A MARKET FOR JOBS APPROACH FOR ANALYZING THE COMPETITION FOR CAPITAL

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Incentive competition is on the rise, is costly and generally inefficient, and often not effective 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. 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.[1]

In this paper, I argue that incentive competition cannot be adequately approached in a game-theoretic, microeconomic fashion without an institutional and political analysis. I contrast three different approaches to incentive competition: 1) the benign view that incentive competition is an efficient way for communities to compete for mobile firms with optimal packages of public services and associated tax prices; 2) the game-theoretic prisoners' dilemma approach, which concludes that incentive competition has a zero sum or negative efficiency outcome; and 3) a market for jobs and fiscal capacity approach, in which information asymmetries not only disadvantage state and local governments competing for jobs but are created and maintained as rent-producing devices through the intermediation of the site consulting industry.

Evidence on the actual outcomes of incentive competition is 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. Incentive packages often incur large, long-term opportunity costs. I argue for a unified economic development budget as a policy innovation for evaluating and improving incentive offers.

ANALYTICAL APPROACHES TO INCENTIVE COMPETITION

In regional bidding wars, the principal actors are state or local governments, on the one hand, and private sector employers, on the other. Incentive packages are put together by the governmental unit, in response to an expression of interest, and sometimes demands, by a potential employer, who may state that he/she also has other sites in mind. Each set of actors operates in a historically evolved institutional context that conditions options and responses (Markusen, 2003). Two major 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. Explored in greater depth elsewhere (Markusen and Nesse, 2007, forthcoming), these features are important causal and conditioning factors in incentive competition.

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 opposes attempts 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.

Tiebout-type Models of Spatial Competition for Firms

In an analog of the famous Tiebout (1956) argument in favor of fragmented local governments, one approach views the establishment-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.

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 often broken, and the notion that firms' taxes pay for public services rendered disappears. The pro-competition approach is also appealing because it offers a way of disciplining public officials whose behavior may not otherwise 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. In reality, bargaining takes place as a time-constrained drama between a single firm and 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 political leaders also are concerned about equity and environmental impacts.

Prisoners' Dilemma Approaches

A second, prisoners' dilemma, approach argues that subsidy competition is inefficient because it wastes resources by luring firms away from sites they would otherwise favor. In addition, because 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). In the long run, if the relocation buy-off succeeds, other firms, including those already in residence, may demand similar tax and subsidy relief (Wohlgemuth and Kilkenny, 1998).

In this approach, incentive competition is at best a zero-sum proposition with little or no net new investment created across regions, but more likely to be negative, because of public goods under-provision. 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 have occurred, and all governments will have reduced taxes so that public spending is suboptimal (Graham, 2003). Governments would all be better off if they offered nothing, or colluded on the same package, but since they do not know each others' bids, a "race to the bottom" is likely (Oates, 1972). This approach is 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 highlights the information asymmetry that encumbers most bargaining and deduces the plausibility of overall welfare loss from incentive competition.

But there are problems with the prisoners' dilemma framework. It is a highly simplistic formulation. As an event-based model, it is difficult to evaluate strings of repeat games, especially since the cast of characters may change (Wood, 2003). Certain jurisdictions may accumulate skill through repeat games that improve their prospects and bargaining power (Weber, 2007, forthcoming), while firms pay site consultants to accumulate such skills on their behalf. Repeat games may also help competing governments learn the virtues of collaborating, as game theory predicts (Thomas, 2000). The prisoners' dilemma framework cannot easily encompass institutional changes in interests, power, and actors; does not permit information asymmetries to be constructed; and can't easily incorporate other firm-attracting strategies: lowering the overall tax rate, improving infrastructure, investing in schools or research and development, worker retraining, and provision of amenities.

The prisoners' dilemma model has difficulty comprehending the complexity of the spatial market for investment. In actuality, government decision makers have multiple constituencies with competing claims. Empirical evidence for an actual race to the bottom is quite weak, because domestic politics modify governments' behavior (Basinger and Hallerberg, 2004; Thomas, forthcoming; LeRoy, 2007, forthcoming).

The Market for Jobs and Tax Capacity Approach

A more nuanced approach posits that state and local governments are preoccupied with creating jobs and amplifying tax capacity. The market in which they face firms seeking sites is more accurately characterized as a market for jobs and tax base, rather than for public services or for capital investments (Blair, 1995; Markusen and Nesse, 2007, forthcoming). 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.

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 (Courant, 1994; Bartik, 2001, 2004). 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, local-serving businesses, and politicians (for their announcement value). Competing governments can be characterized as competing for jobs and tax base, and firms looking for sites as supplying them, in some cases for economic rents (Wolkoff, 1992; Weber, 2002).

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 over-announce the numbers of jobs to be created to increase the size of incentives offered. In a study of 366 Ohio expansions between 1993 and 1995, they found that expanding Ohio firms receiving incentives between 1993 and 1995 over-announced employment targets but created no new jobs (and actually reduced total jobs), while those that did not receive incentives accurately forecasted their job expansion and did create new jobs. They suggest that the puzzling job decline might be explained by firm reallocation of resources away from internal efficiencies in production and toward rent-seeking.

