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# Business Incentives, Interstate Competition, and the Commerce Clause

Clayton P. Gillette\*

## INTRODUCTION

Recent literature has begun to address whether legal doctrine can be employed to constrain certain forms of competition among localities and states for business development.<sup>1</sup> The argument has taken place primarily in discussions of whether Congress possesses authority under the Commerce Clause to enact constraining legislation and, if it does, whether Congress would be well advised to do so. The claim for intervention rests on a combination of theoretical and economic arguments about the consequences of interstate competition, and a confidence in the capacity of courts to distinguish in either a logical or formal manner between appropriate and unsuitable policies to induce businesses to locate or remain within a particular jurisdiction.

In this Article, I cast a skeptical look at these arguments. My objective is not to demonstrate that the alleged “war between the states” or “arms race” does not or could not exist. Rather, my concern is that the feared scope and consequences of such competition may be overblown, and that the benefits of such competition may be understated. Furthermore, the pro-

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1. See Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377 (1996); Philip P. Frickey, *The Congressional Process and the Constitutionality of Federal Legislation to End the Economic War among the States*, THE REGION, June 1996, at 58; Walter Hellerstein & Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 CORNELL. L. REV. 789 (1996).

posed remedy—federal intervention—imposes additional costs, both in removing from states the capacity to promote the values that underlie federalism and in introducing into legal analysis distinctions that cannot help but fly in the face of logical consistency. Indeed, the stronger form of my claim is that competition among states for businesses may actually facilitate the objective created by the Commerce Clause of achieving economic integration for the benefit of the nation as a whole.

The very claim that competition for business location will have a negative impact seems odd. We typically think of competition as an effective mechanism for allocating scarce social resources to the party that values them most highly, and there initially seems little reason to believe that governmental bids vary from this principle. Although Tiebout models of local government services are usually directed at the market for residence,<sup>2</sup> the same desire for preference satisfaction should apply to the market for firms. Indeed, the package of local public goods and services that a jurisdiction offers, and the tax prices charged for them, is frequently explained in terms of the jurisdiction's capacity and desire for attracting businesses.<sup>3</sup> Just as localities offer a package of goods and services in order to attract a relatively homogeneous group of residents, and thus ensure the efficient delivery of local public goods, businesses that seek a particular type of environment, work force, or package of goods and services will gravitate to those locations that signal their desire to attract firms with similar preferences.

Of course, the packages offered by states and localities do not indicate that they have unlimited desire to attract businesses, any more than their capacity for residents is uncapped. Instead, for each package of goods and services established by a state or locality, there is an optimal size population, including businesses, determined by the number of residents for which the package can be produced at the lowest average cost.<sup>4</sup>

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2. See Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 416 (1956) (using the examples of residents of a government housing project and other residents in the community).

3. See Dan A. Black & William H. Hoyt, *Bidding for Firms*, 79 AM. ECON. REV. 1249, 1249 (1989) (contending that government subsidies to firms facilitates the efficient location of industry); Wallace E. Oates & Robert M. Schwab, *Economic Competition Among Jurisdictions: Efficiency Enhancing or Distortion Inducing?*, 35 J. PUB. ECON. 333, 335-36 (1988) (proposing a model for interjurisdictional competition in which jurisdictions compete for stock capital by lowering taxes and relaxing environmental standards).

4. See Tiebout, *supra* note 2, at 419 (stating "there is an optimum com-

Communities below the optimum will use incentives to attract residents (including businesses), and thus decrease average costs, while those above the optimum are likely to reduce services until a sufficient number of residents (including businesses) emigrate.<sup>5</sup> Indeed, there is some reason to believe that states and localities are particularly adept at and appropriate for pursuing policies that match businesses and location. Paul Peterson, for instance, contends that developmental policies, those programs that enhance the economic position of a community, albeit at the expense of neighbors, are best implemented by local or state, rather than national governments in order to permit greater satisfaction of preferences between those who provide and those who consume service packages.<sup>6</sup>

Locational incentives directed at businesses would appear, on their face, to serve these objectives of interstate competition. Indeed, much of what we normally think of as the characteristics that make a community attractive may easily be cast as "business incentives," since they correlate well with the factors—for example, access to transportation, infrastructure, education, level of unionism, climate—that serve as a primary basis for business location decisions.<sup>7</sup> From this perspective, governmental use of subsidies, exemptions, and abatements simply constitutes the business counterpart to well-accepted forms of competition among other state actors bidding for

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munity . . . defined in terms of the number of residents for which this bundle of services can be produced at the lowest average cost.”)

