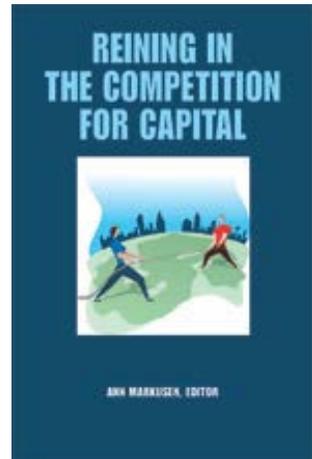

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Institutional and Political Determinants of Incentive Competition

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Incentive competition is on the rise. It is costly, generally inefficient, and often ineffective even for the winning regions. Yet some regions do very well by attracting large, new facilities that create sustained jobs, bolster the tax base, and have multiplier effects. The nation states of Europe have developed an effective regulatory system that curtails abuse, but the United States, Canada, and Australia have grappled with forms of cooperation and regulation less successfully. Incentive competition is spreading to developing countries, especially as responsibility for and fiscal capacity to support economic development have devolved to subnational levels of government. Local governments also compete for mobile capital, export-oriented as well as retail. Incentive competition for capital is an increasingly important public policy issue, because it consumes considerable resources, alters the spatial distribution of economic activity, and entails large opportunity costs for citizens and businesses.

In this chapter, we argue that incentive competition cannot be adequately approached in a game theoretic, microeconomic fashion. The phenomenon deserves a historical explanation that probes national and global institutional and political changes shaping the rise and character of bidding wars. Our treatment is thus interdisciplinary, incorporating insights from economics, economic history, geography and regional science, political science, political sociology, and urban and regional

planning. This chapter is both an original interpretation of the origins and analytics of the “regional market for jobs and tax capacity” and an introduction to and framing of the contributions in the volume.

We first show that incentive competition is proliferating, not just in the United States and other OECD countries, but also in large, developing countries with federal power sharing, such as Brazil, India, and China. Many more state and local governments have been thrust into such competition worldwide, and the total amount spent on incentive competition has been rising rapidly. Incentive competition is also waxing among nations, and we explore briefly how the policy and institutional environment differs in these cases.

In an effort to analyze the source of this trend, we offer an institutional and political interpretation of the rise of incentive competition. To economic and geographic causes such as falling transportation and communication costs, vertical disintegration of firms, and a greater spatial division of labor within firms, we stress three additional developments: the rise of site consultants who broker deals between firms and governments; the spread of devolution across the globe, with its delegation of responsibility for economic development to subnational governments; and the significance of politics and political calculus on the part of participating governments.

We then contrast three different approaches to incentive competition, each with its own economic logic and cast of characters. First, we review the relatively benign view that incentive competition is a healthy way for communities to compete for mobile firms with optimal packages of public services at tax prices and that the outcome is efficient. We review the prisoner’s dilemma approach, which views incentive competition in game-analytic terms and concludes that it has at best a zero sum and at worst a negative efficiency outcome. We offer our own model, what we call the “market for jobs and fiscal capacity” approach, in which information asymmetries not only disadvantage government competitors for jobs but are created and maintained as rent-producing devices through the intermediation of the site consulting industry. For each of the three competing theories, we identify the conceptualization of the market in which incentives are negotiated, the actors and their assumed behavior, market outcomes, normative underpinnings, and strengths and weaknesses from both analytical and policy points of view.

Our model, with its explicit institutional and political dimensions, favors the retention of local government's ability to allocate resources to and regulate economic development activity but advocates reforms that will improve the performance of the market for jobs. This position, in contrast to the "leave it alone, it is good" or the "tax or regulate it away" recommendations of the other approaches, is compatible with most of the findings and recommendations of other authors in this volume.

We then ask what is known about the outcomes of incentive competition, referring to various contributions in this volume and others' work. We find it quite mixed. In some cases, incentives can and do create jobs and enhance the tax base in ways that are efficient, equitable, and environmentally benign. But microeconomic theoretic approaches limit the assessment of outcomes too narrowly, and the political drama of incentive competition tends to crowd out other economic development paths. We challenge the implicit premise that external investments of plants or facilities are the only route to regional economic development, reviewing the evolution of export base theory. Endogenous entrepreneurial activity, investments in human capital and amenities, and even reshaping local consumption patterns can yield significant long-term job growth. Bidding wars divert decision-makers' attention from a broader portfolio of economic development tools and options. Incentive packages thus incur large opportunity costs. We argue for a unified economic development budget as a policy innovation for evaluating and improving incentive offers. We support many of the reforms spelled out by the other authors in this volume.

IS THE GEOGRAPHIC COMPETITION FOR CAPITAL INCREASING?

Many writers and economy watchers contend that the spatial competition for capital is increasing and more intense than ever. In this volume, both Kenneth Thomas and Timothy Bartik make this statement, echoing notable book-length treatments by Bluestone and Harrison (1982); Nojonen, Graham, and Markusen (1993); and more recently Friedman (2006). Little hard evidence is offered for this view beyond the surge in transnational capital flows and internationally traded com-

modities, concentrated deindustrialization, and an appeal to our common experience. Thomas's argument is that greater fluidity of capital across regional and national borders increases the number of sites that are possible for any particular investment and thus makes the problem less manageable for competing governments.

Yet worldwide, regional and local communities with responsibility for their own economic development perceive that the competition for mobile capital, linked to the expectation of extraregional exports, is increasing. Many communities are directly affected when companies show an interest in sites and ask what can be done to help them; those that have not been so lucky are interested in becoming candidates. Does a review of national and subnational government behavior around the world suggest that competition for mobile physical capital has increased? Have governments increased their involvement in bidding wars, and has the size of packages offered increased? Our answer is a cautious "yes."

In the United States, the evidence is fairly strong that incentive competition has increased since the 1960s. "Bidding wars" for specific plants or facilities have become widespread, with incentive packages escalating in total worth. In addition, firms already operating in jurisdictions are now asking for comparable concessions just to remain open and retain jobs. LeRoy (2005) has done a masterful job of documenting hundreds of individual cases of successful and failed incentive competitions in the United States over the past 20 years.

Hard evidence of an increase in numbers of governments involved and size of incentives is harder to come by, because of the complexity of modeling and testing for change over time. However, two recent studies suggest that incentive competition in the United States has increased over the past few decades. Using state-level data on manufacturing income, capital and labor and their tax-adjusted prices, Chirinko and Wilson (2006) show that investment tax incentives have become increasingly common and increasingly large over the period 1963–2004. Peter Fisher, in Chapter 3, cites data showing that in the 1990s, the average incentive package available to new business investment in 20 U.S. states increased from 10 percent to 30 percent of gross business taxes.

The competition for mobile capital in the United States is not solely a late twentieth century phenomenon. In the nineteenth and twentieth centuries, communities across the United States competed for agri-

cultural capital, railroad lines, grain mills, meatpacking plants, and steel mills, as well as farmers and workers (Sbragia 1996). Fascinating histories have been written about the competition for mobile facilities, public and private, in certain sectors and in entire regions. For example, Lotchin (1984) reveals how California cities competed for large military bases in the late nineteenth and early twentieth centuries, and Markusen et al. (1991) show how Colorado Springs out-competed other U.S. cities for the army air bases, the Air Force Academy, and the Space Command from the 1930s to the 1980s. Cobb (1993) reveals how southern states crusaded for industrial development by attempting to lure branch plants in the period from 1936 to 1990. But the character of this competition has changed. In the following section, we address the postwar emergence of an organized U.S. “market” for mobile plants and the jobs and tax base that they bring, the product of institutional innovations that are now spreading to other continents.

