ontario's approach, we think, has not hurt our investment attraction efforts to date. The success of Ontario's approach is evident from the results -- we have had a booming economy, and eight hundred twenty-three thousand net new jobs since September of 1995. We have strong growth in capital investments and exports; and, accelerating cross-border U.S. investment in the call center, information technology and automotive industries, just to name a few. By every economic measure; Gross Domestic Product (GDP) growth, jobs, exports, investment, the decision to focus on improving the business climate, rather than incentives, appears to have been the right one. Over the past four years, for example, Ontario has created more manufacturing jobs than any U.S. state or Canadian province.

The economy has grown by well over four percent in each of the last four years, a marked contrast from the one percent average growth from 1990 to 1995, when Ontario did offer a wide range of incentives.

So what have we learned from the various studies and our own experience?

The evidence suggests to us that most incentives do not work; even if some do, they are rarely, if ever, cost effective, and they are not sustainable in the long term. Most objective observers of the incentives game have real-
ized that large sums of money spent have led to a prisoners-dilemma-type situation, where every state or city would be better off if they all reduced their incentives. This is best achieved through multi-lateral policy coordination under the auspices of, say, the World Trade Organization (WTO) or some other organization. In the U.S. there have been calls to legislate an end to the “Economic War Between the States”, but no significant action has been taken. Ontario has taken bold steps with a different approach, and our experience continues to demonstrate that a good business case far outweighs the benefits of incentives.

Thank you very much for your attention.