

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is a darker shade of blue. The hourglass is centered on the page.

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Report 98-516

*FOREIGN INVESTMENT IN THE UNITED STATES: AN  
ANALYSIS OF ECONOMIC EFFECTS OF STATE  
INCENTIVES*

James K. Jackson, Economics Division

Updated May 26, 1998

**Abstract.** This report focuses on several topics related to economic and financial incentives state and local governments offer firms, especially foreign firms, to invest in their jurisdictions. It examines empirical research on the role incentives and subsidies play in the decisions of firms to invest abroad and the competition between state and local governments to attract investments. It also examines recent international attempts to address the issue of incentives and subsidies offered by an increasing number of developing countries to attract multinational firms to invest within their borders.

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## Foreign Investment in the United States: An Analysis of Economic Effects of State Incentives

May 26, 1998

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## **ABSTRACT**

This report focuses on several topics related to economic and financial incentives state and local governments offer firms, especially foreign firms, to invest in their jurisdictions. It briefly examines empirical research on the role incentives and subsidies play in the decisions of firms to invest abroad and the competition between state and local governments to attract investments. This report also examines recent international attempts to address the issue of incentives and subsidies offered by an increasing number of developing countries to attract multinational firms to invest within their borders. This report may be updated as legislative developments require.

# Foreign Investment in the United States: An Analysis of Economic Effects of State Incentives

## Summary

State and local governments have long sponsored economic incentives to firms. Such incentives are designed to attract investment and to stimulate and diversify the local economies. In general, these incentives can include such economic subsidies and tax breaks as loans, grants, public venture capital programs, tax exemptions, tax deductions, and tax abatements. These programs, however, have both strong supporters and detractors, who disagree sharply over the economic effects, both intended and unintended, of industrial location incentives.

Supporters argue that they need economic incentives, because they send a message to businesses that the state or locality is favorably disposed toward business. The supporters also argue that they need a well developed package of incentives to compete with other localities that offer similar types of incentives. Critics argue that this type of "beggar-thy-neighbor" competition among localities and states contributes nothing to the national economy and likely costs more in lost revenues and direct outlays than it generates in tax revenues and jobs.

Empirical analyses offer mixed evidence. A majority of studies indicates that industrial location subsidies and incentives do little to affect business location decisions. In most cases, other economic factors outweigh incentives and subsidies in importance to firms making location decisions. Nevertheless, recent research indicates that, under some circumstances, tax incentives may be important factors for some firms making investment decisions.

Many of the developing nations, starved for investment funds, have proliferated the use of investment subsidies and incentives to attract foreign investment. This has increased the cost of such subsidies for all nations and pushed the issue into the forefront of international negotiations on foreign investment. Subsidies were to have been on the agenda for discussion among the developed economies during the negotiations over the Multilateral Agreement on Investment (MAI), but those negotiations ceased in early 1998.

Within the United States, some Members of Congress have expressed concern over the use of incentives by jurisdictions and the competition for investments. Congress also is concerned that subsidies offered abroad will spur U.S. firms to invest overseas at the expense of investments and jobs at home. Despite these concerns, Congress has been reluctant to step in to regulate or control the subsidies state and local governments offer firms. Moreover, state and local governments apparently feel compelled to continue offering incentives to stay competitive with other states. So far, no one state has been willing to risk a possible loss in corporate investment by being the first to reject such subsidies. It is unlikely, therefore, that the present situation will change, despite expressed disenchantment among all levels of government.

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# Foreign Investment in the United States: An Analysis of Economic Effects of State Incentives

State sponsored economic incentives for firms are not new. They date back to at least 1791, when New Jersey offered tax incentives to Alexander Hamilton to induce him to locate his manufacturing business in the state.<sup>1</sup> In the 1980s and 1990s, however, subsidies and incentives escalated sharply as states and localities competed in bidding wars to attract foreign and domestic firms and the attendant jobs, prompting calls within the United States and abroad for curbs on such activities. There have been numerous attempts to rein in investment subsidies, including the Multilateral Agreement on Investment (MAI).<sup>2</sup> This agreement attempted to standardize such practices and to make them more easily discernible, or transparent, to firms of all nationalities.

Within the United States, state and local governments generally exercise broad discretion in designing and offering incentives, but they do not have unlimited authority. They are restrained by the U.S. Constitution, which gives to the Congress the power "to regulate Commerce with foreign nations and among the several states..." In general, state and local governments use economic and financial incentives to attract investment and to stimulate and diversify their respective economies. Such activities have a strong core of supporters and critics who disagree sharply over the effects, intended and unintended, that are associated with such investment incentives. Congress has expressed concern over investment subsidies and their role in competition between states for investments. Investment subsidies are emerging as an important international issue and was to have been a key component of the Multilateral Agreement on Investment (MAI) before those talks collapsed. It is likely, however, that Congress will have to confront this issue again as it reemerges in other international discussions.

Some critics argue that competition among states and local governments spurs the governments to lower their respective environmental and labor standards to satisfy firms seeking the lowest level of standards. These conclusions are not universally accepted. Some observers argue that investment subsidies shift some economic activity from one state or locality to another, but they doubt that such "beggar-thy-neighbor" competition is sustainable over the long run or that it adds to the productive capacity of the U.S. economy as a whole.<sup>3</sup>

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<sup>1</sup> Key, Kimberly Gillian, and James K. Smith. Trends in State and Local Economic Development Incentives. *Journal of State Taxation*. Fall 1996. p. 1.

<sup>2</sup> See CRS Report 97-469 E, *Multilateral Agreement on Investment: Implications for the United States*, by James K. Jackson.

<sup>3</sup> The term, beggar-thy-neighbor, arises from the field of international trade in which  
(continued...)

## Incentives by State

Economic competition between states and cities is not new. During the nineteenth century, states and cities competed against each other by offering subsidies to railroad companies to gain access to the growing national rail system.<sup>4</sup> A CRS report on state economic development programs indicates that, "state and local governments have long provided various incentives to businesses as part of their larger strategies of promoting economic development."<sup>5</sup> Over the last decade, state and local governments broadened their efforts by offering incentives specifically targeted to attract foreign investors,<sup>6</sup> an act some have termed, "the new mercantilism."<sup>7</sup> Investment incentives and subsidies have also increased as state and local governments have broadened their search for additional revenue sources to compensate for reduced federal government spending.<sup>8</sup> **Appendix A** lists a sample of the incentives that are offered by the six states with the largest amounts of foreign direct investment.<sup>9</sup>

The National Association of State Development Agencies publishes a directory of each state and the types of incentives each offers.<sup>10</sup> This directory indicates that states offer a broad array of incentives, which can be grouped into three main categories:

- *Capital subsidies* consisting of direct state loans, loan guarantees, grants, public venture capital programs, and industrial revenue bonds.

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<sup>3</sup>(...continued)

one country attempts to improve its income and welfare at the expense of other countries.

<sup>4</sup> Taylor, Mark. A Proposal to Prohibit Industrial Relocation Subsidies. *Texas Law Review*, February 1994. p. 671.

<sup>5</sup> CRS Report 89-680, *State Economic Development Programs: Their Evolution, Characteristics and Implications for Trade Agreements*, by J. F. Hornbeck.

<sup>6</sup> Milward, H. Brinton, and Heidi Hosbach Newman. State Incentive Packages and the Industrial Location Decision. *Economic Development Quarterly*, August 1989. p. 203.

<sup>7</sup> Hansen, Susan B. Industrial Policies in the American States: Historical and Comparative Perspectives. In: *The Politics of Industrial Recruitment: Japanese Automobile Investment and Economic Development in the American States*. ed. by Ernest J. Yanarella and William C. Green. New York, Greenwood Press, 1990. p. 4.

<sup>8</sup> Kenyon, Daphne, A. Theories of Interjurisdictional Competition. *New England Economic Review*, March-April 1997. p. 31-35.

<sup>9</sup> The United States defines direct investment abroad as the ownership or control, directly or indirectly, by one person (individual, branch, partnership, association, government, etc.) of 10 percent or more of the voting securities of an incorporated business enterprise or an equivalent interest in an unincorporated business enterprise. 15 CFR § 806.15 (a)(1).