Other countries with federal systems have long experienced similar subnational competition for large capital investments, but the stakes have ballooned in recent decades. Australia has a long history of competition for capital among states, led by its major East Coast cities (Berry 1984). Lagging regions such as South Australia used subsidies to lure major East Coast suppliers—in the auto industry, for instance—in the post-World War II era (Wanna 1980). In 2003, following Rupert Murdoch’s News Corporation’s extraction of A\$100 million in concessions to build the \$430 million Fox Studios development in Sydney, all but one of Australia’s state governments, Queensland, signed an agreement to end investment bidding wars, pledging to exchange information on projects where companies attempt to play one state against the other (State of Victoria 2003). Queensland, the fastest-growing region, refused to participate because at the time it was successfully bidding corporate headquarters and facilities away from Victoria and New South Wales with undisclosed deals. In 2006, five states signed a five-year renewal, agreeing to cooperate against multinational efforts to pit them against each other, to provide each other with an annual report on attraction activities, and to construct a mechanism where concerns about breaches can be raised. Queensland again refused to join, and thus the agreement does not include efforts by states to use tax cuts or other incentives to lure business from interstate rivals (Hughes 2006).

Regional competition for capital may be waxing in Europe as well. The European states, as Adinda Sinnaeve describes in Chapter 4, made a historic decision to rein in the competition for capital among member states and locations within them. In the 1957 Treaty of Rome that formed the European Union, they agree to ban most subsidies to business for plant locations except under certain circumstances. Underdeveloped regions are permitted to attract businesses with incentives, and certain types of inducements—for job training and R&D, for instance—are permitted. The regulatory system is highly effective, especially at deterring incentives from being offered. Modest reforms are contemplated (Wishlade 2004), but by and large, the regime is robust.

Nevertheless, as European countries devolve economic development responsibility to lower levels of government, a response to the demand for autonomy on the part of regions (e.g., Spain) and central government fiscal fatigue, the phenomenon of incentive competition may reemerge. The European Union regulatory scheme does not extend to local governments' use of their own resources or taxing powers to attract new plants or facilities, unless national governments compensate them for such incentives, and court cases are now pressing regions' rights in this regard (Nicolaidis 2005, 2006). Yet to date, such subnational discretionary powers are quite limited, and the conditions set by the courts on their use are quite restrictive.

Since the early 1990s, the American-style regional competition for capital is proliferating in developing countries, especially within large countries with federal systems of governance such as Brazil and India, and in China. Nowhere has it been fiercer than among Brazilian states in their competition for 22 new assembly plants planned and built by foreign auto companies since 1995. Despite Brazilian laws forbidding the reduction of state taxes to attract business, fiscal competition has been rampant and has resulted in excessively large incentives packages that radically relocated the industry away from Sao Paulo to four neighboring states (Rodriguez-Pose and Arbix 2001; Varsano, Ferriera, and Afonso 2002). The cost per job created appears to be much higher (on the order of \$54,000 to \$340,000 per job) than in the United States (Oman 2000), and incentives have induced 40 percent more auto-making capacity in Brazil than would otherwise have been built (Farrell, Remes, and Schulz 2003). India, where economic development responsibilities and fiscal tools have been devolving to the states, is

hosting greater fiscal competition and larger tax incentives packages (Venkatesan 2000; Schneider 2004).

In China, recent fiscal reforms give cities and regions greater responsibility for local economic development. Cities can now launch large development projects and retain the resulting income (rents, taxes), and they can customize their investment to the specifications of individual foreign investors. Although they cannot engage in bonding, they can form partnerships with banks and foreign investors, and have done so to finance huge infrastructure projects. Concomitantly, a fierce battle for competitive status has broken out, with cities ranked nationally on their success in attracting capital. Xu and Yeh (2005) describe the proliferation of this competition and its dangers, in that Chinese cities (and banks) face only soft budget constraints; if returns do not materialize, the nation state is required to bail them out. This creates conditions, they argue, for excessive and inefficient investments. In reality, enormous differences in natural resources, accessibility and physical infrastructure dominate the locational calculus of mobile firms in China (Yeung 2003).

Incentive competition occurs between nations as well as within them. Smaller countries increasingly believe that they must compete for mobile capital with each other. They have been protagonists in high-profile bidding wars, as in the famous shopping expedition of John DeLorean to Puerto Rico, Ireland, and Northern Ireland to site his auto plant. The winning total incentive package can add up to as much as 75 percent of the total investment cost of a project (Guisinger 1995). In the 1990s, newly independent and democratic Eastern European countries competed for European, Japanese, and American plants, often with little assurance that such incentives deals might be effective (Helinska-Hughes and Hughes 2003). Following the fall of the Berlin wall, Eastern European countries such as Poland and Bulgaria offered special location incentive packages with very mixed results. Critics argue that these countries would have been better off investing in the overall business environment and infrastructure and that their use has eroded the tax base without significantly attracting investment (Sorsa 2003). As these countries join the EU, they must bring their practices in line with the EU's regulatory framework.

A small but important literature documents and addresses growing incentive competition among Canada, the United States, and Mex-

ico both before and after the North American Free Trade Agreement (NAFTA) (DeMont 1994; Jenkins 1987; Leyton-Brown 1979–1980). An increase in the size of subsidies to the auto industry in the United States and Canada is documented by Thomas (1997), who attributes it to fiercer competition for auto plants. Several policy researchers have made the case for a European-type commission in NAFTA to regulate incentive competition among the three countries (Graham and Warner 1994; Pastor 2001).

Although we do not address incentive competition between nations in this volume, some policy initiatives at multilateral and bilateral levels have begun to address it. East Asia is a focal point for strategy and experimentation. A study of Cambodia, Lao PDR, and Vietnam found that incentives are expensive and not very effective (Fletcher 2002). Another policy analyst concluded that competition among countries in Southeast Asia for inward investment may be unavoidable, but that national incentive offers should be streamlined and designed to limit the drain on budgets and the potential for corruption (Tseng 2002). Another considers the Asian-Pacific region ripe for an investment code that would put limits on incentive levels, simplify incentive instruments, create greater transparency, and evaluate the results of incentives (Guisinger 1995).

Investment competition between nation-states is distinguished from the subnational focus of our study in that the former is governed by international organizations such as the World Trade Organization (WTO), the International Monetary Fund (IMF), and the World Bank. Each of these organizations has an interest in reining in the use of subnational tax incentives and subsidies to minimize trade distortions. The WTO has opposed export or local content performance requirements in return for incentives and allows other countries to apply countervailing duties against export subsidies, while the IMF and World Bank encourage borrowers to reduce subsidies (Guisinger 1995). In a carefully reasoned paper, Schweke and Stumberg (1999) anticipate that subnational economic development could become illegal in the new global policy environment. However, a recent WTO World Trade Annual Report focused on the issue of subsidies acknowledges that some subsidies can benefit society and offset the negative externalities of economic activity and that both national and subnational governments have legitimate objectives in using them, including for economic development. The WTO

remains concerned that such subsidies may be trade-distorting. The report notes that few governments fully meet their notification obligations under the WTO, contributing to a serious lack of information and transparency on the use and effect of subsidies, a situation aggravated by lack of common definitions of subsidy practices (WTO 2006).