5. Tiebout expands on this phenomenon in light of the political reality and explains that officials will not want to preside over a shrinking population as follows:

The case of the city that is too large and tries to get rid of residents is more difficult to imagine. No alderman in his right political mind would ever admit that the city is too big. Nevertheless, economic forces are at work to push people out of it. Every resident who moves to the suburbs to find better schools, more parks, and so forth, is reacting, in part, against the pattern the city has to offer.

Tiebout, *supra* note 2, at 420.

6. See PAUL E. PETERSON, CITY LIMITS 42-43, 69-70 (1981) (discussing developmental policies).

7. See, e.g., KEON S. CHI, COUNCIL OF STATE GOV'TS, ECONOMIC DEVELOPMENT IN THE STATES: STATE BUSINESS INCENTIVES AND ECONOMIC GROWTH: ARE THEY EFFECTIVE? A REVIEW OF THE LITERATURE 9 (1989) (noting that transportation and economic factors, such as infrastructure, education, climate, and services, are important factors in the location of industries); Roger W. Schmenner et al., *Geographic Differences and the Location of New Manufacturing Facilities*, 21 J. URB. ECON. 83 (1987) (proposing the use of divisional decision stages and plant-specific characteristics to modify the empirical study of plant locations).

scarce resources. For instance, state universities bid for students by offering scholarships and positions on sports teams, and advertising campaigns by states indicate fierce competition for tourism dollars. No one suggests that such actions are barred by the Commerce Clause. Certainly those law professors who contend that federal intervention is necessary to prevent states from engaging in explicit bidding for businesses have not suggested that there exists any Commerce Clause barrier to state law schools offering some salaries out of line with those of others in order to attract or retain faculty members.

Thus, it cannot be that the Commerce Clause seeks to prohibit *all* forms of interstate competition. If there is an argument against business incentives, it must be that they possess some feature or consequence that distinguishes them from other competitive tools. Moreover, those characteristics must be distinguishable in some principled way from other cases in which we find no objection to interstate competition.

The negative reaction to competition lies at least partially in the same intuition that underlies the Commerce Clause. Contemporary literature views the Commerce Clause largely as a response to fears that states, left to their own devices, would regulate trade in a protectionist manner, and thus seek to exploit monopolies or otherwise impose external costs that the regulating state did not have to internalize.<sup>8</sup> Thus, states would likely regulate even where regulatory costs exceeded benefits, as long as those costs are imposed on residents of other jurisdictions, or on politically powerless groups within the regulating jurisdiction.<sup>9</sup> Protectionism would have the ad-

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8. See William N. Eskridge, Jr. & John Ferejohn, *The Elastic Commerce Clause: A Political Theory of American Federalism*, 47 VAND. L. REV. 1355, 1363-64 (1994) (recognizing that judicial oversight might be required when state policies create extra-territorial effects); Saul Levmore, *Interstate Exploitation and Judicial Intervention*, 69 VA. L. REV. 563, 563 (1983) (showing that the distinction between "interferences" and "exploitations" has descriptive and normative value in understanding the judicial response to interstate trade barriers); Donald H. Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause*, 84 MICH. L. REV. 1091, 1092 (1986) (arguing that the dormant Commerce Clause should be interpreted to prohibit states from engaging in economic protectionism); Cass Sunstein, *Constitutionalism and Secession*, 58 U. CHI. L. REV. 633, 640 (1991) (noting that the Commerce Clause solves situations when a state pursues self-interest that is destructive to all the states).

9. If the states imposed regulatory costs exclusively on the jurisdiction's residents, there might be less reason for federal intervention, unless the burdened group fell within a category entitled to special protection under federal law. Groups that lack political power as a result of some mechanism other

ditional effect of inviting retaliation, so that consumers in the initiating state would also suffer.