<sup>10</sup> *Directory of Incentives for Business Investment and Development in the United States: A State-by-State Guide*. National Association of State Development Agencies. The Urban Institute, Washington, 1986; also, see: Fahey, Jennifer Campbell, Janine E. Kaczmarowski, and Dorothy Krauss. States Use Several Methods to Attract and Retain Business. *Journal of State Taxation*, summer 1997. p. 45-78.

- *Tax subsidies* which include exemptions, credits, deductions, and local property tax abatements.
- *Economic development strategies* which include enterprise zones and incubator programs.<sup>11</sup>

Although these incentives have become quite ubiquitous, states are not entirely free to design and implement investment incentives in any manner they wish. They are restrained by the U.S. Constitution, which gives Congress the power to regulate commerce between states and with foreign countries, and by international trade agreements.<sup>12</sup> The U.S. Supreme Court has not addressed directly the constitutionality of state economic incentive programs, but there are a number of cases which indicate that the Court places limits on some of these activities.<sup>13</sup> States apparently are free to create an environment conducive to economic activities as long as they do not enact schemes that discriminate in favor of a specific group of investors, such as local businesses.<sup>14</sup>

Generally, state and local governments offer incentives to businesses, regardless of their nationality. **Table 1** (page 4) shows how one group of state governments has used incentives to entice firms to locate within their borders. These incentives include such financial inducements as bonds and loans, and tax incentives covering income, sales, and ad valorem taxes. As foreign investors displayed their interest in investing in the United States in the 1980s and 1990s, state and local governments offered incentives to these firms as well.

Except for some highly visible cases, however, it generally is difficult to determine whether states or local governments offered incentives to foreign firms that were not offered to U.S. firms. This is not to suggest that state and local governments have not occasionally offered foreign investors additional incentives to locate parts of their business operations within their borders, only that such incentives are likely to be case-specific and difficult to assess. According to a mid-1980 survey by the National Governors' Association, half of all states had a designated international trade office responsible for both promoting exports and attracting foreign direct investment. The same survey also indicated that 33 states had some form of official overseas representation, and that all but three states conducted overseas trade missions.<sup>15</sup>

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<sup>11</sup> Hornbeck, *State Economic Development Programs...*, p. 6-19

<sup>12</sup> Key and Smith, Trends in State and Local Economic Development Incentives, p. 1.

<sup>13</sup> For additional details, see: Ibid., p. 8-9.

<sup>14</sup> The difference between benign and discriminatory incentives under the Commerce Clause are explored in: Hellerstein, Walter, and Dan T. Coenen. Commerce Clause Restraints on State Business Development Incentives. *Cornell Law Review*, May 1996. p. 789-878; and Enrich, Peter D. Saving the States From Themselves: Commerce Clause Constraints on State Tax Incentives for Business. *Harvard Law Review*, December 1996. p. 377-468.

<sup>15</sup> Clark, Marianne K. *Revitalizing State Economies*. National Governors' Association, 1986, Chapter 6.



**Table 1. Selected States: Financial And Tax Incentives Offered to Prospective Businesses, 1993**

	AR	IL	IN	KY	MS	MO	TN
<b>FINANCIAL INCENTIVES</b>							
<i>Revenue bonds</i>	Y	Y	Y	Y	Y	Y	Y
<i>State loans</i>	Y	Y	Y	Y	Y	Y	Y
<i>State or agency guaranty programs</i>	Y	N	Y	Y	Y	Y	N
<i>General obligation bonds</i>	Y	Y	Y	N	Y	Y	Y
<b>TAX INCENTIVES</b>							
<i>Sales and use tax exemptions</i>							
Machinery and equipment	Y	Y	Y	N	N	Y	Y
Pollution control devices	Y	Y	Y	N	N	Y	Y
Raw materials	Y	Y	Y	N	Y	Y	Y
<i>State income taxes</i>							
Personal income tax levied	Y	Y	Y	Y	Y	Y	Y
Corporate income tax levied	Y	Y	Y	Y	Y	Y	Y
<i>Federal income tax deductible</i>							
Personal	N	Y	Y	N	N	Y	N
Corporate	N	Y	Y	N	N	Y	N
<i>Ad valorem tax exemptions</i>							
Real estate	N	Y	N	Y	Y	Y	N
Machinery and equipment	N	Y	N	Y	Y	N	N
Raw materials	N	Y	N	Y	Y	Y	N
<b>OTHER INCENTIVES</b>							
<i>Right-to-work laws</i>	Y	N	N	N	Y	N	Y
<i>Enterprise zone exemption</i>							
Property tax	N	Y	Y	Y	N	Y	N
Corporate income tax	Y	Y	Y	Y	N	Y	Y
Sales tax	Y	Y	N	Y	N	N	Y

Note: the states in this table are: Arkansas, Illinois, Indiana, Kentucky, Mississippi, Missouri, and Tennessee.

Source: Zaretsky, Adam M. Are States Giving Away the Store? *Federal Reserve Bank of Saint Louis*, January 1994. p. 7.

Some reported examples of the incentives state and local governments have offered foreign firms include:

- In a bidding war between Washington and Oregon for a \$60 million Nippon Kokan plant to make polychrystalline silicon, Oregon secured the investment by offering a one million dollar water pipeline, partial property tax exemption for five years, and

cut-rate power, and funding for a Japanese school for children of the managers.<sup>16</sup>

- Flat Rock, Michigan secured an investment by Mazda Motors in an automobile assembly plant by waiving property taxes for 14 years.
- Kentucky promised Toyota 1,500 acres of free land, \$47 million in new roads, and \$65 million in employee training programs to attract a \$800 million plant.<sup>17</sup>
- In an escalating "border war" in 1994 between Connecticut and New York, New York lured the Dress Barn company, Connecticut's 55th largest public corporation, to relocate to New York. In turn, Connecticut offered Swiss Bank Corporation \$120 million in tax breaks to move from New York to Connecticut. New York responded to this move by offering Viacom Inc. \$15 million in tax incentives to stay in Manhattan.<sup>18</sup>
- In 1992, South Carolina gave BMW (Bavarian Motor Works) \$135 million in incentives to locate a plant in the state; in 1993, Alabama gave Mercedes Benz \$253 million in incentives and tax breaks to entice the German firm to locate an assembly operation in that state.
- Virginia offered \$166 million in tax breaks and incentives to an IBM-Toshiba joint venture to locate a semiconductor manufacturing facility in Virginia.
- Alabama gave Mercedes Benz \$42.6 million in "tax increment" bonds by the State Industrial Development Authority as reimbursement cost for constructing a \$300 million automobile factory. The state also exempted the firm from corporate income taxes equal to the value of the bonds. Alabama gave Mercedes a property tax abatement for ten years, while providing infrastructure improvements for sewer and road access, reimbursing the firm for the costs of training facilities and equipment, and providing rail line access.<sup>19</sup>

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<sup>16</sup> Once-Insular Oregon Opening its Arms to Japanese Investments. *The Wall Street Journal*, July 21, 1987. p. 1.

<sup>17</sup> The Grab That Never Was. *The Economist*. April 11, 1987, p. 28.

<sup>18</sup> Behr, Peter, To Lure Jobs, States Surrender Key Tax Revenue. *The Washington Post*, Aug. 24, 1995. p. A1.

<sup>19</sup> Hartzheim, Lori A. State Tax Incentives: Headed in the Right Direction. *Journal of State Taxation*, Spring 1997. p. 56.