There undoubtedly will be future tussles over WTO policies toward subsidies at all levels of government. If EU-type reasoning is followed, a case might be made for allowing developing but not developed nations to use incentives, analogous to the permissiveness the EU rules show to underdeveloped regions in Europe. Currently, the WTO estimates that 21 developed countries spend almost \$250 billion on subsidies of all types, almost 85 percent of all countries' subsidies. The average ratio of subsidies to GDP is lower in developing countries than developed, though there are large variations within each country group (WTO 2006, pp. 112–114). Developed countries, which have the largest stake in preserving subsidies, appear to have successfully argued within the WTO that many subsidies are not primarily trade-motivated but are designed to build infrastructure, foster new industries, promote research and develop new knowledge, protect the environment, redistribute income, and help poor consumers (WTO 2006, p. xxii).

To summarize, then, incentive competition is on the rise, as demonstrated in the energies devoted to it by subnational governments and the size of incentive packages. It is most common in nations with federal structures that share taxing and economic development powers with state and local governments. Although analogous competition occurs among nation states, it is better regulated and subject to international organizational scrutiny. Technological change has obliterated many former barriers to interglobal location, enabling such competition. But incentive competition is also very much shaped by important institutional and political changes, to which we now turn.

INSTITUTIONAL AND POLITICAL SOURCES OF INCENTIVE COMPETITION

In regional bidding wars, the principal actors are state or local governments and private sector employers. Incentive packages are put to-

gether by the governmental unit, in response to an expression of interest, and sometimes demands, by the potential employer, who may state that he/she also has other potential sites in mind. Each set of actors operates in a historically evolved institutional context that conditions their options and responses (Markusen 2003). In this section, we argue that two important institutional changes have altered this environment: the rise of site consultants as a third party in the process, and increasing devolution of economic development responsibilities from central to subnational governments. In addition, the motivations of regional political leaders exacerbate the intensity of bidding wars, with negative social and economic results.

American regional scientists and public finance economists were long puzzled by a seemingly paradoxical phenomenon: despite dozens of surveys of the determinants of firm plant location that placed geographical tax differentials very far down on the list of factors that matter, state and local governments continue to feel that they must offer incentives and lower tax burdens. Firms surveyed from the 1950s well into the 1980s dismissed the importance of taxes as an interregional siting factor—instead, transportation costs, raw material access, labor costs, land costs, infrastructure, and access to markets dominated their locational calculus. But in the past decade or so, firms are now more likely to claim that taxes matter, and empirical estimates suggest that they do matter in terms of differential job creation (Bartik 2007; Wasylenko 1997). Why this shift?

Falling transportation and communications costs are one contributor, as noted by Bartik in Chapter 5. These ease the friction of distance and make other determinants—land costs, labor costs, and infrastructure more important. Yet these costs have been falling for at least two centuries as sequential transportation breakthroughs (steam ship, railroad, trucking, containerization) and communications breakthroughs (telegraph, telephone, radio, and radar) without triggering much incentive competition until recently. Corporate vertical disintegration and greater geographical separation of sequential stages in the production process also have contributed, creating a spatial division of labor in which routine manufacturing or final assembly can be located in far-flung sites for either cost or market access reasons, while management, research and development, advance manufacturing, and other functions are placed elsewhere (Fröbel, Heinrichs, and Kreye 1979; Markusen 1985).

Our view is that these explanations contribute to but are inadequate for fully accounting for the spread of subsidy competition and the size of recent incentive packages. Two recent institutional forces are central to this process. First, an entrepreneurial innovation in the site selection process has altered the institutional environment: the rise of the site location consultant. Even though firms did not consider tax differentials important, they were in a position to extract concessions or “rents” from regions in the negotiating process. Research on defense industry location over the decades demonstrates that company leaders were often completely oblivious to the potential profit they could make by relocating their facilities elsewhere and selling existing sites, often adjacent to major airports, for tremendous returns—engineers dominated management circles, and to them, real estate was just an unimportant happenstance (Markusen et al. 1991). We hypothesize that this attitude toward local government and its tax/service offerings prevailed for U.S. firms until the emergence of site consultants.

The rise of site consultants as brokers in the location process is a fascinating story. The Fantus Corporation pioneered this line of work in the 1930s and dominated the field until the late 1970s, by which time they had relocated 4,000 plants, mostly to low wage, antiunion, low business tax and nonurban sites in the south. Fantus, named after its industrial real estate founder, specialized in comparative analysis of potential sites for companies looking to locate new branch plants or offices. When son-in-law Leonard Yaseen took over the business, he began to charge for the analysis. In the 1950s, when fears of strategic bombing were strong, the U.S. government began promoting the dispersal of military manufacturing plants, amplifying the market for site relocation services. In the same era, Fantus began to help large corporations investigate overseas locations. Yaseen then suggested that companies play one location against the other, demonstrating that the tax and subsidy savings generated could cover his fee. Working the trade media and corporate networking channels, Fantus became a major opinion-maker in the market for sites. For instance, Yaseen dismissed New York City as a place to do business, a function of personal animosity despite his location there. In 1975, Fantus authored the first state “business climate” rankings, setting off state bidding wars. Eventually, Fantus was sold to the accounting firm Deloitte & Touche, and other firms entered the site selection business (Cobb 1993; LeRoy 2005).

Over time the industry has become more fragmented, split between independent consulting firms, large international accounting firms, and law firms, but is still quite oligopolistic in character, especially in the large plant location business. Its success has been linked to other developments in corporate governance: the rise of institutional investors and their pressuring of management for higher short-term returns, the ascendancy of professional managers, and the growth of real estate as a corporate asset class.¹

This site brokering business has become institutionalized in ways that enhanced the rate of return for site consultants and their clients. The emergence of a brokering function diminishes competition among suppliers of jobs and tax base by standardizing the way large corporations approach subnational governments (Thomas 2000, p. 31). Site consultants began to hold specialist conferences and create organizations like the World Association of Investment Promotion Agencies (Raines 2003). Trade magazines such as *Corporate Location* and *Site Selection*, supported by advertising dollars from site location firms, encouraged negotiating firms to choose several states/cities to approach and play off against each other, even if they already had decided on an optimal location. They list deal winners and losers in every issue.

Site consultants began working for the other side, too, marketing their services to cities and regions on the grounds that they have knowledge about firm priorities that government officials do not have. When hired, consultants gain access to knowledge of cities and states' fiscal circumstances and economic development strategies that they can then use in service of their corporate clients (LeRoy 2005). However, site consultants' loyalties almost always lie with the interests of the job-selling corporation, especially, as is common, when they earn their fees on a commission basis. The higher the tax break and subsidy package extracted, the higher their fees. In real estate sales, where this lopsided relationship is also pervasive, many states have banned such dual agency. In Chapter 8, Greg LeRoy argues that site location consultants have come "to occupy a space where they defy norms about professional ethics and the proper representation of opposing parties," noting that commissions can run up to 30 percent of the value of acquired subsidies.

Our argument, then, is that a concerted institution-building process has introduced a new set of players, site consultants, into the spatial competition for jobs. As we argue in the next section, their success can

be attributed to economic rents that can be extracted from job-hungry governments, especially when information asymmetries can be exploited and even created.