Opponents of business incentives attribute this same negative result to efforts to attract firms from other jurisdictions. Each state, on this view, must preempt or retaliate against raiders by offering their own incentives to retain or attract business. The result is allegedly a "race to the bottom" in which mobile firms, which might be well positioned to share the redistributive tax burden imposed by states, are able to bid jurisdictions against each other to the point where the firms become subject only to benefit taxes. The bidding process under these conditions creates deadweight losses from the national perspective, as any gain that one jurisdiction obtains by attracting a firm is offset by the loss to another jurisdiction. As a corollary, states would underinvest in redistributive programs in order to reduce financing requirements that mobile firms would find objectionable, or that would otherwise have to be imposed on existing residents.<sup>10</sup> Presumably, all states would elect to prevent this scenario, but none can act unilaterally without becoming a net loser in the war for industry, and transaction costs preclude multistate agreements that might otherwise preclude each state's opportunistic behavior. As in the traditional prisoner's dilemma, a centralized entity—the national government—is seen as the mechanism for implementing the deal that all parties desire, but none can enforce.

The interjurisdictional causes of net social losses are allegedly exacerbated by intrajurisdictional losses. Bidding states and localities allegedly overpay relative to the gains they receive by attracting new business. This claim is perhaps more interesting, for it assumes systematic miscalculation by state and local officials. Here, the culprits are 1) cognitive error manifested in the "Winner's Curse," which posits that winners of common-value auctions will tend to bid in excess of the return they receive or should expect to receive from their investment; and 2) capture of the decisionmaking process about providing incentives by those who benefit from the incentives provided.

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than invidious discrimination may simply be the inevitable losers in any system that operates under majority rule.

10. See, e.g., Jerry L. Mashaw & Susan Rose-Ackerman, *Federalism and Regulation*, in *THE REAGAN REGULATORY STRATEGY: AN ASSESSMENT* 111, 115-45 (George C. Eads & Michael Fix eds., 1984) (arguing for the continuation of "cooperative federalism").

Empirical studies that seek to evaluate these allegations are inconclusive.<sup>11</sup> This is exactly what one would expect given the difficulty of identifying the effects of a subsidy, especially if one recognizes that the relevant benefit to which cost must be compared is the benefit to the subsidizing jurisdiction and not simply to the courted firm.<sup>12</sup> Different states mean different things by "economic incentives," making comparisons based on the states' own reports difficult, and some benefits resist objective measurement.<sup>13</sup> Additionally, researchers have used different variables in trying to measure the effects of such policies as property tax reductions, and much of the debate has involved the issue of how best to model the determinants of industrial location.<sup>14</sup> In the absence of hard data, it may be useful to resort to theory and ask whether there are reasons to believe that the adverse effects suggested for business incentives will predominate, or whether there are competing reasons to suggest that they will be more moderate than some profess.

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11. See Chris Farrell, *The Economic War among the States: An Overview*, THE REGION, June 1996, at 4, 6 (explaining that economic studies suggest that programs which award business incentives have a positive, but small, impact in manufacturing); INDUSTRY LOCATION AND PUBLIC POLICY 1, 13-80 (Henry W. Herzog, Jr. & Alan M. Schlottmann eds., 1991) [hereinafter INDUSTRY LOCATION] (discussing theory and methodology of industry location determinates); Joe Matthey & Mark Spiegel, *On the Efficiency Effects of Tax Competition for Firms*, THE REGION, June 1996, at 50 (arguing that empirical evidence, which suggests revenue losses occur from competition, are partly offset by increased taxes from other sources); Joseph M. Phillips & Ernest P. Goss, *The Effect of State and Local Taxes on Economic Development: A Meta-Analysis*, 62 S. ECON. J. 320, 320-22 (1995) (statistically analyzing results across empirical studies that assess the impact of state and local taxes on economic development).

12. See Dick Netzer, *An Evaluation of Interjurisdictional Competition Through Economic Development Incentives*, in COMPETITION AMONG STATES AND LOCAL GOVERNMENTS: EFFICIENCY AND EQUITY IN AMERICAN FEDERALISM 221, 232-34 (Daphne A. Kenyon & John Kincaid eds., 1991) (discussing the problems with the effects of a government subsidy as an economic development measure).