The power balance in the market for jobs is uneven, in part because local governments are embedded in space and not footloose like the businesses they are wooing and because of information asymmetries. Firms are better able to control the flow of information during incentive negotiations, and the size of the incentive package they need to make a project feasible may be much smaller than what they ask for. Local governments are not privy to actual cost structures and hurdle rates (Weber, 2002, 2007, forthcoming.)

Site consultants may exploit information asymmetries and exacerbate rent-taking. They often encourage candidate communities to think of themselves as in competition with other communities (Leroy, 2005). After landing large incentives packages, corporate executives have admitted that other sites were never seriously considered (Reid and Gatrell, 2003). Site consultants advise governments to keep their bids top secret, the implied sanction being permanent blackballing by site brokers and their clients. Site consultants, who often operate as dual agents, can hoard information on firms' intentions and on competitors, including the willingness and ability of other communities and states to offer incentives. Thus collusion among localities is suppressed, while the site-consulting industry practices informal collusion on behalf of firms to maximize the rents that can be extracted.

The market for jobs approach 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 tradeoffs associated with developing an incentive offer.

Among the virtues of the market for jobs approach is its focus on institutional factors – on the messy way that subsidy competition unfolds and how an expanded set of actors (including politicians, growth machines, and site consultants) behave under such circumstances. Its emphasis on the desire for jobs is a strength, but this can obscure the role of taxes as a price for public services and neglect the negative long-term consequences of associated tax erosion. Fisher (2007, forthcoming) summarizes the evidence on long-term corporate tax erosion and is in that sense compatible with the prisoners' dilemma implications. All three call for reforms and make specific detailed recommendations for reform.

DOES INCENTIVE COMPETITION YIELD ECONOMIC DEVELOPMENT FOR WINNERS?

There is little agreement whether engaging in incentive competition results in benefits for bid-winning states and localities. 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. 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, forthcoming). The evidence appears stronger for job creation than net positive tax effects (Peters and Fisher, 2004). Bartik (1994) argues that it is likely that incentives are always revenue negative. The causality is so complex, however, that at least one researcher, reviewing the U.S. case, concluded that no one really knows the effectiveness or welfare implications of incentive competition (Graham, 2003).

Even if governments that engage in successful incentive offers generate more output, jobs and tax revenues subsequently, this does not necessarily constitute optimal economic development. Tax burdens may have shifted to residents, or the quality of public services undermined. The long-term erosion in business tax shares of state revenues fell from a high of nearly 10 percent in 1980 to just under 5 percent by 2002 (Fisher, 2007, forthcoming). During just eight years in the 1990s, the effective state tax rate on new investment fell by 30 percent (Peters and Fisher, 2004). Many 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, have had to ask their residents to shoulder a higher share of the tax burden for public services (Leroy, 2005).

Bid-winning localities' economic development outcomes might have been even better had those resources been used differently. Each subsidy and tax expenditure involves opportunity costs for governments and their citizens. To address this potential, unified economic development budgets that cover both spending and tax expenditures have been proposed and modeled in a number of states (Hull, Schweke, and Rist, 2000; Mountain Association for Community Economic Development, 2005).

CONCLUSION AND SUMMARY OF THE CONTRIBUTIONS

State and local governments are responsible for economic development. Taxes and expenditures are among the few tools they have to pursue good jobs and long-term stability for their constituents. The policy challenge is not to fully embrace incentive competition or 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. Governments must look beyond jobs and tax revenues to include costs and benefits of associated public services and the prospects for local versus nonlocal hiring (Bartik, 2007, forthcoming). Tailored incentives that would target high unemployment counties or cyclically-impacted industries have been proposed in place of indiscriminate incentives or across-the-board tax cuts (Schweke, 2007, forthcoming).

A number of doable reforms would improve the operation of the spatial market for jobs and tax base. These include deal transparency, performance requirements, community benefits agreements, pay-as-you-go deals, school board authority on TIF and tax abatements (to prevent erosion of public funds for schools), unified development budgets, and multi-jurisdictional tax regime reforms, such as closing corporate reporting loopholes and repealing the single sales factor formulation at the state level (Bartik, 2007, forthcoming; Weber, 2007, forthcoming). Federal actions include disclosure of state-by-state taxes paid to corporate shareholders (raising 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 (Leroy, 2007, forthcoming).

As the market for jobs goes global and devolution deepens (Markusen and Nesse, 2007, forthcoming), the site consulting industry is entering new territory, especially in developing countries. Internationalization of subsidy competition will pose an additional challenge for economists, policy makers, and economic development practitioners. 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.

Note

[1] The author wishes to acknowledge David Wildasin for comments on an earlier version of this paper. A much more elaborate treatment of these issues can be found in Markusen, 2007, especially the first chapter.

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