Ending the Economic Race to the Bottom

An Interstate Compact is a Win-Win Solution to Subsidies

Michael Farren, Research Fellow

Mercatus Center at George Mason University

MERCATUS CENTER
George Mason University

Overview

1) A Quick History of Targeted Economic Development Subsidies (TEDS)
2) Understanding the Problems with TEDS
3) Why Do Governments Continue to Offer TEDS?
4) Solutions to the TEDS Dilemma
5) The All-in-One Solution: An Interstate Compact

Section 1:

A Quick History of Targeted Economic Development Subsidies (TEDS)

History of Targeted Economic Development Subsidies

- Italy offered the earliest recorded subsidy in the 12th century
- Alexander Hamilton advocated for the US's first manufacturing subsidy in 1791
- Interestingly, the Boston Tea Party was not a protest against a tax increase, but rather against a tax *decrease* that only applied to the East India Company

History of Targeted Economic Development Subsidies

- Subsidies of private canals, ferries, and railroads caused multiple states to default on their debt in the mid-1800s, leading to most states passing anti-subsidy constitutional amendments
- Mississippi fired the first shot in the current subsidy war between the states in 1936
  - The war has steadily escalated over the last 80 years

Section 2:

Understanding the Problems with TEDS

The Problems with TEDS

1) TEDS don’t actually “work”
2) TEDS may actually *reduce* long-run growth
3) TEDS create national economic inefficiency
4) TEDS analyses don’t consider costs

TEDS Don’t Actually “Work”

1) Location & expansion decisions are based on production and profitability factors
   - E.g.: access to resources or a skilled workforce, supply chain synergies, proximity to customers
   - Bartik (2018): TEDS “work” 2%-25% of the time
2) Opportunities for long-term growth take precedence over short-term subsidies
   - Farren & Philpot (2018): If the best location for HQ2 enabled Amazon to grow total revenue just 1% faster than the 2nd-best location, we project an extra $3-$23 billion in profits over 15 years

TEDS Don’t Actually “Work”

“While corporate decision-makers’ top location concern is the availability of education and training, policymakers and lay people often think that tax incentives matter most.

Tax incentives and tax packages are uniformly viewed as low priorities by location consultants, relatively unimportant to the basic decision.”

-Natalie Cohen (2000),
Brookings Institution research

“Typical incentives probably tip somewhere between 2 percent and 25 percent of incented firms toward making a decision favoring the location providing the incentive.

In other words, for at least 75 percent of incented firms, the firm would have made a similar location/expansion/retention decision without the incentive.”

-Timothy Bartik (2018),
Upjohn Institute research

TEDS Reduce Long-Run Economic Growth

1) Holding public services constant, TEDS require higher taxes on other businesses & individuals
   - Bartik (1991): A 1% increase in taxes reduces the long-run local GDP by 0.1% to 0.6%
2) TEDS reward unproductive entrepreneurship and protect inefficient production
   - Baumol (1990): Talented entrepreneurs are motivated to pursue profit using politics rather than finding better ways to serve customers
   - Leibenstein (1966): When shielded from competition, businesses are less motivated to avoid wasting resources

TEDS Reduce Long-Run Economic Growth

"…there are a variety of roles among which the entrepreneur's efforts can be reallocated, and some of those roles do not follow the constructive and innovative script that is conventionally attributed to that person. Indeed, at times the entrepreneur may even lead a parasitical existence that is actually damaging to the economy.

How the entrepreneur acts at a given time and place depends heavily on the rules of the game—the reward structure in the economy—that happen to prevail."

-William Baumol (1990)

"The bottom line is that unwarranted business subsidies lower economic efficiency."

- Joseph Stiglitz,
Chairman of the Council of Economic Advisers,
Economic Report of the President, 1996

TEDS Create National Economic Inefficiency

1) TEDS motivate inefficient production both when they work as well as when they don’t
2) State and local governments waste $45-$70 billion on TEDS *every year*
3) This economic waste reduces Americans’ quality of life and harms the country’s international competitiveness

TEDS Analyses Don't Consider Costs

1) Economic development officials and corporations often enlist consultants to produce economic impact analyses to justify TEDS
   - These reports provide a "benefits-only" analysis, failing to incorporate costs
   - Nor do they compare the subsidy with alternatives uses of the funds
2) The taxes needed to fund the subsidies impose economic costs that counteract the benefits
   - Similar to Bartik (1991), the net effect may actually *harm* the local economy over the long run

Section 3:

Why Do Governments Continue to Offer TEDS?