A second institutional change contributes significantly to the ferocity of subsidy competition among subnational governments. Over the past 20 years, national governments have engaged in a process of devolution, abandoning the practice of regional policies aimed at balancing uneven development and relegating responsibility for economic development to subnational governments. More and more countries, large and small, are creating federal systems of shared powers, following the apparently successful models of the United States and Germany, where multipolar urban systems (Markusen and Gwiasda 1993) ameliorate private city-centric rural to urban migration and create competition among subnational governments. In the United States, the federal system has long dampened enthusiasm for the type of national regional policies practiced in Europe—the territorially based Congress (in contrast to a party-based Parliament) acts as an informal resource distribution system instead (Markusen 1994).

Devolution has complex sources of political support. Many state and local governors and politicians welcome greater control over public and private investments decisions, especially if their regions have suffered from neglect from a former political regime, as in such diverse settings as Cataluña, Wales, Chile, Nicaragua, and South Korea. In some cases, devolution is tied to powerful political movements for greater autonomy, including the assertion of cultural identity. Economists preoccupied with efficiency in location government spending and taxation, à la Tiebout (1956b), argue that public services can be better tailored to regional and local preferences under decentralized structures. Devolution has been favored and strongly incentivized by international organizations such as the IMF and the World Bank as a means of fiscal discipline for national governments in developing countries where regional policy often provided fertile ground for corruption and wasteful spending. National leaders often see devolution as offering relief from expensive (and sometimes inefficient) regional programs and a budget-saving windfall. Concern for uneven development, for the cumulative causation process so elegantly analyzed by Myrdal (1957) and Kaldor (1970), and for the distributional consequences of mobile investment, including the inefficient underutilization of local infrastructure in de-

clining regions (Markusen 1979), is much less often articulated in national economic policymaking in the early twenty-first century.

However, devolution is neither a simple nor universally successful way of deploying public responsibility for economic development. In the United States, the implicit role model, state governments have had powerful tools for raising revenues and engaging in public infrastructure provision since the Constitution was drafted in 1787. In general, they have in turn delegated revenue-raising and bonding powers to local governments. As a result, subnational governments have considerable but uneven resources to bring to bear on economic development. In many contemporary instances of devolution, central governments give their states and localities economic development responsibility but do not complement them with adequate resources or revenue-raising powers (Llanes 1998). Furthermore, most subnational governments have little expertise or experience with economic development, exposing them to greater information asymmetries in bargaining with multinational corporations and their site consultants. As a result, devolution may quicken incentive competition among states and localities while exacerbating disparities in economic outcomes, as shown by Markusen and Diniz (2005) for Latin America, and Schneider (2004) for India, where the wealthiest states usually win such competition.

Politics are also important. Scholars have long contended that economic development practice cannot be understood without an appreciation for political structure and interest group politics. Molotch (1976) made the seminal and durable case that localities develop “growth machines” comprised of groups who own local assets or make their living selling or maintaining them and who do not have options for expanding or relocating elsewhere. In general, Molotch argued, these groups will develop inordinate influence in local politics and push for policies that induce aggregate population growth. In a survey of European cities, Gordon and Jayet (1991) document the rise of recognizable urban growth machines in Europe, and Cheshire and Gordon (1996) offer a pessimistic view of the ability of territorial agreements to rein in such competition. More recently, Lovering (2003) offers a theory of the regional service class as a group with high stakes in the attraction of outside capital. These political economy theories predict that subnational governments will overinvest in incentives that help owners of local-specific assets at a net cost to local residents.²

A number of policy analysts have offered behavioral explanations for why state and local politicians will espouse and energetically pursue large incentive packages even when they are risky, unnecessary, damaging to the fiscal future of the locality, displacing, or place extraordinary burdens on constituents to fund future services. For one, politicians are motivated by the desire to be reelected, which relies on name recognition and on contributions from individuals and businesses. These often lead to high-profile, large commitments to and ribbon-cutting ceremonies for new plants and facilities, often in the richest, fastest-growing areas, even when economic development programs passed by legislatures contain explicit language that favors smaller firms and poorer regions (Dewar 1998; Luger and Bae 2005; Wolman and Spitzley 1996). For another, local officials may want to be seen as proactive in economic development matters and fear that nay-saying will provide fodder for opponents in future elections or saddle the region with a bad reputation among the site consultants who they see as gatekeepers to job-creating investment (Reid and Gatrell 2003; Wolman 1988). Brazilian state governments are subject to similar political distortions, affecting incentive competition and leading to bankruptcy (Rodrigues-Pose and Arbix 2001).

These institutional features caution against treating the spatial market for jobs as a conventional market. On neither side of this market are the participants operating from simple microeconomic demand and supply positions. Politicians, as demanders of jobs, are motivated by features of the political process as well as the collective welfare of their constituents. Companies, as suppliers of jobs, rely on site consultants to massage the market in their interests; they act as surrogates for firm managers. In the following section, we review the various models that others have used to conceptualize subsidy competition and offer a third, institutionally grounded view.

ANALYTICAL APPROACHES TO INCENTIVE COMPETITION

Schematically, analyses of and policy implications toward spatial incentive competition can be divided into three camps. One argues that incentive competition is an efficient way of allocating public resources

to economic development because it sets up a competition among units of government for mobile capital. This approach approves of the status quo and is opposed to any attempt to regulate or eliminate such competition. A second camp argues that incentive competition is inefficient because it distorts the location of productive capacity from what it would have been in the absence of subsidies, and recommends that it be outlawed or taxed away at higher levels of government. A third camp argues that subnational governments should and do have responsibility for economic development but that contemporary excesses are associated with asymmetries in the market for jobs that should be regulated. Next, we lay out the logic of each of these positions, comparing how each conceptualizes the market for subsidies, how policy posture follows from these, and which economic and political agents are aligned with each.

Tiebout-Type Models of Spatial Competition for Firms

The “let it be” camp conceives (often implicitly) of the siting process and subsidy bargaining between units of government and firms as taking place in a spatially differentiated market for public services, in which firms seek a set of public services, inputs into their production process, at the lowest possible tax price. Each competing government offers a supply of such services at a tax price. The market is thus structured as a straightforward competition between site and service-offering governments and site-searching firms. Since there are many demanders and suppliers on both sides of the market, the resulting allocation of firm investments will optimize the use of scarce public sector resources and maximize overall local welfare, as firms with different public service needs will be drawn to the specific communities that offer these at the lowest cost.

This model is an analog of the famous Tiebout (1956b) argument in favor of fragmented local governments. In Tiebout’s model, households searched across metropolitan local governments for the utility-maximizing mix of public services (schools, public safety, and so on) at the lowest tax price. The Tiebout argument has been used as a post facto rationale for the efficiency of competing local governments in U.S. metropolitan areas, a form of state-level devolution that dates back to the late nineteenth century. Although it has been hotly contested, especially

on equity grounds (Markusen 1974), the theory has proven to be as robust as the proliferation of local jurisdictions. In the United States, the National Governors' Association, although it has many times debated the issue, has repeatedly rejected any attempts to curtail subsidy competition (Kayne and Shonka 1994). Similarly, in Europe, Tiebout-type arguments that tax competition can be welfare-improving have been used to oppose tax harmonization among EU states (Varsano, Ferreira, and Afonso 2002).

The Tiebout-like approach has several virtues. One is its acknowledgement of the linkage between taxes and services received by firms. In various other approaches, and in practice, this link is broken, and the notion that firms' taxes pay for services rendered disappears. The procompetition approach is also appealing because it offers a way of disciplining public officials whose behavior may otherwise not be in the interests of taxpayers.

