Dell and the Incentives Game

By: Andrew Brod

Brod, Andrew (2005). Dell and the Incentives Game. *Greensboro News & Record*, January 2, 2005

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Article:

At long last, the Dell deal is a done deal. As nearly everyone now knows, Dell will locate its new manufacturing facility in southeastern Forsyth County, on land that Winston-Salem plans to annex. The site's proximity to Highway 311 appears to make it a bit more favorable for Winston-Salem and High Point than for Greensboro. But the site is centrally located within the Triad, and the facility will certainly benefit the entire region in both direct and indirect ways. As the single biggest engine in the regional economy, Greensboro will get its share of the benefits.

Economic incentives were big news throughout the whole process. First the state of North Carolina approved an incentive package totaling more than $242 million. Then Dell announced that it would locate the plant somewhere in the Triad, sparking a bidding contest among local communities.

Winston-Salem (with Forsyth County) offered Dell the most, a package valued at more than $37 million. Greensboro (with Guilford County) offered the least, a bit over $12 million. Davidson County and High Point (with Guilford County) were somewhere in the middle, each a little over $20 million.

Now that the deal is done, let's step back and think about economic incentives and their role in the Dell deal and beyond.

Did Dell choose Forsyth because it offered so much in incentives?

Companies are always circumspect, if not coy, when it comes to discussing the reasons for their location decisions. They always say that incentives are important, but they generally add that other, often unnamed, factors are important as well. Dell has followed this pattern. But we can infer something about those other factors from the company's apparent seriousness about having the new facility up and running by the fall of 2005. It appears that time is of the essence to Dell, and the relatively flat Forsyth site will be easy to grade and prepare for construction. The gap between the Winston-Salem and Greensboro offers was $25 million. Were staying on schedule and incurring lower site-preparation costs worth more to Dell than that $25 million? Only Dell knows.

Keep in mind that if we include the state's contribution, Dell's total incentive package for locating in Forsyth is roughly $280 million. If Dell had located in Guilford, the total amount would have been more like $255 million, which is still huge. The $25 million gap seems a bit smaller in this context.

Do incentives work?

The John Locke Foundation in Raleigh says no. It opposes incentives and points to research indicating that they are a minor consideration in business location decisions. That's probably true in the grand scheme of things. Factors like transportation costs, labor costs, and worker skills no doubt matter more. Dell didn't include North Carolina among its possible sites because of incentives, but rather because of its proximity to its markets and its manufacturing tradition.

However, incentives can matter at the margin. Once all other factors are in place and the short list of sites has been determined by the company, incentives can indeed be a deciding factor.

Are incentives bad for state and local governments?

The answer depends on whether one takes a broad or narrow view of the issue. Taking the narrow view, the answer is usually no. As a rule, state and local governments don't offer incentive packages that cost more than they expect to get in return in the form of increased tax revenues. In the case of Dell, state officials estimated that the future tax revenues resulting from increased employment, new businesses, etc. would be greater than the $242 million cost of the package.

At the local level, I made similar projections on behalf of both Guilford and Forsyth Counties, and I got a similar result. Taking into account the cost of the local incentive packages, I found that local governments in both counties would have come out ahead had Dell accepted their offers. (Not surprisingly, it will take longer for Forsyth to recoup its costs than it would have for Guilford.) One Guilford County commissioner has declared that it's fortunate that Dell didn't choose Guilford, because the county couldn't afford its own bid. That appears not to be the case.

Occasionally, however, an incentive package is too big. Among economists, this is known as the Winner's Curse, and it arises in bidding processes in which no one knows for sure how to value the item they're bidding on. When that happens, it's possible for the eventual winner to bid too much. When Alabama outbid North Carolina for a Mercedes-Benz factory in 1993, it looked for many years that the state had fallen prey to the Winner's Curse. More recently, some observers are saying that Alabama's gains have finally started to outweigh the huge costs.

The broad view of the incentives issue leads to a different conclusion than the narrow view. Economic incentives are an example of what economists call the Prisoner's Dilemma. The dilemma is that the best action for each individual decision-maker makes them all worse off. In the incentives game, competition among states ensures that virtually all of them grant incentives in one form or another. And yet all states would be better off if none did so. Therefore, the current legal environment that allows incentives is worse for state and local governments than one that would prohibit them. This is reflected in the way people talk about incentives. No one really likes them, and even their defenders characterize them as a necessary evil.

Are incentives unconstitutional?

They are according to the 6th Circuit Court of Appeals. That court recently found that a tax credit offered to DaimlerChrysler by the state of Ohio violated the commerce clause of the U.S. Constitution. The clause gives Congress the power "to regulate Commerce... among the several States." The court reasoned that by offering special incentives to DaimlerChrysler for locating in Ohio, the state disadvantaged companies in other states, and according to the court, that's an infringement of interstate commerce.

Now, when it comes to economics, what's legal isn't always what makes sense. But I have to wonder about a couple of points here. First, the commerce clause doesn't say that Congress has an *exclusive* right to regulate interstate commerce. And lest we forget, another part of the Constitution, the pesky 1 0th Amendment so beloved by constitutional conservatives, says that any powers not specifically delegated to the federal government "are reserved to the States." It seems to me that until there's a federal law limiting the ability of states to play the incentives game, they should be allowed to play it.

Second, if one accepts the court's reasoning, then *any* policy that favors in-state companies to the detriment of out-of-state companies should be unconstitutional as well. But wouldn't that apply to general tax levels as well as to the targeted tax incentives at issue in the Ohio case? If a company locates in a state with generally low taxes, doesn't it put companies in higher-tax states in precisely the same disadvantage as claimed by the 6th Circuit Court of Appeals? The decision has been appealed and the case is moving upward toward the U.S. Supreme Court. I doubt that anyone expects *that* court to rule that states cannot set their own tax levels.

Another legal front in the war on incentives may soon emerge in North Carolina. An organization called the North Carolina Institute for Constitutional Law, led by a former state Supreme Court justice, claims that the state law governing incentives violates the state's constitution. I hope this effort fails. The thing about the Prisoner's Dilemma is that no one wants to disarm unilaterally. As long as other states are playing the incentives game, I want my state to play as well.

Is there an alternative to the incentives game?

The only way out of the economic-incentives version of the Prisoner's Dilemma is federal legislation. My non-lawyerly opinion is that lawsuits like the Ohio case aren't the answer. But will Congress do anything about incentives? After all, the corporations that contribute to political campaigns probably think incentives are swell. And a groundswell of public support for federal legislation seems unlikely, because the conservatives who tend to be the biggest opponents of incentives don't usually look to Congress for solutions. We may be stuck playing the incentives game for the foreseeable future.