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Professor Yinger

Case: Alabama and the Mercedes-Benz Plant[(1)]

It is the Fall of 1993. The Governor of Alabama faces a very tough decision. Although income in Alabama and other southern states has been growing faster than the national average for quite a while, a decline in employment in Alabama over the last year has clouded the state's economic outlook. Now the governor has a chance to head off future trouble--or at least he might. Mercedes-Benz, the German car manufacturer wants to build a factory to produce its new four-wheel-drive sports utility vehicle and appears ready to move to Alabama if it receives a package of financial incentives it has negotiated with the State Department of Trade and Industry. The Governor must decide whether to approve this package.

The Plant and the Package

The new Mercedes-Benz plant would be located on 1,000 acres of pine forest east of Tuscaloosa, Alabama. It would be a $300 million investment, and would ultimately have a workforce of about 1,500. Companies supplying parts for the new plant are expected to hire many times that number of workers. Because Alabama now has virtually no automobile production, and hence no experience autoworkers, most of the initial employees may come from out of state. Over the long term, however, the employees of the plant are all expected to be from Alabama.

The incentive package involves $77.5 million to improve water, sewer, gas, and electrical services, $92.2 million to improve and develop the factory site, and $60 million to train Mercedes-Benz employees, suppliers, and workers in related industries. Mercedes-Benz also will receive tax breaks, including an exemption from all property taxes for 20 years. Total cost of the package could be as high as $300 million, which comes to $200,000 per direct job created.

This incentive package is large by recent national standards. South Carolina laid out $150 million to attract a BMW plant that employs 1,500 workers, for example, and Kentucky provided a $147 million package for a Toyota plant with a workforce of 3,000.

The Issues

The main issue for the governor, as for many other governors facing similar decisions, is jobs. Will the Mercedes-Benz plant really be able to sustain 1,500 jobs? How many jobs will be created in related industries? These are questions without any clear answers.

The official state study of the Mercedes-Benz plant, conducted by Prof. Mac R. Holmes of Troy State University, found that the plant and the businesses it attracts could add 15,000 to 17,000 new jobs over 10 years and additional wages of $5.9 billion over 20 years. "This kind of opportunity comes once in a lifetime," Professor Holmes said. "Not only are there the returns in terms of money, but the symbolism may be as important as the direct economic impact." He says this analysis, which is based on standard input-output multipliers, is conservative and indicated that over 20 years the plant would mean at least $320 million in increased state tax receipts, and $115 million in benefits to local governments.

A report by scholars at the Midwest Center for Labor Research disagrees. This report concludes that the state report inflated virtually every assumption in its cost-benefit analysis, from the multiplier used to the calculation of the plant's ripple effect to the amount of equipment Mercedes-Benz will be able to buy within the state to the annual sales--and therefore annual tax payments--the plant will generate. This report concludes that even under the best of circumstances, Alabama's state and local governments will not be able to recoup up-front expenses for a minimum of seven years.

Moreover, many experts warn against job counting as a way to measure a plant's benefits. According to Dr. Timothy J. Bartik of the Upjohn Institute, a leading expert on economic development policy, "Political officials and the media often mistakenly assume that the economic benefits of a new manufacturing plant are equal to the payroll provided by the plant and its support industries. This benefit measurement would be correct only if the new jobs did not displace other jobs and if the new workers employed all placed a zero value on their leisure time. This would be most nearly true if the plant were located in an area with depression-level unemployment and all hiring were done locally. In a full-employment economy, a new plant leads to bidding up of wages, which both displaces some private employment and causes some marginal workers (that is, workers who are close to indifferent between work at prevailing wages and leisure) to join the labor force. In this case, the benefits caused by the additional labor demand are zero."

Many public officials also are becoming concerned about the high-costs of inter-state competition for jobs. "The Cold War is over," said Jack Kyser, chief economist for the Los Angeles County Economic Development Corporation, "and now you have a new war between the states. It's an economic development war, and the stakes keep getting bigger." According to Illinois' Republican Governor Jim Edgar, "The competition has escalated in the last few years into states all trying to outbid each other. Once you get something, you might have given up so much it wasn't worth getting the project, and everyone else that pays taxes is frustrated." At the urging of Governor Edgar and others, the National Governor's Association just passed a resolution saying competition for jobs "should not be characterized by how much direct assistance a state can provide to individual companies." They urged states to use incentives that can benefit an entire community, like worker training.

Many experts echo this conclusion. According to Jeffrey A. Finkle, executive director of the National Council for Urban Economic Development, a Washington-based group representing economic development organization and professionals, states "are making a terrible mistake" in falling over one another to hand out the fattest packages. With public treasuries strapped for cash, "The last thing we need to be doing is getting into a position where we can be held hostage by a few businesses dangling jobs in front of us in return for subsidies." Larry C. Ledebur, director of the Center for Urban Studies at Wayne State University, concurs. "State and local government are paying money to get companies that might locate there anyway," said "Staggering sums of money are being wasted."