On the other hand, this approach is highly simplistic. It assumes that the market for public services is transparent and that all parties have access to full information. It ignores the fact that, in reality, bargaining takes place as a time-constrained drama between a single firm and (or so communities believe) multiple bidding jurisdictions. It cannot easily cope with the fact that from a community's point of view, firms aren't just public service consumers and taxpayers, but are also suppliers of jobs. Finally, it operates from a single, selective optimality criterion—efficiency. Many citizens and practitioners of economic development care as much about equity, and in some cases, environmental impacts, as they do about efficient resource allocation.

Prisoner's Dilemma Approaches

The second position, the "suppress it" view, argues that subsidy competition is inefficient because it wastes resources by luring firms away from sites they would otherwise favor. In addition, some economists also argue that as a result of shortfalls in revenue associated with tax giveaways, public goods such as education, parks, and public infrastructure will be undersupplied (Burstein and Rolnick 1995; Zodrow and Mieszkowski 1986). Burstein and Rolnick make both these arguments in their call for Congress to tax away state and local business-specific tax and subsidies. Others reason that the mix of public services

will be skewed by incentive competition to favor business interests at residents' expense—too many business centers and airports but not enough parks or libraries (Keen and Marchand 1997).

Economists making these arguments conclude that incentive competition is at best a zero-sum proposition, because little or no net new investment is created across regions, but more likely to be negative, because of public goods under-provision. Following such competition to its logical end, one economist notes, could mean that if every government copies the bids of every other government, the firm will end up where it would have gone anyway, no net new investment will be created, and all governments will have reduced taxes so that public spending is suboptimal (Graham, 2003, pp. 69–71).

That is a general equilibrium approach, but theorists working on this problem often conceptualize it as a “prisoner’s dilemma,” a single event, or game, in which a government (a prisoner) is bidding against other governments (other prisoners) for a single plant or facility. They would all be better off if they offered nothing, or the same package, the logic goes, but since they do not know each others’ bids, a “race to the bottom” is likely (Oates 1972).

The use of the prisoner’s dilemma game to characterize spatial competition for capital has a long history (Thomas 2000). Cooper (1972) first used it to characterize subsidy competition between countries, followed by Guisinger (1985). Quite sophisticated formulations have recently been offered, including Wohlgemuth and Kilkenny’s (1998) modeling of state governments’ optimal response to a firm’s threat to relocate, taking into account both asymmetrical information and the fact that other firms in the state may, if the relocation buy-off succeeds, demand similar tax and subsidy relief.

The prisoner’s dilemma model and its predicted outcomes are useful in demonstrating that firms can extract rents in return for their decision to locate new facilities or even to retain current employment. Indeed, the increasing exploitation of such rents may itself have exacerbated the mobility of capital, lowering the cost of relocation for firms. It is also useful in highlighting the information asymmetry that encumbers most bargaining, and it raises the interesting question why governments do not collude by sharing intelligence on bids to avoid rent extraction. It underscores the plausibility of overall welfare loss from incentive competition. It also captures how many governments perceive the situation,

although such perceptions may themselves be a product of the popularization of the model by journalists and site consultants.

But there are problems with the prisoner's dilemma framework. It is a highly stylized, simplistic formulation. It is an event-based model, which makes it difficult to evaluate strings of repeat games, especially since the cast of characters may change (Wood 2003). Rachel Weber, in Chapter 6, makes the point that certain jurisdictions may accumulate skill through repeat games that improve their prospects and bargaining power. (Firms that employ site consultants pay them to accumulate such skills on their behalf.) Repeat games may also help competing governments learn the virtues of collaborating, as game theory predicts more generally (Dixit and Skeath 2004, Chapter 11) and as demonstrated in the European and Australian cases we discuss above. A central theme of Thomas's (2000) seminal book, *Competing for Capital*, is that iteration makes it possible for governments to cooperate to regulate investment competition. Ironically, some national governments (e.g., Australia) have recently adopted competition policies that consider such collaboration potentially "anticompetitive."

The prisoner's dilemma model cannot easily encompass institutional changes in interests, power, and actors, including the rise and behavior of site consultants. It does not permit information asymmetries to be constructed. In its more simplistic formulations, it allows bidders only to give or not give firm-specific subsidies. Yet, the model's assumptions can be modified to permit such intermediate positions (Buchholtz 1998; Thomas 2000). Harder to build into this model are the other paths governments might follow to attract firms: lowering the overall tax rate, improving infrastructure, investing in schools or research and development, worker retraining, and provision of amenities.

Some versions of the prisoner's dilemma model predict that winning governments will actually be worse off (e.g., Graham 2003). But others show analytically that use of a prisoner's dilemma model does not necessarily produce a "winner's curse" (Thomas 2000, Appendix). Bartik, in Chapter 5, argues that the jobs and tax base created can more than cover the costs of incentives if offers are carefully crafted. He also argues that losing bidders may be better off not being saddled with excess debt and shrinking tax revenues. When modelers begin relaxing assumptions, the welfare losses and gains from incentive competition

become less clear, with some winning and some losing (Varsano, Ferrera, and Afonso 2002).

The remedy indicated by the simplistic application of this model—taxing away subsidies and tax breaks nationally—is a relatively conservative notion. It is driven by a focus on interregional efficiency rather than the welfare of individual regions. As Bartik notes, some economists making this argument (Burstein and Rolnick 1995) have no complaint with across-the-board tax reductions for all business, even though these could be highly inefficient from the point of view of the public sector and would create particularly difficult circumstances for economically distressed local areas.

Finally, the prisoner's dilemma model has difficulty comprehending the complexity of the market for investment. In actuality, government decision makers have multiple constituencies with competing claims, and their motivations are more complex than the model suggests. An ingenious corrective for this deficit is offered by Basinger and Hallerberg (2004), two political scientists who note that the empirical evidence for the race to the bottom is actually quite weak. They argue that political institutions and organizations mitigate the predicted downward spiral. Modifying the prisoner's dilemma model by allowing domestic politics to modify governments' behavior, they argue that governments may be resistant to requests for tax breaks. For instance, ruling parties may have strong commitments to social programs or be ideologically opposed to tax cuts. Both Thomas and LeRoy in this volume make the case that mobilized citizens can make a difference in politicians' willingness to engage in incentive competition or in the type of deals struck.

The Market for Jobs and Tax Capacity Approach

A less elegant but more complex view is that regional governments are preoccupied with creating jobs and amplifying tax capacity. While the two approaches reviewed above are rooted in public finance and microeconomics, this view is more attentive to institutional structure and behavior and common among economists, geographers, planners, and other researchers working on economic development. The market in which governments face firms seeking sites can thus be considered a market for jobs and tax base, rather than for public services or for capital investments. State and local governments offer incentives in return for

promised jobs, revealed in both the rhetoric accompanying announcements of sitings and in efforts to hold firms to their job-creating commitments with clawback provisions or penalties for nonperformance, though the latter are often weak. In a similar analysis of the “market for economic development,” Weber (2002a) uses an institutionalist transactions cost framework to conceptualize this process.