13. See, e.g., CHI, *supra* note 7, at 28 ("[T]his review alludes to the complexity and non-quantifiable nature of the effects of business incentives. It includes uncertainty, subjectivity and other unknown and uncontrollable factors in the negotiation process that goes on between governments and businesses.").

14. See, e.g., Timothy J. Bartik, *The Effects of Property Taxes and Other Local Public Policies on the Intrametropolitan Pattern of Business Location*, in INDUSTRY LOCATION, *supra* note 11, at 63-70 (discussing the issues of land-price capitalization and community characteristics in modeling intrametropolitan industrial location). On the limitations of survey approaches, see F.J. Calzonetti and Robert T. Walker, *Factors Affecting Industrial Location Decisions: A Survey Approach*, in INDUSTRY LOCATION, *supra* note 11, at 222-30.

In Part I of this Article, therefore, I consider in greater depth the arguments against incentives. I suggest reasons for skepticism about the critique of incentives, and suggest why such programs might satisfy tests of intrajurisdictional rationality and acceptable political process. In Part II, I consider the possibility that business incentives impose interjurisdictional costs, and suggest that incentives may instead induce matching of firms and locations that serves interjurisdictional welfare. That Part also discusses whether the judiciary or competitive processes themselves are more capable of distinguishing between business incentives that contribute to social welfare and those that impose the costs feared by the critics. I conclude with some remarks about the desirability of harmonization in state economic policies.

### I. INTRAJURISDICTIONAL EFFECTS OF INCENTIVES

In this Part, I consider claims that incentive programs harm the offering jurisdiction, wholly apart from any interjurisdictional effects. These claims center on the contention that officials who offer incentives systematically miscalculate the benefits to be generated by attracted or retained firms. If anticipated financial benefits do not materialize, the result of the promised incentives, which generally take the form of financial relief to the firm, is that the jurisdiction's total revenues decline. Relief may take the form of exemption from taxes or the dedication of public moneys to the firm. Thus the jurisdiction must make up the forgone revenue from other sources or provide fewer public goods. To the extent that jurisdictions do provide public goods, payment is distorted, since mobile firms are allegedly able to bargain taxes down to the point that they are paying only benefit taxes. The tax burden for redistributive efforts shifts to less mobile entities and individuals, notwithstanding the relative capacity of mobile firms to bear the redistributive burden.

These claims deny the basic premise of the competitive story about incentives, that is, that they facilitate optimal matching of firms and jurisdictions, and suggest that incentives are self-defeating in that they hurt the very jurisdictions that offer them. Such claims are typically accompanied by anecdotal evidence, such as the substantial subsidies offered for the Saturn plant or the Supercollider project.<sup>15</sup> However, anecdotal

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15. See, e.g., Enrich, *supra* note 1, at 389 ("Five years later, the cost for

evidence proves only the possibility of localized miscalculation, not its systemic presence; carried to its extreme, the claim that miscalculation of benefits warrants limits on competition would undermine the argument for private sector competition, since miscalculation is hardly unique to public sector investments.<sup>16</sup> Thus, legal intervention would be warranted, at best, if there were grounds to believe that states and localities systematically miscalculated the value of the incentives they offered and did so for reasons not equally attributable to private firms.

#### A. WINNER'S CURSE OR WINNER'S CURE

Two explanations for systematic miscalculation have been offered. The first takes the form of the Winner's Curse. The phrase describes a cognitive phenomenon of routinized overbidding by winning bidders in common-value auctions. The rationale for its presence is that where there are multiple bidders for the same good, the winner is required to bid more aggressively. As a result, the probability that the winner will have overestimated the value of the good increases, since those with lower estimations will not win the auction.<sup>17</sup> Both field studies and experimental data reveal that the Winner's Curse is "a general phenomenon exhibited by most agents."<sup>18</sup> In addition, there is some evidence that the phenomenon persists with experience, although its magnitude and frequency may decline. That is, those subject to the effect learn little from their mistakes.<sup>19</sup> Worse from the perspective of business incentives, these underlying judgmental errors may be enhanced where the estimator has limited liability for mistakes.<sup>20</sup> As I

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Tennessee to attract GM's Saturn plant, with its 6000 jobs, had risen to \$150 million in state and local incentives.").