## Factors Involved in Site Selection

Analysts, representing economics, business, law, and sociology, have contributed to the literature on industrial location. Often, however, these analysts have reached contradictory or ambiguous conclusions. Part of this problem arises from shortcomings inherent in attempting to draw general conclusions about industrial location decisions when the very factors involved in reaching those decisions change in importance as firms proceed through a multistage process they use to decide where to locate. As one analyst has written, "The location decision is a non-standard, complex, and trying one for many managers largely because the factors that affect it can be quite numerous, and not easily quantified."<sup>20</sup>

### Recent Views

According to economists' traditional view of direct investment, firms invest abroad to maximize their profits.<sup>21</sup> While true, this view offers little insight into the direct investment process. More recent views argue that firms invest abroad because they possess superior technology or manufacturing processes, which give them an economic advantage over their competitors; another theory stresses that firms invest overseas because they are attracted by the economic performance of foreign markets. Once firms have decided to invest overseas, they use a different set of factors to differentiate among locations. Often, these factors are difficult to quantify and the decision-making process may be imperceptible to those outside the firm's chain of command. After reviewing a broad spectrum of the industrial location literature, two economists concluded that the location process is a sequential decision-making process that involves a number of stages.

The first stage is the choice of a state or region. Over half of all locational studies make their first cut at the multistate level. Once the state or region has been selected, a more micro-focus will culminate in the selection of a specific community and site. The important locational factors differ between the first stage when firms are seeking a general region in which to locate and the second, more geographically focused stage. In selecting a broad region, the site selection team will focus on labor, state tax variables, climate, proximity to markets, and other features that may have significant interregional variation, but are similar almost everywhere within the region. Locational factors that vary at the micro-geographic level of detail such as land costs, access to major roads, and schools are generally available somewhere within all major regions.<sup>22</sup>

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<sup>20</sup> Schemenner, Roger W. *Making Business Location Decisions*. Englewood Cliffs, Prentice-Hall, Inc., 1982. p. 121.

<sup>21</sup> Hayter, Roger. *The Dynamics of Industrial Location: The Factory, the Firm, and the Production System*. Chichester, John Wiley and Sons, 1997. p. 79.

<sup>22</sup> Blair, John p., and Robert Premus. Major Factors in Industrial Location: A Review. *Economic Development Quarterly*, February 1987. p. 74-75.

The range and rank order of factors involved in a firm's location decision also vary by a range of industrial characteristics. This means that the factors relevant to a location decision can vary by industry, by the types and amounts of raw materials and skilled labor that are used, by the type and area of the market, by company size, experience, personal preferences, and by other factors.<sup>23</sup> For instance, labor costs are especially important in the apparel and shoe industries and other labor-intensive industries. Labor-intensive industries, on the whole are also more likely to be sensitive to labor unionization than are such capital-intensive industries as petroleum, chemicals, food processing, basic metals, and paper-making. Transportation costs are especially important for firms in food processing, lumber or paper, common chemicals, plastic, glass, metals, and metal fabricating. Firms which process agricultural, mining, or forest products generally prefer to locate close to sources of raw materials, while firms in industries involving multi-stage, or complex, processes prefer to locate in close proximity to existing facilities.<sup>24</sup>

These and other factors involved in the industrial location process means that the process is complicated and generally not fully captured in empirical studies. As a result, most of the empirical literature offers little evidence that state-sponsored economic and tax incentives are important factors affecting firms' location choices. One survey of firms receiving state-sponsored economic incentives indicated that the firms did not view the incentives as significant or as giving them a competitive advantage over their competitors, because they believed their competitors received similar treatment.<sup>25</sup> On the other hand, some firms apparently do view tax and financial credits as important factors if competing sites are comparable in terms of labor market costs and proximity to resources and markets.<sup>26</sup>

## Advanced Technology Industries

The fast-growing advanced technology industries have led analysts to conclude that these industries use a new and different set of factors in deciding where to locate their plants. According to this viewpoint, state and local tax systems, education, the "business climate," and the availability of certain types of skilled labor are important location factors. Other analysts argue that state-sponsored incentives help promote economic conditions that are unique to a state and help familiarize others, especially foreign firms, with the resources of that state. Such promotional activities appear to be important to firms that do not engage in a rigorous state-by-state analysis of location factors.<sup>27</sup> A panel of experts assembled by the Federal Reserve Bank of Boston on the topic of state and local government policies on economic development concluded that, contrary to the conventional wisdom of the 1960s and 1970s, state-sponsored location incentives:

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<sup>23</sup> Haigh, Robert W. *Investment Strategies and the Plant-Location Decision: Foreign Companies in the United States*. New York, Praeger, 1989. p. 9.

<sup>24</sup> Schemenner, *Making Business Location Decisions*, p. 121-127.

<sup>25</sup> Key and Smith, *Trends in State and Local Economic Development Incentives*, p. 5.

<sup>26</sup> Hartzheim, *State Tax Incentives: Headed in the Right Direction*, p. 57.

<sup>27</sup> Haigh, *Investment Strategies and the Plant-Location Decision*, p. 31.

...do affect the pace of economic development within their (state and local governments) borders. However...these effects are generally modest. Evidence is inconclusive about which policies exert the greatest effects and under which circumstances. The conditions under which state policies can significantly influence business location and economic growth are limited, mainly because the most important determinants of a jurisdiction's relative rate of economic growth are largely beyond the control of state and local governments...<sup>28</sup>

## Empirical Research

Recent empirical research on foreign firms indicates that four factors appear to be particularly important in influencing foreign firms to invest in the United States. These factors are market size (positively related), manufacturing wage rate (negatively related), transportation infrastructure (positively related), and state promotional activities designed to attract foreign investment (positively related).<sup>29</sup>

**Table 2** (page 9) presents the results of this research.<sup>30</sup>

Not all economists agree with the factors identified in **Table 2**. Land area was used in a number of studies as a proxy for the availability of potential location sites, although Friedman, et al. question using this variable in this way. The influence of taxes on the location of foreign direct investment also had mixed results, with Friedman, et al., alone, concluding that taxes are a significant factor.<sup>31</sup> Part of the disparity among empirical studies likely reflects the complexity of measuring and interpreting this factor. Also, the discrepancy over the significance of taxes may reflect the use of different measures of taxes in the studies: the various measures of taxes include personal, corporate, unitary taxes, and per capita state and local taxes.

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<sup>28</sup> Bradbury, Katherine L., Yolanda K Kodrzycki, and Robert Tannerwald. The Effects of State and Local Public Policies on Economic Development: An Overview. *New England Economic Review*, March-April 1997. p. 1.

<sup>29</sup> Friedman, Joseph, Daniel A. Gerlowski, and Johnathan Silberman. What Attracts Foreign Multinational Corporations? Evidence From Branch Plant Location in the United States. *Journal of Regional Science*, December 1992. p. 414-415.

<sup>30</sup> **Table 2** is taken from: Friedman, Gerlowski, and Silberman, What Attracts Foreign Multinational Corporations? Evidence from Branch Plant Location in the United States, p. 403-418. The other studies included in the table are: Woodward, Douglas p. Locational Determinants of Japanese Manufacturing Start-ups in the United States. *Southern Economic Journal*, January 1992. p. 690-708; Coughlin, Cletus C., Joseph V. Terza, and Vachira Arromdee. State Characteristics and the Location of Foreign Direct Investment Within the United States. *The Review of Economics and Statistics*, November 1991. p. 675-683; Luger, Michael I., and Sudhir Shetty. Determinants of Foreign Plant Start-ups in the United States: Lessons For Policymakers in the Southeast. *Vanderbilt Journal of Transnational Law*, Spring 1985. p. 223-245.

<sup>31</sup> Friedman, Gerlowski, and Silberman, What Attracts Foreign Multinational Corporations?..., p. 413.

**Table 2. Summary of Research on Locational Factors Involved in Site Selection**

	Friedman, Gerlowski & Silberman (1992)	Woodward (1992)	Coughlin, Terza & Arromdee (1991)	Luger & Shetty (1985)
Geographic Unit Used	States	Counties/States	States	States
Type of FDI	New Plants	New Plants	All Types	New Plants
Time Period	1977-88	1980-89	1981-83	1979-93
Source Country	All Countries, Japan, Europe	Japan	All Countries	All Countries
Industry	All Manu- facturing	All Manu- facturing	All Manu- facturing	SIC 283, 355 356, 371*
<u>Results of Tests on Various Factors</u>				
Market Size	Significant (+)	Significant (+)	Significant (+)	Significant (+)
Union	Significant (+)	Significant (-)	Significant(+)	Not Included
Taxes	Significant (-)	Mixed	Not Significant	Not Significant
Land Area	Not Significant	Mixed	Mixed	Not Included
Promotion	Significant (+)	Not Significant	Significant (+)	Significant (+)
Wage Rate	Significant (-)	Not Included	Significant (-)	Significant (-)
Unemployment Rate	Significant (+)	Not Included	Significant (+)	Not Included
Productivity	Significant (+)	Not Included	Not Included	Not Included
Transportation	Significant (+)	Not Included	Significant (+)	Not Included

Note: a + indicates that a factor is significant in a positive way, or that increases in this factor were associated with increases in foreign direct investment in a location; a - indicates that the factor is significant in a negative way.