Jobs thus generated are socially valuable, in that they lower local unemployment, raise local labor force participation, enable skill acquisition, and have progressive effects on the local income distribution (Bartik 2001, 2004; Courant 1994). The jobs created also generate higher incomes for residents, who in turn spend the additional income on local goods and services that generate yet other jobs and are invested in housing that generates real estate taxes. Jobs and expanded tax capacity are valued by residents, by politicians for their announcement value, as we argued above, and by the local growth machine as well. Competing governments can be characterized as competing for jobs and tax base, and firms looking for sites as supplying them. The firms pursue incentives as a rent-seeking activity (Weber 2002a; Wolkoff 1992). In what follows, we focus on job creation and less on tax capacity, because it applies more generically to international as well as domestic cases, and because the institutional setting for incentive competition at the submetropolitan level is more particularistic, involving the retail sector and the growing role of planners and local government officials in real estate development (Weber 2002b).

Evidence for the pivotal role of jobs in such bargains comes from a remarkable study by Gabe and Kraybill (2002), who argue that firms have an incentive to overannounce the numbers of jobs they will create to increase the size of incentives offered. In a study of 366 Ohio establishments’ expansions between 1993 and 1995, they found that those that received incentives overannounced employment targets but created no new jobs (and actually led to a reduction in the overall number of jobs), while those that did not receive incentives accurately forecast their job expansion and did create new jobs. Gabe and Kraybill, citing Krueger (1974), suggest that the puzzling job decline in establishments winning incentives might be explained by firm reallocation of resources away from internal efficiencies in production and toward rent-seeking.

We view incentive competition as taking place in a spatial “market for jobs” that is an institutional innovation of site consultants who work

to maintain information asymmetries that permit rent-taking. As Weber argues in Chapter 6 of this book and elsewhere (2002a), the power balance in the market for jobs is uneven, in part because local governments “are embedded in space and not footloose like businesses.” She notes that businesses are better able to control the flow of information during incentive negotiations and that the size of the incentive package they need “to make a project feasible may be much smaller than what they would have the public sector believe.” Local governments are not privy to actual cost structures and hurdle rates.

Institutional economists have long understood the importance of opportunistic behavior and the role of information asymmetries in facilitating it (Williamson 1975). Close observers of incentive competition note that government officials rarely possess accurate information regarding an investor’s true intentions (Bachelor 1997; Thomas 2007; Weber 2007). Reid and Gatrell (2003, pp. 112–113) argue that companies that least need incentives have the resources to most effectively engage in opportunistic behavior. They cite documented cases where, after large incentives packages had been granted on the presumption of competition, corporate executives admitted that other sites were never seriously considered.

LeRoy (2005) details how site consultants encourage candidate communities to think of themselves as in competition with other communities, sometimes creating high-profile bidding, as in the Chicago/Denver/Dallas competition for Boeing’s relocating headquarters, but often not revealing the identity of competitors. Governments are counseled to keep their bids top secret, the implied sanction being permanent black-balling by the site brokering consultants. Thus, collusion among localities is suppressed, while the site consulting brokerages can be seen as practicing a sort of informal collusion on behalf of firms to maximize the rents that can be extracted. This is why site-seeking firms themselves do not invest in site selection but purchase such services from a supplier sector.

The way that the site consultant sector organizes and mediates incentive competition reveals the extent to which information asymmetries are created and maintained as a condition of rent extraction. Gabe and Kraybill (2002, p. 707) document how the state of Ohio interacts with the site selection industry. Every year, the state submits to *Site Selection* magazine its list of firm attractions or expansions in the state with an-

nounced creation of 50 or more jobs. The magazine then uses this data to compare business growth in states across the nation. By creating this competition and a data base that solicits state announced job expansions, the site selection industry has created an incentive for states to list (and thus to subsidize) as many projects as possible to improve the state's ranking relative to other states. Site consultants, especially when acting as dual agents, can hoard information that they have on firms' intentions and on the larger field of competition, including the willingness and ability of other communities and states to offer incentives.

The "market for jobs" approach generally accepts the necessity for governments to compete for capital and to use tools at hand in pursuit of jobs and community well-being. The policy implications, then, focus on how to curtail rent-taking, improve transparency in location decisions, understand why some tools are better than others, and help governments understand the complicated current and long-term trade-offs associated with developing an incentive offer.

Among the virtues of the market for jobs approach is this focus on institutional factors—on the messy, complicated way that subsidy competition unfolds in reality and how an expanded set of actors (including politicians, growth machines, and site consultants) behave under such circumstances. It acknowledges the centrality of the desire for jobs as a motivation for competing governments. Yet in doing so, it has the disadvantage of obscuring the role of taxes as a price for public services and neglects the negative long-term consequences of associated tax erosion.

Most of the authors in this book work from a market for jobs and tax capacity point of view, although Bartik's strong defense of state and local governments' legitimate economic development role and rejection of higher level prohibitions shares elements of the Tiebout-based approach. Thomas, using a prisoner's dilemma approach, concludes that subsidy competition has efficiency, equity, and environmental drawbacks and should be regulated, but does not believe subsidies are always bad policy. Fisher's chapter summarizes the evidence on long-term corporate tax erosion and is in that sense compatible with the prisoner's dilemma implications. All three call for reforms and make specific detailed recommendations for reform.

Normative Issues

In evaluating the power and usefulness of those three approaches, it is useful to acknowledge differences in underlying normative posture. In general, economists using Tiebout-type or prisoner's dilemma models work from an explicit assumption that economic efficiency is the sole concern of economic analysis and rationale for policy intervention. However, in economic development practice, a strong case is often made by economists and planners for equity and environmental quality norms co-equal with efficiency (Fitzgerald and Leigh 2002). Much of economic development practice is framed by an overarching concern for jobs, and not just any jobs, but quality jobs and jobs for the hardest to employ. Bartik, in Chapter 5, states that more local employment is a social good and points out that if all local governments competed in a smart way, it is not obvious that their optimal economic development subsidies would impose a net efficiency cost on other jurisdictions.

In this volume, distributional concerns receive careful attention. Bartik, Schweke, Weber, and LeRoy all address the creation of quality jobs. Bartik (1993) evaluates incentives for their ability to produce jobs for existing residents rather than newcomers and finds that in the long run, about 80 percent of new jobs in local economies are reflected in more population rather than higher employment rates. However, Bartik (1991) also finds that spurts of local growth benefit locals at the back of the labor queue and less-skilled and African American workers especially. Schweke specifically addresses the targeting of incentives to those regions and individuals most in need of work.

Others—Thomas, for instance—are sensitive to the regressive distributional impact of subsidies that favor owners of capital at the expense of residents of the community and worsen the income distribution. Fisher, in Chapter 3, gives hard estimates for the degree of regressivity that has accompanied the erosion of state and local business taxes overall. Thomas addresses harmful environmental consequences, as when subsidies induce building in a floodplain or when negative externalities are imposed on neighboring communities.

In his chapter, Fisher cautions against attributing all observed negative fiscal trends in recent years to incentive competition. He offers three other plausible hypotheses. For one, conservative ideological opposition to the size of the public sector per se may be contributing. For

those who believe government is too large, the strategy is to “starve the beast,” first by cutting taxes and then by claiming fiscal responsibility and the necessity to cut services. For another, there is the durable though minority “supply side” theory that contends that growth is only possible by lightening the tax burden on business. Third, some conservatives forthrightly attack progressive income taxes, a form of class warfare rationalized by the tenuous idea that cutting capital gains taxes for individuals will stimulate new business activity in the same state. These are important normative and ideological contributors to conflict over subnational taxation. In legislatures and city councils where the Republican party has dominated (including the national Congress for the last decade), business tax base erosion and tax regressivity have been on the rise.