16. For debacles in private sector investments, see, for example, Barnaby J. Feder, *Quaker to Sell Snapple for \$300 Million*, N.Y. TIMES, Mar. 28, 1997, at D1 (reporting that Quaker Oats sold Snapple for 1.4 billion dollars less than it paid for the company).

17. See RICHARD H. THALER, *THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE* 50-51 (1992) (explaining the "Winner's Curse").

18. Barry Lind & Charles R. Plott, *The Winner's Curse: Experiments with Buyers and with Sellers*, 81 AM. ECON. REV. 335, 336 (1991).

19. See *id.*

20. See Robert G. Hansen & John R. Lott, Jr., *The Winner's Curse and Public Information in Common Value Auctions: A Comment*, 81 AM. ECON. REV. 347, 347 (1991) (positing that the factor of a bidder's limited liability significantly affects the equilibrium bidding strategies for rational individuals

suggest below, there are public choice reasons to believe that state and local officials will be able to insulate themselves from blame for mistaken decisions about subsidies. If that is true, then the officials enjoy the political equivalent of limited liability in that the major avenue by which their tendency to overbid can be checked—electoral accountability—has been eliminated. Thus, there are reasons to believe that the Winner's Choice heuristic would systematically induce overpayment to attract firms.

There are countervailing considerations, however, that both moderate the effect of the Winner's Curse in location decisions and suggest instead that high bids may play a more positive social role. Bidding would presumably be consistent with competitive objectives if it allowed more accurate matching of jurisdictions and firms, that is, if firms use the bidding process to identify jurisdictions where they will be optimally productive. If bids provide information otherwise unavailable to firms, but known to the bidding jurisdiction, then bids provide a cure to the joint problems of asymmetric information and suboptimal productivity rather than a psychological trap.

### 1. A Critical View of the Winner's Curse

Before turning to the issue of whether bidding can cure these problems, there is a more critical reaction to the claim that the Winner's Curse infects bidders for firms. The conditions under which jurisdictions make bids frequently do not fit the ideal conditions under which the Winner's Curse arises. First, the possibility that winners of auctions will be disappointed with results is directly correlated to the number of bidders. While there may be multiple bidders for some highly publicized businesses (such as the Saturn plant), assuming that jurisdictions seek an optimal, not maximum, number of businesses, other auctions are likely to attract few bidders, so that the possibility of substantial numbers of lesser bids will be reduced in those settings. Even if bids are implicit—such as where the incentive takes the form of a statutory abatement granted to all firms rather than a negotiated deal for a specific firm, so that theoretically all states are bidding (since all states offer some form of statutory incentives<sup>21</sup>)—firms are unlikely to

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in an auction).

21. See CHI, *supra* note 7, at 12-113 (highlighting the state business tax and financial incentive programs of each state).

weigh all jurisdictions equally, because only a few may offer the other amenities that affect plant location.

Second, the Winner's Curse typically is attributed to bidders who are engaged in one-stage, sealed-bid auctions. That is, each bidder submits a single bid that cannot be revised and no bidder has reliable information about what other bidders are doing. A bidder who knows the content of other bids and who is able to revise her initial bid (upwards or downwards) in light of that information is less likely to be susceptible to the Winner's Curse. She can better calculate the expected value of a winning bid in light of information from other bidders that the firm has a value different than the one she initially assigned to it.<sup>22</sup> Firms do not typically make locational decisions based on one-stage, sealed bids. Instead, they negotiate with one or more jurisdictions about the terms under which they will locate. These terms frequently are made public prior to the time when the final location decision is made. Thus, there is little reason to believe that the conditions most conducive to materialization of the Winner's Curse exist in location decisions.