\* Indicates industries in drugs, industrial machinery, and motor vehicles.

Source: Friedman, Joseph, Daniel A. Gerlowski, and Johnathan Silberman. What Attracts Foreign Multinational Corporations? Evidence From Branch Plant Location in the United States. *Journal of Regional Science*, December 1992.

One puzzling result from the Friedman et al. study is the significant, positive impact of unionization, whereas Woodward finds that unionization has a significant, negative impact on firms' location decisions.<sup>32</sup> The generally accepted proposition argues that a higher degree of unionization would be expected to have a negative impact on foreign direct investment, because unionization would be expected to raise the local wage scale. Friedman et al. argue that unionization has become less important to foreign firms as unions have declined in power and effectiveness. Woodward argues that unionization is important to Japanese firms because of the

<sup>32</sup> Ibid., p. 416.

potentially negative effect the unions would have on Japanese managerial practices. He argues:

The reasons Japanese firms desire nonunion sites may have less to do with saving on labor costs than with the organizational changes wrought by the Japanese model of production. Japanese manufacturing plants often require far fewer job categories than those commonly employed in U.S. industry and introduce different labor relations practices. Facing only enterprise unions at home, Japanese investors may perceive that adversarial unions would impede the introduction of flexible production practices.<sup>33</sup>

Researchers have also concluded that market potential and access to foreign markets are positive and important influences on firms' decision to locate a facility abroad. U.S. states with large market potential have well-developed infrastructure, transportation facilities, certain economies of scale associated with firms involved in similar economic activities (agglomeration economies<sup>34</sup>), and access to customer markets that attract foreign, as well as U.S., firms.<sup>35</sup> Changes in the industrial structure of the U.S. economy toward greater services and advanced technology led other economists to conclude that these changes are heightening the importance of such other factors as state and local taxes, education, business climate, labor skills, and state and local physical infrastructure.<sup>36</sup> These economists also concluded that so many factors seem to be involved that it is difficult to determine whether subsidies or locational incentives are significant factors in where firms decide to invest:

The lack of strong econometric and survey evidence contrasts with the opinions of many policymakers that some development incentives are essential for a successful job creation effort. Perhaps the varieties of incentives are too complex to be captured by the econometric models or perhaps they are so widely offered that they cancel out.<sup>37</sup>

Higher manufacturing wages relative to other states apparently are a significant detriment to attracting some types of foreign direct investment. Foreign firms apparently respond differently to the relative magnitudes of wage rates. For instance, Japanese firms apparently are highly sensitive to wage rates and to labor productivity in deciding where to locate their plants. European firms, on the other hand, apparently do not respond to labor market conditions in this way and their decisions seem to be only marginally responsive to relative wage rates. European firms apparently are influenced more in their location decisions by such factors as access

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<sup>33</sup> Woodward, *Locational Determinants of Japanese Manufacturing Start-ups in the United States*, p. 696.

<sup>34</sup> Krugman refers to these as "localization economies." Krugman, Paul. *Geography and Trade*. Cambridge, the MIT Press. 1991.

<sup>35</sup> Friedman, Gerlowski, and Silberman, *What Attracts Foreign Multinational Corporations?....*, p. 415.

<sup>36</sup> Blair, John p., and Robert Premus. *Major Factors in Industrial Location: A Review. Economic Development Quarterly*, February, 1987. p. 83.

<sup>37</sup> *Ibid.*, p. 83.

to markets, including port facilities, local tax burden, and state promotional activities.<sup>38</sup>

## Economic Implications

There is little doubt that financial and economic incentives are important elements of every state's economic development strategy. What is questionable, however, is whether the economic benefits that arise from such programs outweigh the costs. Empirical research indicates that incentives or subsidies do not drive firms' decisions to locate a plant or a facility abroad and, as such, constitute a "questionable economic practice."<sup>39</sup> Economists also conclude that such incentives generally misallocate economic and financial resources. This misallocation arises from at least three sources:

- Jurisdictions must expend resources to monitor the incentives offered by each other.
- Incentives and subsidies offered to firms may not be recouped in a reasonable time frame, or never fully recouped.
- Subsidies may encourage firms or business activities that are a poor match with the market or industrial structure existing within the jurisdiction, or they may encourage firms to continue a line of activity that is unprofitable under normal market conditions (i.e., a market without subsidies).

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<sup>38</sup> Friedman, Gerlowski, and Silberman, What Attracts Foreign Multinational Corporations?..., p. 413.

<sup>39</sup> Key and Smith, Trends in State and Local Economic Development Incentives, p. 6.



## Experience in the 1990s

Many state and local jurisdictions grew disillusioned in the 1990s with industrial location incentives,<sup>40</sup> even though they claimed publicly that such incentives helped them "capture" firms. One author argues that jurisdictions continue to engage in such activities, despite their reservations, because they apparently produce more immediate political results than waiting for longer-term entrepreneurial programs to mature.<sup>41</sup> These jurisdictions also believe they are unable, by themselves, to stop this activity.<sup>42</sup> Further compounding the issue, firms often expect to be offered attractive incentives since they have become accustomed to having state and local governments offer incentives to attract businesses. In some cases, states even find they have to offer incentives merely to retain certain businesses already located within their borders. According to one author:

Many of the incentives...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 hard pressed to withhold it from another.<sup>43</sup>

A number of state and local jurisdictions have also used incentives to signal their interest in attracting business, or as part of an effort to establish a business friendly atmosphere.<sup>44</sup> Once these incentives proliferated, many jurisdictions determined that they reduced their effectiveness.<sup>45</sup> Competition among states became so intense that state governments adopted a "truce" in 1993. Proposed by the National Governors' Association, the truce urged states not to use public resources merely to influence the location of private investment. Without any enforcement provisions, however, the truce had little noticeable effect.<sup>46</sup> Some state and local governments apparently believe they must pursue business investment to offset losses in federal assistance.<sup>47</sup> One author argues:

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<sup>40</sup> Furton, Matthew T. The Use of Penalty Clauses in Location Incentive Agreements. *Indiana Law Journal*, Summer 1995. p. 1010.

<sup>41</sup> Eisinger, Peter. State Economic Development in the 1990s: Politics and Policy Learning. *Economic Development Quarterly*, May 1995. p. 155.

<sup>42</sup> Holmes, Thomas J. Analyzing a Proposal to Ban State Tax Breaks to Businesses. *Federal Reserve Bank of Minneapolis Quarterly Review*, Spring 1995. p. 29.

<sup>43</sup> Zaretsky, Adam M. Are States Giving Away the Store? *Federal Reserve Bank of Saint Louis*, January 1994. p. 6.

<sup>44</sup> Elkins, David R., Richard D. Bingham, and William M. Bowen. Patterns in State Economic Development Policy: Programmatically Rich and Programmatically Lean Policy Patterns. *State and Local Government Review*, Fall 1996. p. 158-172.

<sup>45</sup> Reese, Laura A., and David Fasenfest. More of the Same: A Research Note on Local Economic Development Policies over Time. *Economic Development Quarterly*, August 1996. p. 288.

<sup>46</sup> Mahtesian, Charles. Romancing the Smokestack. *Governing*, November 1994. p. 36.

<sup>47</sup> Herzog, Henry W. Jr., and Alan M. Schlottmann. Industrial Location in the United States: Some New Evidence of Public Policy Efficacy. *Survey of Business*, Summer/Fall 1993.

(continued...)

