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The Sources and Processes of Tax and Subsidy Competition

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Tax and subsidy competition has two structural sources: the need of governments for investment, what Winters (1996) calls the “investment imperative” in his updating of Lindblom (1977); and the mobility of capital. Together, they create a dynamic in which governments must compete for investment in what, since World War II, has been an ever-widening market. Today, as virtually all governments engage in this behavior, the “market for investment” is one where the “sellers” (potential investors) have certain advantages over the “buyers” (governments).¹ First, capital mobility is increasing, making more locations feasible sites for any particular investment, thereby intensifying competition. Examples range from national and regional governments bidding on auto assembly plants, to suburbs fighting to land the sales tax revenue that comes from a retail development. Second, while uncoordinated sanctioning of adverse government policies occurs, there also exists coordination among direct investors through the operations of site location consultants. These consulting firms work to extract greater concessions in negotiations over individual projects, and in doing so create an atmosphere where governments believe it is necessary to offer incentives to be considered for an investment project at all. Finally, information asymmetries favor firms over governments. The latter have little idea of what is truly necessary to offer to land a particular investment, nor do they know when the next desirable investment opportunity will come along (particularly at the level of truly large projects, of which there are only about 200–300 annually in the United States). Coordination of government policies is the logical way to blunt the dynamic of competition for investment. Only the European Union, however, has proved successful at this; favorable basic laws (the Treaty of Rome)

and a centralized monitoring and enforcement capacity have enabled the EU to exert some control over the investment-attraction activities of Member State, regional, and local governments within its territory (Thomas 2000).

This chapter begins with a discussion of why a market for investment arises in a capitalist system with multiple polities. It highlights the investment imperative and documents the growing mobility of capital. It argues that the two-sided prisoner's dilemma that comprises a market has been reduced to a single prisoner's dilemma among the buyers of investment due to inherent advantages investors possess. This result emphasizes the need for comprehensive, cooperative solutions among governments, at the state level to regulate cities' behavior, and at the federal level to regulate states.

The bulk of this chapter analyzes the use and abuse of location incentives—those subsidies, of whatever form, that are used to attract investment to a particular jurisdiction. It briefly reviews the potential efficiency, equity, and environmental drawbacks to these subsidies, and then focuses on several case studies that illustrate the main policy dilemmas that arise with the use of location incentives. Several important themes stand out: backroom deals, lack of transparency and effective citizen participation, the pernicious influence of site location consultants, and the comingling of eminent domain abuse with subsidy abuse.

The cases considered all come from the St. Louis metropolitan region. Missouri has been prominently noted as one of the country's worst abusers of tax increment financing (LeRoy 2005, p. 146), and as one of the worst abusers of eminent domain (Berliner 2003, p. 117). The St. Louis region is notably more abusive than the Kansas City region, as documented by the Brookings Institution (Luce 2003, p. 16; see also LeRoy 2005, p. 146).

The chapter concludes with a number of policy recommendations. To preview them briefly, they are the introduction of transparency and accountability legislation, as pioneered in Minnesota, guarantees of effective citizen participation in the economic development process, a national ban on relocation subsidies, and eventual establishment of rules about what is and is not an allowable subsidy, along with the means to monitor and enforce these rules.

THE MARKET FOR INVESTMENT

The market for investment consists of governments competing for investment and firms competing for investment sites. It arises as a result of two structural features of the world's political-economic system. First, as it has been for over 500 years, the global economic system is capitalist in nature. Since most economic activity is private under capitalism, the ability of government to produce the investment it needs is limited. Second, the world is a political system with multiple polities. This is the ultimate structural basis for the mobility of capital, as Chase-Dunn (1981, p. 31) argues. Thus, in a capitalist system with multiple polities, governments must compete with each other for investment, whether the competition takes place between nations or in subnational units such as U.S. states, Canadian provinces, and cities.

Governments depend on private investors for investment because without it there is neither economic activity to tax (and hence no way to attain their goals, whatever they might be) nor economic outcomes conducive to reelection. This classic formulation of Lindblom (1977) (the "privileged position" of business) has been updated by Winters (1996, p. 1–41), who extends it to nondemocratic states, and grounds it in more general theories of resource dependence. Because securing investment is a prerequisite to any goal government might have, Winters calls this the "investment imperative." However, if capital were not mobile, governments and firms would simply negotiate over the conditions of investment (perhaps only implicitly). The addition of capital mobility intensifies this dynamic by forcing governments to compete for investment with other governments in the same structural situation.