Third, note that the Winner's Curse is predicated on common-value auctions, that is, auctions in which the item being bid for has a single, but unknown objective value, typically reflected in its market value. Common-value auctions, for instance, may involve bidders who intend to resell the auctioned good on the open market.<sup>23</sup> In some sense, competition among states for the same business might be thought to fall within this category—a plant that will offer one hundred jobs might be thought to be of the same value in North Carolina as it is in North Dakota. If the Tiebout story about optimal size of localities is cor-

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22. See Steven J. Brams & Alan D. Taylor, *FAIR DIVISION: FROM CAKE-CUTTING TO DISPUTE RESOLUTION* 188-98 (1996) (discussing the effect of providing auction bidders with information on the other bidders' initial estimates).

23. See, e.g., R. Preston McAfee & John McMillan, *Auctions and Bidding*, 25 *J. ECON. LITERATURE* 699, 705 (1987) (explaining the "common-value model" for auctions where bidders intend to resell the item on which they bid). Auctions may have some of the characteristics of a common-value auction without fully falling within that category. McAfee and McMillan, for instance, posit the possibility that bidders at an antiques auction may intend to resell their winnings, but differ in their selling capacities, "so that the ultimate market value depends on which dealer wins the bidding." *Id.* Similarly, I suggest that different bidders for firms may have different capacities for developing the productive capacities of the firms and thus place different values on them.

rect, however, then not only will the plant have positive value only to locations that are seeking to grow, but that value will also vary depending on how close the bidders are to their optimal size. The value of the firm, then, will not be common to all bidders.

## 2. A Cure to Asymmetric Information and Suboptimal Performance Problems?

I want to elaborate on the claim that the same firm could have different value in different jurisdictions, depending on how that firm fits into an overriding business plan for each jurisdiction. Assume, for instance, that a jurisdiction desires to develop a particular resource that is not shared by all other jurisdictions. That jurisdiction may place a higher value on firms that can assist in the development of that resource than some alternative jurisdiction that either did not have or did not want to develop the same resource. Bids in this situation may be used to convey new information about the value that the jurisdiction places on the firm. It is in this sense that bids may be viewed as a solution to a problem of asymmetric information.

Even if localities have information, conveying that information solves a problem only if the information is relevant to the firm's location decision. Even if the conditions for the Winner's Curse are not perfectly reflected in business incentives, the consequence of that curse, systematic overbidding relative to actual value, is reflected if all competing localities bid too high. Certainly that result would occur if bids were superfluous because they did not, in fact, influence business location decisions. There may be some situations in which we think that a bid is unnecessary to attract a firm, even though the jurisdiction desires the firm and there would be a good fit between the two. Assume, for instance, that the jurisdiction is willing to allow exploitation of a natural monopoly that the firm desires to exploit. If the basis for the monopoly is readily apparent, then firms that can take advantage of that resource will be attracted to the jurisdiction without any additional incentive, so that any bid brings about the wasteful results that the Winner's Curse predicts. A firm that wants to extract minerals will have to go to the source of the minerals and does not need additional incentives or information to select that location.

Other industries, however, may be more mobile, so that firms within the industry could locate with relative ease in any of several jurisdictions. Even in this situation, the same firm could have different value to different jurisdictions. This result

could occur either because the firm would be more productive in one location than another or because the firm produces spillover benefits within a jurisdiction that exceed the benefits that it would produce in other jurisdictions. In the first case, bids should influence location decisions and would not be superfluous if the bid conveyed to the firm information about productivity of which it was otherwise unaware. In the second case, the firm would be indifferent about spillover effects that did not increase its own productivity, so bids would be appropriate if they induced firms to make locational decisions that reflected the greater social value of locating in one jurisdiction rather than another. In brief, bids make sense if they solve problems of asymmetric information where localities have a better conception than the firm itself has of the fit between a particular firm and the plans and needs of the locality. We can take three different situations to illustrate these conditions. In each of these cases, the additional value of the firm should be reflected in the bid, and these additional values may vary significantly.