The widespread availability of subsidies has created an environment in which cities and states attempt to outbid each other to attract large industrial plants. The corporations planning new plants openly encourage interested cities to match other cities' offers, and thus the corporations extract ever higher concessions from the municipalities.<sup>48</sup>

In Tennessee, where the state developed a package of incentives for the Nissan automobile plant in Nashville, officials grew skeptical of the economic benefits they would ultimately derive from the tax incentives the state offered. According to one official, there is no evidence that the area grew faster or had higher incomes relative to other places as a result of the plant, only that, "more...employment was in manufacturing than before." When Nissan came in, this official concluded, it "paid high wages and skimmed off the best employees, and raised land rents," which eliminated other businesses from starting up.<sup>49</sup> As a result, some states have amended their approach from recruiting businesses outside the state to developing an entrepreneurial approach of helping firms grow within the state. One analyst summarized these changes by stating:

...it would be difficult to make the case that states are abandoning the commitment to economic development that emerged so powerfully in the 1980s, but there are signs of loss of ardor...economic development is no longer regarded in the 1990s as the keystone policy area on which all other state functions depend and to which other funding claims must be subordinated.<sup>50</sup>

## Budgetary Implications

States face additional financial problems that arise from industrial location incentives. First, the subsidies shift fiscal burdens from one class of taxpayer, principally large corporations, to other classes, such as small businesses and homeowners. Second, corporations that receive such benefits can abandon the promised development with little recourse for the jurisdiction.<sup>51</sup> Moreover, as competition between state and local governments increases, the benefit packages the jurisdictions feel compelled to offer grow. That same competition, however, restrains the ability of the jurisdictions to raise taxes to offset the costs of the

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<sup>47</sup>(...continued)

p. 13.

<sup>48</sup> Taylor, A Proposal to Prohibit Industrial Relocation Subsidies, p. 677; and Hartzheim, State Tax Incentives: Headed in the Right Direction, p. 60-64.

<sup>49</sup> The Effects of State and Local Public Policies on Economic Development. *New England Economic Review*, March/April 1997. p. 142.

<sup>50</sup> Eisinger, State Economic Development in the 1990s: Politics and Policy Learning, p. 150.

<sup>51</sup> Hartzheim, State Tax Incentives: Headed in the Right Direction, p. 58.

business incentives they are offering, squeezing the financial resources of the jurisdictions involved.<sup>52</sup>

Paradoxically, economic development subsidies can distort existing patterns of input use by firms and may cause employment to fall.<sup>53</sup> For instance, subsidies or tax reductions which encourage capital expansion or construction relative to labor could shift the use of inputs in the favor of capital and possibly lead to relatively less labor being used in the production process.

## Taxes

In general, state tax credits and incentives fall into three categories: general economic credits and incentives; targeted social and environmental welfare credits and incentives; and specific economic development credits and incentives.<sup>54</sup> General economic development credits and incentives are available to all of those who invest within the parameters of certain specified programs or within designated areas of a state. The most common programs include investment credits to encourage investment in certain types of property, jobs credits for companies that hire people from targeted groups, research and development credits for qualified research within the state, and targeted economic development area credits, or enterprise zones, for distressed urban and rural communities. A number of states and local communities also offer property tax incentives to lure businesses to locate or to expand their operations in their jurisdiction.

The use of tax credits and incentives are widespread: states have available, or use, 15 separate tax-incentive programs; 18 financial-incentive programs; and 18 special-services programs. While not every state uses all of these programs, the programs are used widely by many of the states. The importance of these tax programs to firms making location decisions in a particular state depends on the economic and tax position of the state relative to other states. As the author concludes:

...actions to attract jobs by reducing taxes or altering expenditures would appear to have significant payoffs only in those states with very poor business climates or poorly designed tax systems.<sup>55</sup>

Targeted credits and incentives are designed to promote or to encourage certain activities that will benefit the societal or environmental conditions of the state. These credits generally are available to all businesses and are not limited to specific

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<sup>52</sup> Kenyon, Daphne A. Theories of Interjurisdictional Competition. *New England Economic Review*, March-April 1997. p. 31-35.

<sup>53</sup> Gerking, Shelby, and William Morgan. Measuring Effects of Industrial Location and State Economic Development Policy: A Survey. In: *Industry Location and Public Policy*, ed. by Henry W. Herzog, Jr., and Alan M. Schlottmann. Knoxville, The University of Tennessee Press. p. 36.

<sup>54</sup> Hartzheim, State Tax Incentives: Headed in the Right Direction, p. 51-52.

<sup>55</sup> *Ibid.*, p. 28.

industries or companies.<sup>56</sup> Specific economic development credits, however, are aimed primarily at large corporations and are designed to encourage specific firms to locate or to remain in a state.

Empirical studies on the effects federal, state, and local taxes have on foreign investment raise a number of thorny issues and generate conflicting results.<sup>57</sup> Some critics argue that U.S. federal and state taxes materially alter the location decisions of firms by encouraging U.S. manufacturing firms to open a plant in a foreign country while closing down a U.S. plant. Most economists disagree with these assertions. They argue that, since tax incentives are small relative to other costs firms face,<sup>58</sup> they are unlikely to play a decisive role in a firm's location decisions. For instance, New York and California have high tax rates, but both of them have high levels of investment.

## Research Results

After surveying a broad number of empirical studies on business location decisions, one author concluded that there is scant evidence, on the whole, about whether tax-incentive programs and other financial incentives actually attract businesses and employment.<sup>59</sup> Despite these results other researchers contend that business leaders will lobby strongly for such incentives, because they "have no reason to turn down tax breaks and other giveaways even if these programs do not affect location decisions."<sup>60</sup>

Contrary to this viewpoint, economist James R. Hines, Jr. concluded in a recent study of state-level taxes that these tax rates "significantly influence the location of FDI in the United States."<sup>61</sup> He argues that previous attempts to assess the

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<sup>56</sup> Ibid., p. 55.

<sup>57</sup> This report is meant to consider only a small range of tax issues which deal specifically with incentives. For a broader treatment of tax issues, refer to: Alworth, Julian S. *The Finance, Investment and Taxation Decisions of Multinationals*. Oxford, Basil Blackwell, 1988; CRS Report 91-582 E, *Federal Taxes and Foreign Investment in the United States: An Assessment*, by David L. Brumbaugh; and CRS Report 91-682 E, *U.S. Taxation of Overseas Investment: Selected Issues in the 102d Congress*, by David L. Brumbaugh.

<sup>58</sup> Carlton, Dennis W. The Location and Employment Choices of New Firms: An Econometric Model with Discrete and Continuous Endogenous Variables. *Review of Economics and Statistics*, August 1983. p. 440-449.

<sup>59</sup> Wasylenko, Michael. Empirical Evidence on Interregional Business Location Decisions and the Role of Fiscal Incentives in Economic Development. In: *Industrial Location and Public Policy*, ed. by Herzog and Schlottmann, p. 13-30.

<sup>60</sup> Ibid., p. 13.

<sup>61</sup> Hines, James R., Jr. Altered States: Taxes and the Location of Foreign Direct Investment in America. *The American Economic Review*, December 1996. p. 1076, also Cummins, Jason G., and R. Glenn Hubbard. *The Tax Sensitivity of Foreign Direct Investment: Evidence From Firm-Level Panel Data*. NBER Working Paper #4703, April (continued...)

importance of such incentives and credits have undervalued their importance because they did not properly control for "important unobservable variables."<sup>62</sup> In some cases, investors are drawn to locations despite high tax rates because other factors dominate their decisions. Hines argues that there are various factors which draw firms to a specific location, although many of those factors are not observable.<sup>63</sup>

Hines also questions what might be expected from a correlation between taxes and business investment. For instance, he argues that if higher business taxes represent part of a fiscal package that includes greater spending on infrastructure and other items that benefit business, then higher taxes might be positively correlated with business activity. Hines concludes that the available data do not allow for a test of the impact tax factors have in explaining foreign investment in the United States as a whole, but that they do allow for a test concerning foreign investment within the United States. Here, Hines finds that even small variations in local tax rates may have "important effects" on capital flows.<sup>64</sup>

Those who assert that taxes are important, are aided little by empirical analysis, which has not yet resolved uncertainties over how taxes affect the decisions of multinational firms. One analyst concluded that there still is little awareness of the actual manner in which the financial decisions of multinational corporations are affected by differences in taxation across government jurisdictions.<sup>65</sup> Another critic argues that incentives are ineffective in stimulating economic activity because: they merely reward activities that would otherwise take place; tax breaks are not targeted and not connected to economic development strategies; local advantages and disadvantages are many and overwhelm state tax costs; and there is no apparent correlation between high-tax and low-growth states.<sup>66</sup>

## **Incentives in International Foreign Investment**

Investment incentives also have become an important international issue as U.S. and other multinational firms increasingly are offered lucrative incentives to invest in both developing and developed countries. Often, these incentives are crafted to attract, or retain, investments within certain industrial sectors. As a result, such incentives can exist along side investment controls as nations seek to protect certain sectors of their economies from foreign competition.