In general, capital mobility refers to the *ability* of owners of capital to place it in a variety of locations (this must be distinguished from actual capital movements). For nonfinancial capital (the focus of this chapter), we can think of it also as the ability to coordinate production over an extended geographical scale. For both financial and nonfinancial capital, these are importantly determined by the costs of transportation and communications. These costs have been falling dramatically, especially since the end of World War II. For example, the cost of international phone calls fell in real terms approximately 95 percent between 1945 and 1990, and international passenger transport costs fell

by about 80 percent in the same period. We have, of course, witnessed further innovations in both of these areas, and rapidly declining costs to use them (Thomas 1997, p. 64–66).

As mentioned above, the concept of a “market for investment” suggests that there is competition among sellers (investors) as well as among buyers. In practice, there is a lot more competition for investment than competition for investment sites. First, capital mobility is increasing. This means there is an increasing number of economically feasible sites for any given investment, leading to an intensification of the bidding wars over each investment, as firms have more options open to them *and* the collective action problem faced by governments becomes less tractable (Thomas 2000, p. 27–29).

Second, governments suffer from substantial information asymmetries in their courting of investment. While a company interested in investing in a particular jurisdiction will have gathered a tremendous amount of information on that location, its political leaders, etc., the government may not even know the identity of the firm they are dealing with; they may only talk to a site location consultant shopping for incentives (at least at the early stages). Government officials will not know the firm’s true decision criteria, and may not even know whether there are sites with which they are competing (Thomas 2000, p. 32). Finally, they do not know when the next desirable project will come along. Loveridge (1996, p. 152) estimated that there were only 200–300 large-scale projects annually in the United States, with 15,000 investment attraction agencies pursuing them.

The third advantage favoring firms over states is that while states must organize to achieve cooperative results, uncoordinated action by firms may lead to their taking the same action. For example, if a given state inaugurates stricter antipollution laws, the likelihood is that any firm affected by this will mark that state off its list for future investment. This need not require any cooperation or even communication by the firms involved; it simply is a logical reaction to the new incentives each faces, as Lindblom (1977) has emphasized. In addition to this uncoordinated sanctioning of adverse government policies, the widespread use of site location consultants has introduced an element of coordination into the behavior of direct investors that bond rating agencies provide for bond and stock investors. Sinclair (1994, pp. 144–145) has shown that bond ratings are affected by the rating agencies’ preferences for

government policies that have no necessary impact on their ability to service a loan. Similarly, site location consultants, in addition to trying to drive the very best bargain for their clients on each individual investment, also strive consciously to create a climate in which governments believe it is necessary to offer incentives in order to be considered for any investment. They do this both in private, preliminary discussions about individual projects, and through public comments in the press. In this way, location consulting firms help to coordinate the behavior of companies seeking investment sites. Moreover, they exacerbate the information asymmetry discussed earlier, and often receive a percentage of the incentive they obtain for their clients, giving them further incentive to drive up incentive packages (Buchholz 1998, Chapter 5).

Taken together, these three factors explain why the market for investment, a two-sided prisoner's dilemma in theory like any other market, in fact reduces to a single prisoner's dilemma among the buyers of investment. The usefulness of this model is demonstrated in both the United States and Canada, where voluntary "no-raiding" agreements among states or provinces have been universally unsuccessful (Thomas 2000, pp. 167–168; 177). The ultimate solution to these bidding wars lies in what game theory would call third-party enforcement, which means that states must regulate the investment attraction activities of their local governments, and the federal government must curb the bidding war among the states. We are, however, a long way from such a solution being politically viable, so the next section will consider the processes of competition for investment with a view toward illuminating the near-term reforms that may be achievable.