Policymakers Are Rewarded for TEDS

1) The political payoff from TEDS is quite different than the economic consequences
   - Jensen & Malesky (2018): Politicians benefit from being seen as "doing something" to improve the local economy

2) The difference in payoffs creates a Prisoner's Dilemma

Section 4:

Solutions to the TEDS Dilemma

MERCATUS CENTER
George Mason University

Institutional Reform is Required to Solve the TEDS Dilemma

1) The solution to a collective action problem is institutional reform that changes the choices or the payoffs

2) Unilateral reforms are possible, but would likely be even more politically difficult than cooperative, multilateral reforms

Institutional Reforms for the TEDS Dilemma

1) Unilateral Solutions

- State constitutional amendments or ballot initiatives prohibiting state and local subsidies

2) Multilateral Solutions

- Federal government preemption, based on the Commerce Clause (an imposed “multilateral” solution)
- Interstate agreements, similar to the NYC-NJ-CT agreement in 1991 and the recent KS-MO agreement (voluntary, but not enforceable)
- Interstate compacts (the most durable and enforceable voluntary agreement)

Section 5:

The All-in-One Solution: An Interstate Compact

Interstate Compacts

1) Relatively unknown, but established in the US Constitution
   - Intended to solve supra-state, sub-federal coordination problems
   - “treaties between the sovereign states”
   - Slightly higher in stature than state constitutional amendments because of their contractual nature
2) Only limited by imagination and the willingness of state legislatures/Congress to authorize

Recent Interstate Compact Legislation

1) Non-compact legislation
   - KS-MO (2014 & 2019); NYC-NJ-CT (1991)
2) Stadium subsidies
   - ALEC model legislation (2017); AZ SB1453 (2018)
   - VA-MD-DC compact RE: Washington Redskins (2018 & 2019)
3) First attempt at TEDS compact legislation (2019)
   - NY (A05249), IL (SB0203), WV (SB643), AZ (SB1322)

Important Elements of an Interstate Compact to End the TEDS Dilemma

1) Transparency
   - Any compact should mandate the highest standards of transparency for all economic development negotiations & outcomes
2) What subsidies does the compact cover?
   - E.g.: Anti-poaching only, all cash & asset gifts, project-required infrastructure, public services benefits, regulatory favoritism, etc.
3) How & when does the compact take effect?
   - Trigger clauses would mitigate the first-mover problem

Important Elements of an Interstate Compact to End the TEDS Dilemma

4) How will the compact be enforced?

- Creating 3rd-party enforcement mechanisms (e.g.: giving taxpayers legal standing to bring suit) would help ensure compact adherence

5) Is exit from the compact be allowed?

- No opportunity for exit is preferable, but if necessary to include it should not allow current politicians to benefit by offering subsidies

6) Will the compact be updated?

- A compact board that meets regularly could help improve an initial compact, but political capture of the board needs to be avoided

Summary

1) The TEDS Dilemma is a historic and repetitive policy problem
2) Economic development subsidies may be politically popular, but they are wasteful and harmful to broad economic growth
3) An interstate compact offers unique policy tools for states to work together toward a permanent solution

Thank You

Michael Farren, Research Fellow

Mercatus Center at George Mason University

MERCATUS CENTER
George Mason University

Addenda Slides

Michael Farren, Research Fellow

Mercatus Center at George Mason University

MERCATUS CENTER
George Mason University

Review: The Prisoner’s Dilemma

	Prisoner B Choice	
Prisoner A Choice	Cooperate	Betray
Cooperate	(-1 , -1)	(-3 , 0)
Betray	(0 , -3)	(-2 , -2)

Review: The Prisoner’s Dilemma

Prisoner A Choice	Prisoner B Choice: Cooperate	Prisoner B Choice: Betray
Cooperate	(-1 , -1)	(-3 , 0)
Betray	(0 , -3)	(-2 , -2)

The TEDS Dilemma

Economic Payoffs

Policymaker B

Policymaker A	Don't Offer	Offer TEDS
Don't Offer	(2 , 2)	(1 , -1)
Offer TEDS	(-1 , 1)	(-2 , -2)

MERCATUS CENTER
George Mason University

The TEDS Dilemma

Economic Payoffs

Policymaker A	Policymaker B: Don't Offer	Policymaker B: Offer TEDS
Don't Offer	(2 , 2)	(1 , -1)
Offer TEDS	(-1 , 1)	(-2 , -2)

The TEDS Dilemma

Political Payoffs

Policymaker B

Policymaker A	Don't Offer	Offer TEDS
Don't Offer	(-1 , -1)	(-2 , 1)
Offer TEDS	(1 , -2)	(2 , 2)

The TEDS Dilemma

Political Payoffs

Policymaker B

Policymaker A	Don't Offer	Offer TEDS
Don't Offer	(-1 , -1)	(-2 , 1)
Offer TEDS	(1 , -2)	(2 , 2)

The TEDS Dilemma

Economic Payoffs

Policymaker A \ Policymaker B	Don't Offer	Offer TEDS
Don't Offer	(2 , 2)	(1 , -1)
Offer TEDS	(-1 , 1)	(-2 , -2)

Political Payoffs

Policymaker A \ Policymaker B	Don't Offer	Offer TEDS
Don't Offer	(-1 , -1)	(-2 , 1)
Offer TEDS	(1 , -2)	(2 , 2)