Inequities are also possible between firms and among regions. Subsidies to particular firms can also be inequitable between owners of capital and their employed workers, when some firms are unfairly subsidized at the expense of their competitors, an argument recently made in important U.S. court cases and pressed by nonrecipient firms in their bid for similar concessions. Indeed, important cases are currently working their way through the courts using the Interstate Commerce Clause that prohibits restraints on trade as a rationale for striking down incentive packages targeted at interstate firm moves.

In general, too, richer states and localities walk away with the prizes, as Varsano, Ferriera, and Afonso (2002) find in Brazil; Schneider (2004) in India; and Luger and Bae (2005) in North Carolina. In Chapter 6, Weber describes how this happens at the local level in the United States: the more assets a place possesses, the more leverage, expertise, and decisional independence it will have and the better negotiating position it will establish. In contrast, poorer jurisdictions will have to offer more to succeed and are much more likely to give away the store to lure a plant, often without demanding performance.

DOES INCENTIVE COMPETITION YIELD ECONOMIC DEVELOPMENT FOR WINNERS?

A paradox in debate over incentive competition is that there is little agreement about whether engaging in it results in benefits for bid-winning states and localities. The evidence, most of it on the U.S. case, is mixed. For an initial assessment of the international case, see Guisinger (1986).

Some researchers argue that incentives are too small to matter to firms in their choice of location. Their evidence is based on surveys in which firms respond to questions about which spatially differentiated factors of product matter most to them in siting plant and facilities (Guisinger 1992; Enrich 1996; Farrell, Remes, and Schulz 2003). Greenstone and Moretti (2003) find that cities winning high-profile plants in the United States did better than their losing competitors, but as Fisher argues in Chapter 3, the researchers assumed that the incentives were decisive rather than bargained for after the fact.

Up through the late 1980s, the consensus was that economic development incentives had at best an ambiguous impact on growth and probably little to no impact at all (Eisinger 1988; Peters and Fisher 2002). Since then, a number of empirical studies have shown that tax incentives and other subsidies do make a difference in regional growth rates (Bartik 2007; Hines 1995; Newman and Sullivan 1988; Phillips and Goss 1995; Wasylenko 1997). The evidence appears stronger for job creation than net positive tax effects (Peters and Fisher 2002). Bartik (1994) argues that it is highly likely that incentives are always revenue negative. The causality is so complex, however, that at least one researcher, reviewing the U.S. case, has concluded that no one really knows what the effectiveness or welfare implications of incentive competition are (Graham 2003, p. 71).

Even if governments that engage in successful incentive offers subsequently generate more output, jobs, and tax revenues, it does not necessarily constitute economic development. For one thing, it may not be positive for the state or country as a whole, if other jurisdictions lose jobs and tax base as a result. And there are the distributional consequences as well, where tax burdens are shifted to residents and the quality of public services declines. Fisher's chapter shows the long-term

erosion in business tax shares of state revenues, from a high of nearly 10 percent in 1980 to just under 5 percent by 2002. Peters and Fisher (2002), in a study of state enterprise zones, show that during just eight years in the 1990s, the effective state tax rate on new investment fell by 30 percent. LeRoy's (2005) book cites many cases of local governments unable to pay for operating expenses and other services following risky underwriting of competed projects, including long-term responsibility for paying off bonds used to build infrastructure that is subsequently unused. Citizens of these jurisdictions are thus now shouldering a higher share of the tax burden for public services (without any clear increase in the share devoted to them) and are going without services they might otherwise have enjoyed.

Furthermore, even for bid-winning localities whose jobs and tax base expand, economic development outcomes might have been more positive had those resources been used differently. Each subsidy and tax expenditure involves opportunity costs for governments and their citizens. Even better jobs and greater tax capacity might have resulted from alternative allocations of economic development resources. To this final question we now turn.

IS ATTRACTION OF EXTERNAL EXPORT-PRODUCING PHYSICAL CAPITAL THE ONLY ROUTE TO JOBS?

So far, we have not tied incentive competition to an important, hal-
lowed theory in economic development—that a region's overall growth is tied to its ability to export to other regions goods and services that in return permit it to import the goods and services that it cannot competitively produce. The prominence of export base theory as a conception of macro growth at the subnational level has not been seriously questioned in the half century since it was formulated, though at the national level, some national governments have engaged in an alternative import substitution strategy, an approach much discredited in recent years. In our view, incentive competition is embraced by state and local governments because leaders believe that only export-oriented activity will generate net new jobs. (Intrametropolitan bidding wars for retail jobs simply decides who gets the jobs without altering the total created.)

In this section we review the history of export base theory, sometimes called economic base theory, and evaluate the evidence on its power to explain aggregate regional growth.

Historically, the world economy has experienced large swings in openness, followed by significant slowdowns and retrenchments. Economic integration is not a unilateral progression over time, nor are exports reliably the leading source of regional economic growth. In the first half of the nineteenth century, economist Douglass North (1966) elegantly demonstrated that slave-cultivated southern cotton drove the aggregate U.S. capital accumulation and the growth rate. After the Civil War, the United States retreated behind high tariff barriers to nurture its own manufacturing economy, growing robustly from an internal elaboration of the division of labor, especially the synergy between increasingly capital-intensive agriculture and producer goods manufacturing (Hobsbawm 1975). Thus, in successive eras, regional and national economic growth has been variously oriented externally or internally. Shifts from one to the other are linked to developments in technology, especially in transportation and communications, but also to political and institutional changes.

We currently live in an era that is preoccupied with trade. Most economists argue that regions must specialize and export more than ever before, because the penetration of inexpensive and often high-quality imports is eroding whole segments of local and regional economies (Howes and Markusen 1993). Ever since North's (1955) elegant statement of it, indebted to Innis's (1930) staples theory, the export base argument goes more or less as follows. In a trade-integrated world, regions outside of one's own are superior producers of many goods and services locally consumed, and in order to be able to pay for these imports, the region must specialize in certain exportable goods and services. In the mid-twentieth century world, with its sophisticated globe-transcending transportation systems that reached far into little hamlets everywhere, the power of this theory was manifest. Economists codified the theory into the economic base model, ubiquitously used even today in multiplier analysis.

Nevertheless, from the beginning, the theory had its critics. In his famous debate with North, Tiebout (1956a) pointed out an obvious logical flaw in the theory: the world economy as a whole does not export. In addition, a regional economy's ability to provide for itself increases as

its income from exports grows, resulting in import substitution. Tiebout also argued that people have different consumption patterns in different regions, complicating the model's application. But more importantly, Tiebout argued for an endogenous theory. Harkening back to Adam Smith, he posited that an elaborating internal division of labor could spur regional growth without export growth. His theory was brilliantly applied by Lindstrom (1978) in her renowned book on the early Philadelphia region, where she showed that a relatively autarchic region grew robustly from growing synergies between diversified farming and more urban manufacturing industries. Bartik (2004) makes the modern case for non-export-oriented sources of job and tax base growth by noting that cases where a new local-serving activity absorbs underutilized land or labor, or where it increases overall productivity.

Subsequently, practitioners of economic development vigorously debated and experimented with import substitution and export-based strategies for regional and national development, especially in the developing world. Many industrialized countries, among them the United States and Japan, nurtured their early industrial economies behind large tariff barriers and succeeded in import substitution on a massive scale. In the 1970s and 1980s, Latin American countries in particular tried to follow this path, but the strategy's apparent failure brought an emphasis on export base strategies back into fashion.