LOCATION INCENTIVES

Location incentives are those subsidies used to attract investment to a particular jurisdiction. They can take many forms: direct grant, tax break, free land, subsidized loan, etc. Some subsidies that started out as incentives to attract investors to a particular state have become so widely copied that it is now more reasonable to consider them what the EU calls "operating aids," that is, subsidies for ongoing production. The classic example is the sales tax exemption for new equipment. The

Council of State Governments (Chi and Leatherby 1997, p. 2) classifies these tax breaks as “incentives,” but their incentive function has been completely blunted by the almost total spread of these programs throughout the country. A related form of subsidy with locational goals is the “retention incentive,” a subsidy given to prevent a firm from leaving its present jurisdiction. New York City, whose companies are frequently targeted by other jurisdictions, awarded over \$2 billion in retention subsidies between 1987 and 2000 (Good Jobs New York 2003).

Location subsidies are not always a bad policy. However, like all subsidies, they can have important potential drawbacks in the areas of efficiency, equity, and the environment. In terms of efficiency, subsidies can induce firms to locate to inefficient locations, to continue inefficient production, and can harm efficient unsubsidized competitors. The major equity concern is that subsidies go to the owners of capital, who receive funds from the average taxpayer. This makes the after-tax, after-subsidy distribution of income more uneven than it would have been in the absence of subsidies. Finally, for an important subset of subsidies, the aided activity has harmful environmental consequences, such as building in a floodplain. These factors should give us pause when we consider whether a subsidy is an appropriate policy in a specific situation (Thomas 2000, pp. 4–5, 169–170). This section now turns to several case studies that illustrate the main policy dilemmas that arise with the use of location incentives. Rather than discussing high-profile national searches, such as those recently conducted by Boeing, I will analyze several of the far more common smaller deals funded by municipal and/or state governments.

Cases

In 1997, Mastercard International announced its intention to consolidate several St. Louis area facilities to a single location, not necessarily in Missouri. A consolidation can lead to an intense bidding war because it means that the firm involved is threatening to disinvest from one or more locations. As psychologists and game theorists have noted, people tend to fear the loss of an existing benefit more than they fear not receiving a new benefit of the same size (“hysteresis”) (Hardin 1982, pp. 82–83). The auto industry, which has suffered from overcapacity in North America for decades, has seen several major cases of head-to-head

consolidation, such as GM's pitting of Arlington, Texas, and Ypsilanti, Michigan, against each other (Thomas 1997, p. 127). In the Mastercard case, the company was reported to have considered 15 cities altogether, with the final decision coming down to a faceoff between Dallas and the outer-ring St. Louis suburb of O'Fallon (*Saint Louis Post-Dispatch*, various issues). For Mastercard's anticipated investment of just over \$90 million, the state of Missouri put together an incentive package worth \$42 million, plus several million more in tax abatements from O'Fallon and the local Francis Howell School District.² This example highlights several of the points made earlier: Mastercard clearly had a better idea of what was going on with the state and local governments in Missouri than Missouri government officials knew of Mastercard's intentions and options. There were numerous feasible options for the site, so Missouri officials could not simply assume that Mastercard was bluffing about the possibility of leaving the state altogether. While press reports do not indicate whether Mastercard used a site location consultant, the company apparently used a tactic consultants recommend. Without having access to Mastercard decision makers and documentation, it is impossible to say what the lowest amount of subsidy the company was willing to accept, but it likely was considerably less than what it received.

Much of what currently passes for "economic development" in U.S. localities is the subsidization of retail facilities. While Missouri likely overpaid for Mastercard, it was at least retaining jobs (and has since added several hundred new jobs at the site) that pay on the order of \$50,000 per year. Retail jobs, by contrast, contain a high proportion of low-pay, zero or low-benefit, often part-time jobs. Why economic development agencies pursue them so aggressively is difficult to explain.³ For example, tax increment financing (TIF) is a subsidy widely used around the country for attracting retail operations (auto dealerships in California, Wal-Marts everywhere, mixed-use retail/housing developments, etc.). In many cases, TIF is close to a straight cash grant in its structure: developers receive their money as soon as they have paid for the eligible costs specified in a redevelopment plan, while the city obtains the money to pay the developer by issuing revenue bonds backed by the incremental tax revenue the project is expected to generate.⁴ When state law allows a municipality to capture some of the sales tax increment, for example 50 percent in Missouri, a Wal-Mart

can be shopped around to cities until it finds one willing to give it a TIF. Municipal governments have proved generally willing, but often have received stiff resistance from citizen organizations that form to fight the plan. Similarly, independent developers dangle pet projects in front of municipal governments until one bites. Numerous examples of sales tax-driven TIFs exist in the St. Louis metropolitan area, including the suburbs of Richmond Heights (Galleria), Brentwood (Brentwood Pointe, Brentwood Promenade), Maplewood (Wal-Mart), and Des Peres (West County Center), the last a case of alleged blight in a city with a median family income over \$90,000 in 1990 (*St. Louis Post-Dispatch* various issues).

