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The Unseen Costs of Ribbon-Cutting:

Losses from Economic Development Programs

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The "Seen" and the "Unseen"

When a governor or mayor cuts the ribbon of a new factory made possible through government funding, the "seen" benefits are loudly touted. Officials congratulate themselves for the number of jobs created. But what are the "unseen" costs? What would have happened in the absence of government funding, if the resources used in economic development activities had, instead, been left in the private sector? Unfortunately, the "unseen" private sector losses are usually greater than the "seen" gains. Could economic development programs stimulate sufficient growth, and thus additional tax revenue, that they pay for themselves? Academic research very clearly shows that this is a fantasy.[1]

The Oregon Lottery has generated $783 million dollars since 1985, all of which is supposed to be spent on economic development. Rapid revenue growth could cause a doubling of the cumulative total in just over two more years. Because of the major expenditures involved, this paper addresses whether the government should spend money on economic development programs. Tax abatements and preferences are left for another discussion.

People benefit when businesses provide the greatest value to their customers for the least possible cost. Competition is central to this process. Those who do the best job thrive; those businesses that do a poorer job have to downsize or go out of business altogether. Government support for economic development programs replaces the discipline of the market with the judgment of politicians and bureaucrats. Is it any wonder that the costs outweigh the benefits?

How the Private Sector Loses from Economic Development

Before any government economic development spending can occur, resources must be transferred to the government from the private sector. This transfer represents a cost. Had the resources been left with their original owners, they would have been (1) spent on consumer goods or business equipment, or (2) saved so that business or consumer borrowers could spend, or (3) invested so that a company could buy equipment, labor, or supplies. Economic development spending reduces the private sector's resources and, in turn, their ability to create jobs and to provide valuable products and services.

Transferring resources away from such private sector activities produces a harmful, yet unintended consequence: these transfers generate losses to the private sector that actually offset any good done by economic development programs. Because public sector decision-making is generally less successful, the gains achieved through economic development programs are smaller than the loss to the private sector.

> *"In the economic sphere an act, a habit, an institution, a law produces not only one effect, but a series of effects. Of these effects, the first alone is immediate; it appears simultaneously with its cause; it is seen. The other effects emerge only subsequently; they are not seen. . . ."*
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> — Frederic Bastiat*

Three hypothetical examples show the ironic consequences of businesses receiving economic development assistance:

The bankrupt company. The resources taken from the private sector have been wasted. A building may have been specially constructed in such a way that it isn't as useful to anyone else. Machinery may have been purchased, only to be sold for scrap. People would have been trained for jobs that no longer exist. Clearly, the community is poorer because the resources invested in this company have been wasted.

The marginally profitable compnay. In this case, the building, the equipment, and the people are producing enough value to cover costs, as the bookkeeper sees those costs. But the total cost of the resources used by the firm is greater, because the public sector is paying part of the tab. Although the business continues to operate, the resources would have produced greater value if left in the private sector. The waste isn't as great as in bankruptcy, but resources have still been wasted.

The successful company. Its physical and human assets produce goods or services that are valued in the marketplace. No waste of resources has occurred. But what has really been accomplished? An enterprise that could have succeeded without state support has succeeded with state support. The business owners have somewhat greater profits, the taxpayers have somewhat less disposable income, so we have merely shifted resources from some people to others. This is not wasteful per se, but it is a reallocation from taxpayers generally to selected business owners.

Could there be a case in which economic development subsidies allow a business to succeed which would not have been started otherwise? If so, profit-seeking investors ignore opportunities that are clearly recognized by bureaucrats. That may happen on occasion, but not regularly by any means. Further discussion appears in the next section.

Economic development also consists of activities other than helping specific businesses. Public works, such as the Oregon Convention Center in Portland, is the largest single use of Oregon economic development funds.[2] Certainly jobs were created in the construction of the center, in the operations of the center, and at nearby restaurants and hotels. But we must ask about the "unseen". How would private citizens have spent the millions of dollars used to build the convention center? If people were not eating in restaurants across from the center, would they not eat at all? Perhaps they would have spent money on food across town, or do we imagine that they would have gone hungry, with untaxed dollars left in their pockets? Indeed, all of the spending associated with the convention center could have occurred elsewhere.

Infrastructure—highways and water systems and such—sounds like a reasonable part of economic development activities. After all, if it is the government's job to build roads, why not tailor-make one to fit a new factory? However, in the name of economic development we have shifted resources from serving existing businesses to chasing after new businesses. Companies on Portland's inner east side today lack access to the freeway that runs just above their factory roofs, but a few years ago the state spent over $5 million on road improvements for Biin, the now-defunct Hillsboro computer company.[3] We must ask what is gained if the climate for existing businesses is sacrificed in the name of economic development. An official will be able to brag about new jobs created; then he or she will wonder why so many old jobs were lost.

Why the Public Sector Often Makes Poor Investments

Examples abound of poor public sector investment decisions, such as the Public Employees Retirement System's investments in PAMCO, the Oregon Economic Development Department's support for Biin; and the Port of Portland's shipyard. Why is public sector decision making so poor?

Reason 1: Experience and talent. Those in the private sector who make large investment decisions have generally been successful at making smaller decisions. Those who have been most successful in the private sector have greater command over resources for future investments; those who have been less successful command fewer resources. But a person can rise to a key political position without a record of successful investing.

Reason 2: Politics. Legislators look out for their districts. If Economic Development officials found that good opportunities were not evenly spread across the state, but instead were lumped in some communities, what would they do? Their choice is to either make good investment decisions and alienate many legislators, or to make poorer decisions to placate legislators. Nationally, we see military spending decisions based on whose state or Congressional district benefits. Oregon's regional strategies program was actually set up to ensure that every region of the state got a cut of lottery dollars, rather than investing funds based upon objective success potential.