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<sup>61</sup>(...continued)  
1994. p. 24-25.

<sup>62</sup> Hines, *Altered States: Taxes and the Location of Foreign Direct Investment in America*, p. 1077.

<sup>63</sup> *Ibid.*, p. 1079.

<sup>64</sup> *Ibid.*, p. 1092.

<sup>65</sup> Alworth, Julian S. *The Finance, Investment and Taxation Decisions of Multinationals*. Oxford, Basil Blackwell, 1988. p. 119.

<sup>66</sup> Key and Smith, *Trends in State and Local Economic Development Incentives*, p. 6; and Moss, Kary L. *The Privatizing of Public Wealth. Fordham Urban Law Journal*, Fall 1995. p. 103-104..

The United Nations, through its Commission on International Investment and Transnational Corporations, released a report<sup>67</sup> in 1995 that details the proliferation of financial and economic incentives as more nations compete aggressively to attract foreign direct investment and to retain domestic investment. Fiscal incentives, including tax deferrals, tax reductions, accelerated depreciation allowances, and exemption from import duties on capital equipment, are the most widely used types of incentive to attract foreign direct investment, as indicated in **Tables 3 and 4**, which show that investment incentives have increased in every region of the world. In explaining this proliferation, the United Nations concluded:

As governments have recognized the potential FDI (foreign direct investment) has in contributing to economic growth, attracting FDI has become a policy priority in many countries, both developed and developing. Incentives are, as a result, an important component of national policy frameworks for FDI and one which by its very nature, can be more easily manipulated by governments than other factors influencing investment decisions.<sup>68</sup>

Prior to the Uruguay Round of Multilateral Trade Negotiations, no rules within the GATT (General Agreement on Tariffs and Trade) dealt explicitly with foreign direct investment. As a result, there was no general discipline that existed either at the multilateral or regional levels to deal with incentives that affect direct investment. The issue of incentives was addressed obliquely through two agreements within the Uruguay Round: the Agreement on Trade-Related Investment Measures (TRIMS); and the General Agreement on Trade in Services. These provisions do not deal directly with investment incentives, but govern subsidies which distort trade. For instance, the TRIMS Agreement seeks to eliminate performance requirements, or conditions governments place on foreign investors desiring to invest within their national borders. Member countries of the GATT are prohibited by the TRIMS Agreement from conditioning investment incentives or subsidies on local content or on export requirements. The Agreement on services merely provides that subsidies on trade in services, which includes direct investment, will be negotiated in the future.

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<sup>67</sup> *Incentives and Foreign Direct Investment*. Geneva, United Nations Conference on Trade and Development, April 1995.

<sup>68</sup> *Ibid.*, p. 5.

**Table 3. Fiscal Incentives for Foreign Investors: Frequency by Region  
Number of Countries Offering a Type of Incentive (early 1990s)**

Region	Number of incentives	Reduction of standard income tax costs	Tax holidays	Accelerated depreciation	Reinvestment allowance	Deduction from social security	Deductions on gross earnings	Exemption from import duties	Duty drawbacks
Africa	24	19	16	13	4	2	14	16	11
Asia	17	12	12	9	5	1	11	12	8
W. Asia	3	2	3	1	--	--	1	2	1
L. America	12	12	8	6	9	2	5	11	11
C., E. Europe	25	20	19	6	3	2	2	13	12
N. America	2	2	2	2	--	--	2	1	--
W. Europe	20	15	7	10	5	5	9	7	6
Total	103	82	67	47	26	12	44	62	49

Source: *Incentives and Foreign Direct Investment*. Geneva, United Nations Conference on Trade and Development, April 1995. p. 14.

During the Uruguay Round of Negotiations, the GATT adopted a definition of subsidy, which states that a subsidy is a financial contribution by a government or some other public body, or some other income or price support, that conveys a benefit to a specific industry or firm.<sup>69</sup> Included within this definition are grants, loans, equity, loan guarantees, tax forgiveness, goods and services, and government purchase of goods. To avoid falling within the definition of a subsidy and, therefore being subject to WTO disciplines, a government must develop its program so that it is generally available throughout a state or local jurisdiction.<sup>70</sup>

<sup>69</sup> Colgan, Charles S. Brave New World: International Regulation of Subsidies and the Future of State and Local Economic Development Programs. *Economic Development Quarterly*, May 1995. p. 107-118; and CRS Report 96-487 E, *Subsidies, Countervailing Duties, and the World Trade Organization*, by J.F. Hornbeck.

<sup>70</sup> Colgan, Brave New World, p. 108-109.

**Table 4. Fiscal Incentives for Foreign Investors: Changes in 92 Countries Between Mid 1980s and Early 1990s**

Incentive	Africa				Asia				Latin America				Central and Eastern Europe				Western Europe				
	No. of incentives		No. of countries that offer the incentive		No. of incentives		No. of countries that offer the incentive		No. of incentives		No. of countries that offer the incentive		No. of incentives		No. of countries that offer the incentive		No. of incentives		No. of countries that offer the incentive		
	More	Less	More	Less	More	Less	More	Less	More	Less	More	Less	More	Less	More	Less	More	Less	More	Less	
Reduction of standard income-tax rate	X		X		X		X			X	X			X		X		X		X	
Tax holidays	X		X		X		X		X		X		X		X		X		X		X
Accelerated depreciation	X		X			X	=	=	X		X		X		X			X		X	
Reinvestment allowance	X		=	=	X		X		X		X		X		X		X		=	=	
Deductions from social security contributions	X		X		X		=	=	X		X		X		X		X		X		X
Specific deductions on gross earnings for income tax purposes, or reduction in other taxes	X		X		X		X		X		X		X		X		X		X		X
Exemption from import duties	X			X	X		X		X		X		X		X		X		X		X
Duty drawbacks	X		X		X		X		X		X		X		X		X		X		X

Source: *Incentives and Foreign Direct Investment*. United Nations Conference on Trade and Development, 1995. p. 13.

To fall within the WTO disciplines, a subsidy or incentive must be shown to distort trade. Even if a government economic development program offers subsidies to investors, the subsidies would not fall within the WTO disciplines unless it also is shown to distort trade. As one author has written, "many economic development programs might be defined as subsidies under the rules but would only be of concern if they actually distort trade."<sup>71</sup> The international push to develop rules on subsidies, however, ultimately may conflict with the efforts of the states and cities.

The American demand for ever-stricter disciplines on subsidies has largely ignored the role that state and local governments have played in economic development efforts...It may be reasonably expected, given past U.S. interest in attacking foreign subsidies and the increased standard of review in the Uruguay round agreement, that American industries will

<sup>71</sup> Ibid., p. 109.



continue to aggressively pursue subsidies in other countries. The result may be the ensnaring of state and local programs.<sup>72</sup>

The Clinton Administration is pursuing a dual approach on direct investment that includes reducing foreign barriers to direct investment and controlling incentives. Consequently, the Administration is seeking agreements within a number of multilateral frameworks to liberalize further the remaining national barriers to direct investment. In May 1995, the Administration launched negotiations within the OECD on a "multinational agreement on investment" (MAI). The intent of this agreement would be to go beyond the obligations nations currently face in the OECD to liberalize their laws and practices relevant to international investment. In particular, the Administration pressed to have the agreement include provisions that:

- limited the number and type of industrial sectors nations can exclude from liberalizing;
- allowed for freedom from performance requirements (conditions imposed on foreign investors as requirements for gaining an approval to invest);
- gave firms the freedom to make any investment-related transfer, including of profits, capital, royalties and fees;
- established international law standards for expropriation, including that compensation must be prompt, adequate and effective; and
- provided access to binding international arbitration of disputes between and investor and the state.