Yet the evidence on the relationship between overall growth and export growth is far from established. In recent decades, economists working in international development have begun to question the lead role of exports in explaining GDP growth for both developing and developed countries. As early as the 1960s, Ball (1962) argued that export expansion could retard domestic development by siphoning off investment. Others have argued that exports may be a consequence rather than a cause of economic growth. In a number of carefully constructed empirical tests, scholars find mixed evidence on both the existence of a relationship and the direction of causality. Jung and Marshall (1985) found that for 37 developing countries, evidence on the period 1950–1981 supports the export promotion thesis in only four cases; five countries reduced exports with growth, while four countries experienced export growth with output reduction. Gharthey (1993) concluded that export-driven development appears to explain growth in Taiwan but not Japan or the United States. In a five-country study, Sharma, Norris,

and Wai-Wah-Cheung (1991) found that Japan and Germany experienced export-led growth from 1960 to 1987 but in the United States and the United Kingdom, output growth appears to have induced export growth.

Thus, at the national level there is no clear evidence that exports drive overall growth. There is equally strong evidence that endogenous developments—new product creation first aimed at local markets and process innovations that increase productivity—may drive growth and prompt export expansion. What about regional growth? Why might locally oriented economic activity drive overall regional growth in an increasingly competitive world?

Several hypotheses have been advanced. For one, an innovation aimed at a local market might turn out to have much broader applicability and become an exported product or service (Cortright 2002). Boeing's original seaplanes, designed for Seattle use, are an example. For another, people are also mobile and may choose locations to live and work based on amenities, creating more local-serving activities paid for with asset income or entitlements (like Social Security) earned elsewhere (Nelson and Beyers 1998). Many mid-sized American metropolitan areas have grown principally from retiree in-migration, and many larger cities have grown through immigration not tied to specific jobs. Third, secular changes in consumption patterns, linked to demographic characteristics such as aging or labor force participation decisions such as two-parent households, may result in disproportionate demand for local-serving industries. Markusen and Schrock (2006) find that over the period 1980–2000, the local-serving occupations in the 30 largest U.S. metros outpaced job growth in export base occupations by four to one. For a more general treatment of the potential for local-serving economic development strategies to produce growth, see Markusen (2007).

The evidence is thus not compelling that exogenous growth, linked to export demand and the attraction of mobile capital, is more powerful than endogenous growth from human capital investments, innovation, an elaborating local division of labor, amenities-led population growth, or consumption shifts. Exports do matter, but they are not everything. If this is the case, decisions about firm subsidies should be embedded in a portfolio approach to economic development, in which the short- and long-term opportunity costs of particular incentives are weighed

against alternative investments that might be superior from a normative point of view for the community involved. LeRoy's chapter includes a call for unified development budgets as one way to implement just such a portfolio approach. Schweke, St. George, and Rist (1998) did the original conceptual work on unified development budgets. To date, the best application of the concept is the study published by Mountain Association for Community Economic Development (2005) for the state of Kentucky.

CONCLUSION AND SUMMARY OF THE CONTRIBUTIONS

With the authors in this volume, we conclude that state and local governments should, and in many countries do, have the responsibility for shepherding economic development in their communities. As Weber states, taxes and expenditures are among the few tools they have to pursue good jobs and long term stability for their constituents, along with certain regulatory strategies. The policy challenge is not to embrace incentive competition or fully suppress it, but to reform it in ways that encourage the benefits to exceed the costs and to achieve normative goals on efficiency, equity, and environmental fronts. Even the European Union, as Sinnaeve articulates, distinguishes between good subsidies and bad.

The chapters in this book are rich in policy recommendations aimed at local, state, and national governments, based on careful reasoning and empirical evidence. Political scientist Thomas makes the case for the excesses of contemporary subsidy competition and tells a sordid tale of information asymmetry and political machinations at the local level in a particular subsidy case. Although he favors eliminating incentive competition with a European Union-type regulatory system, he believes this is unrealistic for the United States. Sinnaeve acknowledges the downside of the EU system—it requires a heavy administrative burden, struggles with the right balance between rule-making and flexibility, and does not fully suppress illegal aid. Other nations, however, might be well-advised to adopt an EU-type regulatory regime because it has achieved impressive gains in deterring subsidy offers and eliminating distorted competition.

Bartik reviews the conditions under which incentives are reasonable, advising the use of cost/benefit analysis for governments engaging in negotiations and competitions. He cautions against looking only at jobs and tax revenues and suggests including the costs and benefits of public services and the prospects for local versus nonlocal hiring.

Schweke critiques an existing incentive program in North Carolina, the William S. Lee Act, that was designed to favor poorer counties but has not, and proposes two targeted state tax incentive programs in its place. One would kick in during cyclical downturns, creating jobs by giving firms tax credits for wages of newly hired workers, spurring a substitution of labor for capital. The other would target the highest unemployment counties in the state by giving employers wage and benefits subsidies to hire unemployed, local workers. These programs would induce job creation in regions and among workers who most need work, in contrast to the Lee Act, which has subsidized mainly large firms to locate in wealthy suburban areas around the largest cities, bringing many of their workers with them. Schweke's proposals demonstrate the careful tailoring that must be undertaken to ensure that the reforms, rather than prohibitions, will be able to address the inefficiencies and inequities of incentive competition.

Bartik, Weber, and LeRoy offer detailed reforms to improve the operation of the jobs market. These include transparency, performance requirements, community benefits agreements, pay-as-you-go deals, school board say on TIF and tax abatements (to prevent erosion of public funds for schools), unified development budgets, and multijurisdictional tax regime reforms, such as closing corporate reporting loopholes and repealing the single sales factor formulation at the state level. Weber focuses her recommendations on local public officials and how they might improve their bargaining position in deal-making. LeRoy, appreciating the virtues of simple and straightforward remedies, offers fewer, simpler laws and stronger enforcement. His set of nine reforms includes three innovative ideas: disclosure of state-by-state taxes paid to corporate shareholders (which would raise the visibility of exploitation of differentials in state tax systems), using federal spending as a carrot (and a stick) against job piracy; and defining site location consultants as lobbyists and regulating them accordingly.

Although many state and local government and interest group leaders have been seeking incentive competition reform in the United States

and elsewhere for some time, there has been a quickening of interest and a coalescing of ideas and organizational energy in the last decade. As the excesses worsen and governments feel greater pressure to spend time and resources in business recruitment, many observers think that the time is ripe for significant reform along the lines of the proposals offered in this book. A great deal of credit goes to LeRoy and his organization, Good Jobs First, which has served as an important clearinghouse for information on subsidy competition and applied research shop for evaluating outcomes of past deals.

As the market for jobs goes global and devolution deepens, the site consulting industry is entering new territory, especially in developing countries. A great challenge for economists, economic development practitioners, and activists working on these issues is to cope with this internationalization of subsidy competition. State and local governments in more developed nations may find themselves pitted not so much against each other but against competitors yet farther afield with whom it is even more difficult to communicate and compare notes. Economic development officials, politicians, and the public in developing countries where incentive competition is spreading need ideas, help and cooperation from experts and organizations that are already successfully regulating such competition, as in the European Union, or who are slowly winning battles in transparency requirements, deal negotiations, court cases, and broader views of economic development strategy and tools. We hope that this volume contributes substantially to this effort.

Notes

1. Rachel Weber, personal communication with the author, 2006.
2. Timothy J. Bartik, personal communication with the author, 2006.

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