Reason 3: Jobs. Wise investors weigh potential reward against risk. Politicians are almost exclusively focused on "how many jobs are created." Imagine three projects: one is likely to return a high return on investment with low risk, but it creates few new jobs. Another has a low expected return, relatively low risk, and creates some jobs. The third has both a low expected return and high risk but creates the most jobs. Which one is favored by politicians looking forward to the next election, or by bureaucrats working for such politicians? Creating jobs sounds nice, but in the end, jobs are not created by poor business decision making.

Inequities from Economic Development Spending

Use of government funds for economic development causes inequities among local businesses. For example, the Economic Development Department has provided assistance for a Portland microbrewery. But what of the other microbreweries in Oregon, which now face a subsidized competitor? This practice does not promote a good business climate.

This inequity is not only unfair; it is harmful. Businesses learn to focus on winning government grants and tax breaks, rather than focus on competitiveness and serving customers. The extreme example of this phenomenon is major league sports, where owners are at least as concerned about receiving subsidies for new arenas as they are about winning games.

Is the Lottery a Tax?

No one is forced to play the lottery, so it may not appear to be a tax. However, no one is forced to buy liquor, but we still call the liquor tax a tax. The gasoline tax is avoided by those who use public transit or bicycles; the property tax is paid only by those who use property; and the income tax is paid only by those who earn income in excess of the standard deduction.

The state lottery makes money only because private gambling is generally illegal. With more competition, the lottery would generate relatively little revenue. The key element of taxation is the extraction of resources from the private sector by force or threat of force. The force involved here is the criminal prosecution of lottery competitors. Indeed, the lottery is a tax.

Myths of Economic Development Spending

Two myths create confusion about economic development programs.

Myth 1: Other states do it, so it must be okay. Teenagers try this line, but wise parents don't give in. If shifting resources from the private sector to the government is bad for the business climate, must we follow along when other states do it? First, we can let them subsidize us. That is, if Alabama taxpayers subsidize an automobile factory, that may help Oregonians get cheaper cars. Although there is no good reason for Alabamians to be taxed to help us, it's their choice to make.

How will Oregonians earn the money to buy cars if Alabama lures the factories there? Oregon can encourage those companies which are not glamorous enough for high-profile subsidies by keeping our business climate healthy. Most new jobs—91 percent of them—are created by existing establishments, not new businesses.[4] And most new businesses are home-grown, not factories lured from out of state.

Myth 2: Economic development is needed to create family wage jobs. High wage jobs cannot be created for low skilled individuals in the 1990s. There are plenty of low skilled people around the globe willing to work cheap. On the other hand, people with skills that are in demand will find companies relocating to be close to them. It's no surprise that Oregon's high tech boom followed years of migration of highly educated people into the state. The only economic development strategy that addresses the issue of family wage jobs is to improve the quality of results of our educational system. (Please note the emphasis on results, rather than funding for the public school system.)

An Economic Development Program for Oregon

If Oregon should not fund a large economic development program, what should be our strategy for promoting the welfare of the public through trade, commerce and industry? Based on the economics outlined above, we conclude that the state should:

1. **Eliminate the Oregon economic development department.** Return the funds to taxpayers to improve the state's business climate.

2. **Ease the regulatory burden on business.** New business owners report a nightmare of regulatory issues that they must face at the most critical stage in a business's life. There may be less red tape needed to collect welfare than to start a business. Legislators should look at all of the state's tax and regulatory functions with an eye to easing the burden of government on business.

3. **Oregon should have low taxes across the board to build our business climate.** Although business taxes should not be excessive, we should also watch the taxes paid by the owners, employees, and customers of Oregon's businesses. The emphasis needs to be on low overall tax rates. (See Cascade Policy Institute's Fiscal Insight #3: <i>Business Taxation: A Loose Cannon on a Dark Night

Counting Jobs

Counting jobs created by economic development programs is highly speculative at best. If new jobs are created by taxing Oregonians, how many of those jobs will be filled by Oregonians? National research shows that 4 out of every 5 jobs will go to outside residents who later move here.[5]

An even greater problem is which jobs are to be counted. Many assisted businesses would have come here anyway. Employment estimates are easily inflated by the huge turnovers of jobs. In 1993, for example, there were over one million new employees hired in Oregon, a state with an average employment of 1.3 million.[6] There were also over one million job "separations," both voluntary and involuntary. With such a large "churn," some of the hiring companies will be involved with economic development grants, allowing the government to take credit for jobs that would have been created anyway. As government also takes credit for jobs retained when existing businesses threaten to move out of state, the job count could even exceed the number of jobs created!

Notes:

1. Timothy J. Bartik, "Jobs, Productivity, and Local Economic Development: What Implications Does Economic Research Have for the Role of Government?", National Tax Journal, December 1994.

2. "Lottery Funds: Where they come from, where they go," Staff report to the Joint Legislative Committee on Trade and Economic Development (Oregon), October 1994. 3. "Biin's travails call state incentives into question," The Business Journal (Portland, Oregon), October 16, 1989.

4. Data supplied by facsimile from Oregon Employment Division, January 26, 1995. 5. Bartik, cited above.

6. Oregon Employment Division, cited above.

* Frederic Bastiat (1801-50) was a French economist. His essay "The Law" is the subject of a Cascade Policy Institute essay contest for high school students in 1995. The quotation cited above is from the essay "What Is Seen and What is Not Seen," in Selected Essays on Political Economy, p. 1.

About the author

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