The MAI talks faltered, however, as the United States and other nations disagreed over the numbers and types of incentives nations could exempt from the disciplines of the agreement. Some critics were concerned that the mandate for national treatment in the agreement harbored potential legal problems for state and local governments which might face suits over state consumer and environmental legislation. Also, every nation wanted some of its industries or economic sectors exempted from the MAI requirements for unfettered national control, either because of national security concerns or because of specific domestic political issues. U.S. negotiators believed that a request by European members for a broad exception for such regional economic organizations as the European Union would have given the European members a wholesale exemption from the agreement. The U.S. negotiators believed this type of exemption would have allowed the Europeans effectively to disregard the MAI obligations on national treatment and to discriminate in favor of investments from other European Union member states.

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<sup>72</sup> Ibid., p. 115.

## Conclusions

Over the last decade, there has been a sharp escalation in the growth of economic and tax incentives to influence the location decisions of firms. State, local, and even national governments are skeptical of the economic benefits associated with such incentives, but seem unable, by themselves, to retard their proliferation across local, state, and national boundaries. Moreover, empirical analyses to date indicate that economic incentives generally are not a decisive factor in where firms decide to locate. Despite these results, there seems to be no reversal occurring any time soon in the number and types of incentives state, local, and national governments seem willing to offer. Members of Congress are concerned over the escalating use of incentives between states that are competing for corporate investment, but Congress has shown little desire to regulate state economic development programs. At the international level, Congress may be required to address the issue of incentives if the Administration negotiates successfully to include incentives as part of an international agreement on investment.

Empirical analyses indicate that a broad array of factors, ranging from labor availability and quality to market access, raw materials, and schools, may all play a role in the location decisions of firms. Superior technology or advanced manufacturing processes, however, likely give firms the initial advantage they need to consider investing abroad. Once firms have made the decision to invest abroad, a separate set of factors likely influence where they decide to locate. For some high technology firms, taxes and other incentives may be important factors that influence where they locate, but empirical research offers conflicting results on the role these factors play. Part of this ambiguity arises from the importance specific factors may play in locational decisions, especially since the relative importance of those factors changes as firms proceed through a multistage process to decide whether and where to invest abroad.

Nearly all economists agree that economic growth is determined at the national level by broad, macroeconomic factors and conditions, but economic growth and employment issues often dominate elections and political developments at the level of state and local governments. As a result, political leaders at these levels feel compelled to compete with other jurisdictions for jobs and businesses by offering incentives even though these types of beggar-thy-neighbor policies have a dubious track record. Few jurisdictions, however, seem willing to buck the trend and eliminate incentives and subsidies to firms at the risk of losing investments or alienating voters.

At the international level, there is a growing movement toward liberalizing foreign investment rules, especially among developing countries, where foreign firms have become highly sought after as a source of capital and technology. These developing countries have demonstrated that they are willing to use the types of subsidies and incentives that developed countries have used for years to attract multinational firms to their borders. Efforts by the developed countries over the last two years to reach an accord on standardizing the national rules on foreign investment have run into stiff opposition by consumer and environmental groups. While various international forums likely will address the issue of incentives again, the collapse of the MAI talks offers little assurance that incentives, subsidies, or a

multitude of other issues related to foreign investment will be resolved at the multinational level any time soon.

## **Appendix A: Economic Development Incentives of Selected States**

### **Texas**

Texas offers a broad range of programs and incentives to business investors,<sup>73</sup> including:

- The state's Business Finance office provides businesses with financial and technical assistance, including securing funds for equipment, building acquisition, and working capital for domestic and export activities.
- The state has three capital fund programs to promote economic growth in rural areas of Texas and a Leverage Fund that is designated as a "economic development bank" for cities.
- New or expanding businesses may qualify for special incentives under Texas' Enterprise Zone Program.
- The Smart Jobs Fund provides grants to existing Texas businesses to expand and create new jobs or retain existing jobs by upgrading the skills of their current work force.
- The Texas Manufacturing Assistance Center provides assistance to small Texas manufacturers seeking to upgrade their operations.
- Texas has 25 Foreign Trade Zones.

One of Texas' recent success stories is the January 1996 announcement by Samsung Electronics that it would locate its first U.S. semiconductor manufacturing plant in Austin, Texas. The City of Austin and the Texas Department of Commerce offered to provide \$2 million to train the 1,000 new employees needed at the plant. The Texas Department of Commerce also aided Samsung with information on site selection, sales and use tax exemptions, industrial revenue bonds, enterprise zones, and permit and regulatory assistance.

### **California**

California engages in a broad array of activities to promote exports and to attract foreign investment.<sup>74</sup> These programs fall under the general categories of

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<sup>73</sup> This information on investment incentives and economic development was obtained over the World Wide Web at the site for the Texas Department of Commerce <[www.tdoc.state.tx.us/](http://www.tdoc.state.tx.us/)>.

<sup>74</sup> This information on investment incentives and economic development was obtained over the World Wide Web at the site for the California Department of Commerce (continued...)

Economic Development and Business Development. The state also has a group of programs focused on international sources of development. The Office of Foreign Investment, which seeks to create jobs in California by attracting new industry to the state and by expanding existing industry. There also is an Office of California-Mexico Affairs, an Office of Export Finance, and Office of Export Development; the state sponsors eight international Offices of Trade and Investment overseas to promote exports and to seek out foreign investment in California. The offices are located in Hong Kong, Tokyo, London, Frankfurt, Jerusalem, Mexico City, Taipei, and Johannesburg. These offices provide in-country coordination and support for state-sponsored trade shows, investment promotions, and business missions.

Under its Economic Development office, California offers a number of incentives to businesses, including:

- Enterprise Zones (EZs) target economically distressed areas and offer tax incentives to businesses which invest in EZs. In addition, Enterprise Zone Hiring Tax Credits permit businesses to earn tax credits by hiring from certain labor pools.
- Manufacturing Credits or Sales and Use Tax Exemptions include tax credits for the purchase of qualified machinery and equipment; a new trade or business in California can apply for an exemption from the state portion of the state sales and uses tax due on manufacturing, processing, refining, fabricating or recycling equipment.
- Business development programs include a range of programs designed to assist local governments to retain, help expand, or attract businesses, including:
- Local Area Military Base Recovery Act (LAMBRA) activities designed to create jobs in areas experiencing military base downsizing and closure.

California also has a wide range of programs and services administered by its Office of Business Development to assist local government in their efforts to retain, expand, and attract businesses. Business Development offers assistance through enterprise zones and LAMBRA legislation similar to the Office of Economic Development. In addition, the Business office sponsors a number of other programs, including:

- The Los Angeles Revitalization Zone was established to stimulate economic growth, create jobs, and rebuild businesses within portions of Los Angeles County that suffered physical and economic damage during the 1992 civil disturbances.
- Team California is a state-wide network of economic development professionals who work collaboratively to share information, to attract and

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<sup>74</sup>(...continued)  
<[www.ca.gov/commerce/](http://www.ca.gov/commerce/)>.

retain businesses, and to provide a link between businesses and the federal and local governments.

- California uses Industrial Development Bonds, issued both at the state and local level, to finance land acquisition, building construction, equipment, architectural and engineering fees, and other incidental costs associated with a project. In addition, California offers direct financial assistance to businesses through three revolving loan funds and through loan guarantees.