O'Fallon, Missouri (estimated population 65,000), is the fastest growing city in the state. St. Charles County, in which it is located, has a higher adjusted median household income than any other county in both Missouri and Illinois (*O'Fallon Journal* 2005). Located across the Missouri River from St. Louis County, O'Fallon and St. Charles County in general are experiencing rapid migration from the city of St. Louis and its inner-ring suburbs. Yet officials in the main municipalities (O'Fallon, Wentzville, St. Peters, and St. Charles) have been more than willing to subsidize retail development, as if it weren't going to follow the residents. St. Peters has used TIF to build a Costco discount supercenter. St. Charles TIF'd the redevelopment of a shopping center located just off the exit from the main thoroughfare in Missouri, Interstate Highway 70. In 2003, O'Fallon proposed to bulldoze its downtown and give the developers involved \$47 million in subsidies to build a new one at a total cost of \$220 million. This case (in which I was an active participant, having moved there in 2002) illustrates many of the common problems seen in competition for investment. The following account is based on my experience in the battle against this project as well as reports in the *St. Louis Post-Dispatch* and the *O'Fallon Journal*.

The project began shrouded in secrecy, even from members of the Downtown Partnership, a consultative group that had been organized by the city. When the city announced the project in March 2003, a majority of the Downtown Partnership's members resigned.

To determine if downtown redevelopment qualified for the use of tax increment financing, the city hired the consulting firm Peckham Guyton Albers and Viets (PGAV). Like its competitors in the St. Louis market, PGAV has virtually never seen a TIF project it said did not

qualify, and PGAV concluded that O'Fallon's mixed-use "Downtown Plan" qualified for TIF. By contrast, in Kansas City the Economic Development Council has full-time staff to work for the TIF Commission. Of the proposed TIFs studied by the Kansas City City Auditor, 43 percent were discouraged by TIF staff, 24 percent were denied by the TIF Commission, and 33 percent were approved (Funkhouser 1998, p. 88). The small size of municipalities in the St. Louis area reduces the level of expertise available to them and increases the number of competitors for any development project. Unsurprisingly, the Brookings Institution (Luce 2003, p. 16) found that there are far more abuses of the original intent of the TIF statute (i.e., to develop economically deprived or "blighted" areas) in the St. Louis area than in the Kansas City area.

Many of the approximately 100 businesses and 50 homeowners did not want to move, and the city made it clear that it would use its power of eminent domain if necessary. As has been the case in many other instances around the country, subsidy abuse goes hand in hand with what might be called "eminent domain abuse," where rather than taking property for infrastructure or other government uses, a city will make a legislative finding that a private development project is a "public use" and replace one private business with another. U.S. Supreme Court rulings have long directed lower courts to give great weight to legislative findings, and up to now they have been virtually impossible to challenge in court, for eminent domain (most recently in the 5-4 *Kelo v. New London* case) or for tax increment financing. However, the Michigan Supreme Court ruled 9-0 in 2004 that such takings were unconstitutional, and the U.S. Supreme Court in *Kelo v. New London* held that states could give property owners greater protection against economic development projects if they so desired.⁵

In Missouri, municipalities are required to do a cost-benefit analysis of any TIF project outside Kansas City that is carried out as part of the consultant's determination of the project's eligibility for TIF. The problem here, as we see in other examples of competition for investment, is that these analyses end at the jurisdictional border. Indeed, they often end at the development area's border, ignoring the effects of subsidized competition on sales of other firms, making much of the sales tax increment "phantom increment," as I called it in testimony before the O'Fallon Board of Aldermen.