Most experts are not willing to say, however, that fiscal incentive packages are always a bad idea. For example, Charles Haywood, director of the Center for Business and Economic Research at the University of Kentucky, said that the incentive package Kentucky offered Toyota clearly was worth the money. Dr. Haywood said that the Toyota plant, which was expected to bring 3,000 jobs, actually would bring a total of 6,000 by 1995. His analysis also indicates that the plant would cost the state $305.2 million by 2005, but also would produce $993.4 in additional state revenues. "It's been a heck of an investment," he said. Other scholars concede that the Toyota plant package may have been a good deal for the state, but estimate much smaller net benefits.

The Governor is particularly concerned about one piece of evidence in the Midwest Center for Labor Studies report. This evidence, which is presented in Table 1, concerns the estimated cost of producing a sports-utility vehicle at all the sites thought to be competing for the Mercedes-Benz plant. These costs include transportation costs, which are based on the distance from each site to the domestic railheads that Mercedes-Benz is likely to use in shipping its cars; local supplier labor costs, which are based on local wage rates in auto-related industries; and state and local taxes, excluding any special tax breaks. Although Alabama is not as close to railheads as some other sites, it has very low wages and very low state and local taxes. As a result, its estimated costs are lower than those in any of the competing sites. These estimates may not correspond to Mercedes-Benz's own calculations, but they do suggest that the Tuscaloosa site is very competitive with the other sites before incentive packages are considered. To attract the Mercedes-Benz plant, therefore, Alabama may have to beat the packages offered by several nearby states, such as Kentucky, but it does not have to overcome severe locational cost disadvantages, as would be true in Ohio, Minnesota, or New York.

Economic development is not, of course, the only item on the Governor's agenda, and he also is concerned about whether a poor state like Alabama can afford such a large investment. The state's other needs are staggering. The educational system is so deficient, for example, that the state's Supreme Court recently ruled that the state failed to provide students with the minimally adequate education guaranteed by the state constitution. Fixing this problem is likely to cost an enormous amount--even more than the incentive package for Mercedes-Benz. Thus this package is an enormous risk. The Governor could require Mercedes-Benz to reimburse the state if it shuts the plant down or fails to produce as many jobs as promised, but this is likely to be an empty requirement. If the plant fails, after all, Mercedes-Benz won't have any resources left in the state and it might prove difficult to obtain compensation from out-of state or even out-of-county funds.

Other Approaches

The backlash against job-chasing subsidies has led many public officials to look for other approaches. One approach focuses on general government services, not tax breaks and specialized services; this has been called the "If we build it, they will come" approach. Wayne Fawbush, Director of Oregon's Economic Development Agency, is a proponent of this approach. He says that "The more you compete for a business, the more you look like your competitors." His strategy is to distance Oregon from its competitors by emphasizing that some jobs aren't worth having and that lasting economic development can only occur in the context of community development.

"For every low-wage job you create," says Fawbush, "you create a liability" in the form of public services that cost more than state taxes received. Dr. Bartik supports this view. He says that "New jobs attract people; on average four out of five new jobs in a local economy will go to people who otherwise would have lived elsewhere. Additional population requires spending on schools and infrastructure that is unlikely to be fully recovered from household taxes." Dr. Bartik concludes that "Fiscal benefits from incentives are often elusive and should not be the main focus of incentive design."

On his second point of emphasis, Fawbush says that "High paying jobs do not exist in a vacuum." They require an educated work force and a well developed public infrastructure, both of which can be created or enhanced by state policies--policies that compete with tax incentives for scarce state funds. Many scholars back up this approach. According to Professor Bartik, "current evidence suggests that roads and education are the key public services for economic growth." Professor Bartik also points out that some states have had success with programs to provide technical assistance for small businesses or to support applied research that falls between basic research traditionally conducted at universities and product development undertaken at firms. Other states have emphasized managerial improvements that bring down the cost of public services and hence make it possible to lower the tax rates for all businesses.

The Decision

As the Director of Department of Trade and Industry, you must make a recommendation to the Governor. Should he approve the incentive package as it stands? Should he approve an amended package? The governor has asked you to clearly explain the basis for your recommendation. He also has asked you to identify important principles of economic development policy that will help him in making future decisions. You have been asked to present your analysis and recommendations in a public meeting on the Mercedes-Benz package.

Table 1
Estimated Costs Per Vehicle

Location	Average Cost of Transport to Market	Local Supplier Labor Cost	State and Local Taxes (before Tax Breaks)	Total Measured Costs
Tuskaloosa, AL	$469	$144	$ 89	$702
Nashville, TN	426	159	118	703
Lexington, KY	423	186	106	715
St. Louis, MO	419	172	134	725
Bloomington, IL	417	202	162	781
Kalamazoo, MI	430	244	116	790
Terre Haute, IN	413	209	168	790
Marysville, OH	427	219	169	815
Minneapolis, MN	494	195	[a]	689[b]
New York, NY	535	184	[a]	719[b]

Notes:
a. Data not available.
b. Labor and transport costs only, but this is a high-tax state.

Bibliography

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[1]This case was written by Professor John Yinger solely for the purposes of class discussion. It draws on the articles in the bibliography, sometimes word for word. Although this case is based on a real decision, some of the information about the situation in Alabama is fabricated for the purposes of the case.