## Ohio

Ohio offers an array of programs and assistance to attract and retain businesses.<sup>75</sup> As a result of these programs, Ohio has been named the number one state in attracting new facilities by site selection magazines. Through the state's Department of Development, Ohio offers such financial assistance as loans, grants, bonds, tax incentives and low-interest financing for fixed assets. The Office of Business Development and Direct Foreign Investment structures incentive packages, provides information on Ohio's business assistance programs and conducts site searches for companies. Officials within the Business Development office review state programs relevant to loans, tax credits, tax exemptions, training and infrastructure programs and consider which would be the best mix for each individual project. The Office also administers the following programs:

- The Site Selection System provides site and building information to interested businesses.
- The Business Development Account provides infrastructure grant assistance to companies and/or communities for projects creating or retaining jobs.
- The Roadwork Development Account provides road work grant assistance for public road improvements and construction to communities and/or companies for projects creating or retaining jobs.

Ohio has other offices which offer direct assistance to businesses:

- The Office of Tax Incentives administers various tax incentives, including the Job Creation Tax Credit, which provides a corporation or a franchise an income tax credit for creating at least 25 new jobs in the state. In addition, the office administers the Ohio Manufacturer's Investment Tax Credit, the Machinery and Equipment Investment Tax Credit, and such property tax incentive programs as Tax Increment Financing, Community Reinvestment Areas, and Enterprise Zones.

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<sup>75</sup> This information on investment incentives and economic development was obtained over the World Wide Web at the site for the Ohio Department of Development <[www.odod.ohio.gov/](http://www.odod.ohio.gov/)>.

- The Office of Financial Incentives engages in both fixed-asset lending and loan servicing. In particular, the state's lending programs are comprised of a Direct Lending Program, the Ohio Enterprise Bond Program, the Ohio Pooled Bond Program, and the Ohio Statewide Development Corporation Loan Program.
- Ohio Job Creation Tax Credit program gives substantial state and municipal tax reduction, which minimize capital expenditure to encourage businesses to expand or to locate in Ohio.
- Research and Development Tax Credits give financial incentives to Ohio companies to produce and perfect technologies and products.
- Ohio Export Tax Credits encourage and reward firms that export.
- Manufacturing Machinery and Equipment Investment Tax Credits encourage small and medium-sized manufacturing companies to invest in new machinery and equipment.
- Ohio Manufacturers Investment Tax Credits are non-refundable corporate franchise income tax credits for a company that purchases new or retools qualified machinery and equipment that is located in Ohio and is used for manufacturing.

Ohio also promotes exports for Ohio manufacturing and service companies and encourages reverse investment in the state. The state's International Trade Division assists Ohio businesses interested in new markets, expanding within a present market or exporting for the first time. The Division works collaboratively with state-sponsored trade offices in Brussels, Tokyo, Hong Kong, Toronto, Tel Aviv, and Mexico City. These offices offer assistance to foreign companies seeking Ohio businesses as suppliers of products and services and identifies Ohio companies interested in joint ventures, licensing arrangements and technology transfers. The state also offers export counseling by providing custom-tailored assistance in international marketing and export finance to small and medium-sized companies, and leads delegations of Ohio exporters to the world's leading trade shows.

## **New York**

New York state boasts of a number of factors which make it a prime location for domestic and foreign investors: 50 percent of the wealth and 50 percent of the population of the United States can be found within a 750 mile radius of central New York, 20 percent of all U.S. merchandise trade flows through New York's ports.<sup>76</sup> The state has ten regional offices which aid firms with comprehensive site and building information, and analyses of economic, demographic, wage, tax, and utility

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<sup>76</sup> This information on investment incentives and economic development was obtained over the World Wide Web at the site for Empire State Development <[www.empire.state.ny.us/](http://www.empire.state.ny.us/)>.

costs. New York has placed a renewed emphasis on attracting foreign investment and offers a host of tax credits to companies, including:

- Tax credit for building or for new capital investment.
- Tax credit for employing New York residents.
- Credit against corporate franchise/income tax for research and development.
- 40 Economic Development Zones which offer extensive tax credits and discounts on electric power and wage tax credits.
- Financial assistance to companies which locate or expand a plant for acquisitions of land, buildings, or machinery and equipment.
- New York state offers financial assistance in the form of direct loans, interest rate subsidies, loan guarantees for working capital assistance, and infrastructure assistance.
- The state offers financial support and technical resources to companies to offset the cost of training employees.
- For companies interested in exporting, New York state provides information about tariffs, industry specifications and government regulations.

## Illinois

The Illinois Department of Commerce & Community Affairs (DCCA) has helped hundreds of firms over the last three decades locate within the state or helped existing firms expand their operations.<sup>77</sup> From this experience, the DCCA concluded that helping firms select their site is the most important way it can aid firms. It argues that firms make a mistake by placing too much emphasis on the degree of unionized labor, state and local taxes, and use of "business climate" rankings. Nevertheless, the state has a number of tax incentives to encourage both existing and new businesses: credits against corporate income tax for capital investments, training, and employment. As an additional aid to firms seeking sites within Illinois, the DCCA developed a computerized database with information about available industrial sites and the communities in which they are located.

Illinois also has 91 Enterprise Zones (EZ), which offer a mix of state incentives to encourage companies to invest within a zone. Each zone also offers a distinctive set of such local incentives as property tax abatements, waiver of business licensing and permit fees, streamlined building code and zoning requirements, and special

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<sup>77</sup> This information on investment incentives and economic development was obtained over the World Wide Web at the site for the Illinois Department of Commerce & Community Affairs <[www.ilcommerce.com/files/business/execguid.html](http://www.ilcommerce.com/files/business/execguid.html)>.



local financing programs and resources. Within Enterprise Zones, the state offers additional incentives:

- Sales tax exemption on building materials.
- Enterprise Zone Utility Tax Exemption: offers a tax exemption on gas, electricity, and the Illinois Commerce Commission's administrative charge.
- Enterprise Zone Investment Tax Credit: is an investment tax credit on machinery, equipment, and buildings.
- Dividend Income Deduction: taxes are not levied on dividend income for individuals, corporations, trusts and estates for corporations doing substantially all their business in an Enterprise Zone.
- Jobs Tax Credit: allows a credit to businesses on income taxes for each job created in a Zone.
- Interest Deduction: Financial institutions are not taxed on the interest received on loans for development within an EZ.

Illinois also offers extensive assistance to firms looking to export. The state was one of the first to organize a network of foreign trade offices and in providing regional export assistance centers across the state. Illinois has Foreign Trade Offices in the following seven cities: Brussels, Hong Kong, Tokyo, Mexico City, Budapest, and Warsaw.

Illinois also has several programs through which it offers direct financial assistance to businesses for industrial and commercial development. These programs augment conventional sources of financing and are administered through four different state departments.

### **Department of Commerce and Community Affairs**

- Small Business Development Program: designed to provide direct financing to small businesses with negotiable interest rates in cooperation with private and public sector lenders.
- Participation Loan Program: works through banks and other conventional lenders to provide financial assistance to small businesses that will employ Illinois workers.
- Development Corporation Participation Loan Program: provides financial assistance through a Development Corporation to provide financial assistance to small businesses that provide jobs to workers in the region served by the Development Corporation.
- Illinois Export Finance Partnership Program: a collaborative effort between various Departments to help small and medium-sized Illinois exporters gain access to working capital loans.

- Surety Bond Guaranty Program: assists small Illinois minority contractors in obtaining bid, performance and payment bonds for government and utility contracts.

### **Development Finance Authority**

- Industrial Revenue Bonds: issued on behalf of manufacturing companies to finance the acquisition of such fixed assets as land, buildings, and equipment, or for new construction or renovation.
- Direct Loan Program: provides loans to small and medium-sized Illinois firms to purchase land or buildings, building construction and renovation costs, and purchase machinery and equipment.
- Commercial Lease Program: provides commercial leases which allow firms to consider the lease payments as expenses, thereby reducing their taxes.

### **Illinois Farm Development Authority**

- Agri-Industries Guarantee Program offers guarantees for loans for land acquisition, building construction and improvements on projects that promote diversification of the farm economy.

### **Office of the State Treasurer**

- Community Development Deposit Program uses state deposits to support community development projects.