In many cases, elected officials try to thwart citizen participation. In Hazelwood, Missouri (an inner-ring suburb of St. Louis), the city refused to accept charter amendment petitions, urged people to remove their names from them, and passed the ordinances establishing a TIF at their last meeting before Christmas, leaving opponents 20 days to acquire signatures referring the ordinances to the ballot at the worst possible time of the year to do so (they did not get enough signatures in time). In O'Fallon, the city threatened to charge people a fee for putting up a "Preserve Old Town O'Fallon" yard sign (it eventually backed down), refused to allow signs in Board of Aldermen meetings, and its public relations firm set up an Astroturf "citizens' group" to fight the opposition Old Town Preservation Committee. However, in the O'Fallon case, citizen opposition was so widespread that a majority of aldermen were swayed against the project, and the mayor withdrew it in August 2003.

CONCLUSION

This chapter highlights both the structural sources of competition for investment and the concrete policy issues that arise when a city or state pursues an investment. There are several policy conclusions we should take away from this analysis. First, too much economic development activity takes place behind closed doors. In many states, there is no way to even find out how much state and local governments give in subsidies. The first recommendation, then, is to adopt transparency and accountability legislation, as pioneered in Minnesota, which requires state and local governments to report all subsidies individually and to take sanctions against firms that fail to keep their commitments. If the true extent of subsidization becomes widely known, I believe it will become a more salient issue than it has been in many states. Some states may need strengthening of their Sunshine Laws (in O'Fallon, aggressive use of Missouri's Sunshine Law yielded a great deal of valuable information). In addition, there should be a guarantee of a referendum on large projects which completely change the character of a city (something unavailable in O'Fallon's case due to its classification as a Fourth Class city). Second, Congress should enact a national ban on relocation

subsidies. Since these merely move jobs from one place to another with no benefit to the country as a whole, they are the most egregious type of subsidy and one that is widely recognized as a problem. At the time of this writing, the case *Cuno v. Daimler-Chrysler* is before the U.S. Supreme Court. If the Appellate Court's decision is upheld, it would invalidate certain investment tax credits in Ohio and other states (Johnston 2006). Similarly, states should ban the use of in-state relocation subsidies, which has been a problem with TIF use in Minnesota's Twin Cities area (LeRoy and Hinkley 2000). In the long run, I would argue that we need to move closer to the European Union's model of establishing rules about what is and is not an allowable subsidy, along with the means to monitor and enforce these rules. That has been the only model of successfully controlling location and other subsidies (Thomas 2000, pp. 238–240).

Notes

The author thanks the participants in the “Reining in the Competition for Capital” conference for their feedback, along with comments from Dennis Judd, Terry Jones, Lana Stein, and Andrew Glassberg.

1. The term “market for investment” was coined by Guisinger (1985, p. 13). He considers firms to be the “buyers” of investment sites, and governments to be the “sellers” of those locations. However, due to the structural imbalances described below, it is more natural to see the market as truly one for the investments rather than the investment sites, making states the “buyers” and companies the “sellers.”
2. Interestingly, multiple Lexis/Nexis searches of MasterCard and Dallas, as well as contact with the business editor of the *Dallas Morning News*, turned up no references to such negotiations in Texas publications. This suggests that while the company said it had other options it was considering, it was in fact only considering the St. Louis area. One site location consultant told me he routinely recommends this stratagem to his clients. Numerous instances of this practice are documented in LeRoy (2005). Note that I reject his contention in Chapter 2 that subsidies almost never affect location choices. This is inconsistent with his acceptance of a prisoner's dilemma model of avoiding subsidies. If subsidies do not increase the probability of landing an investment or cutting a ribbon, a prisoner's dilemma cannot arise.
3. It may have to do with the size of the municipality. Smaller governments are usually not held accountable by their voters for overall macroeconomic outcomes, so their economic development efforts are aimed more at tax revenue than job creation (Thomas 2000, p. 44n29). However, by the logic of my model, the over-

all location pattern of retail facilities is likely to be little changed if all municipalities use location subsidies than if all refrained from doing so.

4. In Missouri, many TIFs, especially smaller ones, are financed on a pay-as-you-go basis. In such cases, TIF is not equivalent to a cash grant because the stretching out of payments over time reduces the present value relative to the nominal value. See Missouri Department of Economic Development (2005).
5. See the following pages from the Institute for Justice Web site: http://www.ij.org/private_property/michigan/index.html and http://www.ij.org/private_property/connecticut/index.html (accessed February 2005).

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