First, other preferences of the jurisdiction may influence the type of economic development that it is willing to sponsor. A jurisdiction that favors a particular form of industry, and that thus narrows the set of acceptable industries, may place a higher value on attracting a firm within that set than does a jurisdiction which is indifferent within a larger set of industries. For instance, a jurisdiction that comprises mountains and scenic areas and wants to develop its tourist industry to take advantage of those assets may place a higher value on a firm that can coexist with a recreational park than a state that is trying to attract the firm solely for the revenues it can generate. The firm's productivity, however, may not be influenced by its fit with other objectives of the jurisdiction. That is, it may be equally productive in a jurisdiction less desirous of attracting environmentally friendly firms. Thus, in attempting to decide where to locate, the firm may not look at the environmental benefits that the firm is producing for the jurisdiction. As a social matter, however, we would want those benefits to be considered in the location decision, since failure to take them into account will constitute a lost opportunity. The firm will become aware of those benefits, and act on them, only as a function of the ability of the jurisdiction to make a higher bid that reflects the greater benefit that the firm brings to that area. Similarly, a jurisdiction that favors environmental safeguards may want to attract "clean" industries, while a juris-

diction less concerned about environment may be indifferent as between two firms that impose different levels of pollution, each of which expects to employ 250 people. Unless the firm values being in a jurisdiction that favors "clean" industries, its location decision will be made without regard to the higher value that it confers on the "clean" jurisdiction, unless that jurisdiction is able to signal that value, and the firm can capture part of it, by use of the bidding process.

Second, there may be synergies related to productivity of the courted firm that are identified by one of the bidding jurisdictions, but not others, even though those same synergies would be realized by any winning jurisdiction. If the firm is aware of the possibility of such synergies, it may wish to locate in a jurisdiction that similarly realizes the productive capacity of those relationships and is willing to make the investment necessary to develop them, as evidenced by its bid for the courted firm. But even a firm unaware of potential synergies may implicitly learn of them through the bidding process. For instance, one jurisdiction may believe (correctly) that it can develop the productive capacities of the industry, in part because it has identified the courted firm as a means of attracting additional firms in a manner that other jurisdictions have not recognized. The location of one firm may influence the location of other firms that deal in products related to those of the first firm, as competitors, customers, or suppliers. Firms that locate along with others can create networks that reduce transaction costs and that facilitate the sharing of information. For instance, firms that manufacture automobile tires and batteries are likely to locate near automobile manufacturing plants, and software companies are likely to locate near each other in order to take advantage of the opportunities of generating beneficial network externalities.<sup>24</sup> A firm that can generate network externalities may have a greater value to a jurisdiction in which other firms within the same network already exist than to a jurisdiction that is initially attempting to create such a network within its boundaries. For instance, one jurisdiction may attempt to create a reputation as a home to industry of a certain sort, even though firms within that industry have no prior

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24. See Michael L. Katz & Carl Shapiro, *Network Externalities, Competition, and Compatibility*, 75 AM. ECON. REV. 424, 424-25 (1985) (defining network externalities); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 762-63 (1995) (defining network externalities).

reason to locate within that jurisdiction. Thus, California and Massachusetts have been able to attract software industries that might with equal ease have located elsewhere. The highly tailored statutory schemes of some states suggests that the states have, in fact, identified industries that they seek to attract,<sup>25</sup> though it is difficult to disaggregate such a desire from the possibility that those same highly tailored preferences represent a simpler and less productive result of capture. The fact that the winner has, by definition, paid a price in excess of the bids of others may reflect that the winner properly recognizes that there is a first-mover advantage to attracting the courted firm, or it may reflect a distinct advantage that the winning jurisdiction believes it has in implementing the productive capacity of the firm.

Third, it may be that all jurisdictions identify the additional value that the firm will generate, and that additional value may be the same in absolute terms for all jurisdictions, but the marginal value of the firm will be different because the jurisdictions are at varying distances from their ideal population and tax rate.<sup>26</sup> A high bid by one jurisdiction may indicate that it has greater excess capacity to absorb the kinds of satellite or related firms that would be attracted by the courted firm, so that the jurisdiction expects and desires to provide the kinds of support that would be essential to the growth of the courted firm. The value of the courted firm to the jurisdiction is not simply the productive value of that firm alone, but that value in addition to the value of other firms that may be advantaged by the first firm. Assume that the courted firm would bring in \$10 of benefits, but would also attract satellite firms that generate an additional \$5. For instance, if an automobile plant were to locate, it might attract tire manufacturers, battery manufacturers, and restaurants. The jurisdiction should be willing to pay up to \$15 to attract the courted firm, even though that amount exceeds the benefits produced by that firm

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25. See, e.g., CHI, *supra* note 7, at 23, 55, 100, 108 (describing incentives offered by several states, including a Massachusetts program directed to attract early-stage, high-risk, technology-based companies; a Utah excise tax exemption available for certain types of industries; a West Virginia warehouse tax exemption; and a California program to encourage innovators in development of new technologies).

26. See Peter S. Fisher & Alan H. Peters, *Taxes, Incentives and Competition for Investment*, THE REGION, June 1996, at 55-56 (finding high unemployment jurisdictions offer the largest incentives, although these incentives do not necessarily translate into higher rates of return).

standing alone. But whether the jurisdiction is willing to bid that amount depends on how close it is to optimal size. One could imagine a second jurisdiction that wanted to attract the automobile manufacturer, but had little interest in simultaneously attracting satellite businesses. It would presumably bid no more than \$10 for the firm. If the firm itself cared about having easy access to the related industries, it would treat the higher bid of the first jurisdiction as a signal of the relative willingness of the jurisdiction to accommodate the firm's needs or to create an environment in which the development of network externalities facilitated the firm's productivity. Of course, these synergies might not be perfect. The firm might be indifferent about whether other industries were attracted by its presence. This does not mean that the winning jurisdiction is bidding inappropriately, because the jurisdiction may care significantly about the fact that the courted firm will attract others. It only reflects the fact that the winner places a different value on attracting the firm than do other bidders.

One response to these possibilities is that the claim of informational asymmetries appears hollow because the firm should have reliable information concerning objective criteria that are relevant to the location decision. Most information that is relevant to the firm's location decision should be available in verifiable form without being subsumed in a jurisdiction's bid. There is no reason to believe that the firm will have inferior information about such issues as climate, employment and wage rates, cultural amenities, housing stock, and school systems that is readily available from objective sources. Thus, even if these factors are reflected in the jurisdiction's bid, they do not constitute a solution to a problem of asymmetric information. Nevertheless, certain types of information that will be less apparent to firms than to jurisdictions might be subsumed within bids. These instances roughly correspond to the categories of hidden information and hidden action that Kenneth Arrow has suggested creates problems of asymmetric information.<sup>27</sup> While these categories are typically seen as potential mechanisms for driving wedges between principals and agents, an agent that wants to signal fidelity to a principal may seek

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27. See Kenneth J. Arrow, *The Economics of Agency*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 37, 38-40 (John W. Pratt & Richard J. Zeckhauser eds., 1985) (describing "hidden actions" and "hidden information" as situations when an agent has information of which the principal is unaware).

ways credibly to indicate that it is not withholding valuable information; bids may play that role where jurisdictions seek to ensure firms of the veracity of their intentions to become optimally productive.

Take first the problem of hidden information. The firm is less likely to have accurate information about future plans of the jurisdiction that will affect the profitability of the firm. This includes such issues as the willingness of the jurisdiction to accept other firms with which the courted firm may share network externalities. One might think that incentives are unnecessary to attract a firm that can generate network externalities, since the firm itself will be aware of that possibility and thus will locate in any jurisdiction that will accept the additional firms with which the courted firm expects to interact. The problem is that firms may have difficulty extracting credible commitments from the competing jurisdictions. In the courtship process, many jurisdictions may be willing to commit to enticing related firms, or at least not interfering with their relocation. A firm cannot, however, rely on promises made by jurisdictions about their fit with the firm, since localities that would obtain positive but relatively small benefits have incentives to mimic the marketing behavior of localities that expect relatively large benefits from attracting the same firm. Talk, after all, is cheap. The result is that courted firms may be unable to separate claims made by competing jurisdictions about the future relationship that can be anticipated between the firm and the jurisdiction.

Alternatively, jurisdictions may have hidden information with respect to factors that influence the success of the firm. For instance, the jurisdiction is likely to have superior information about willingness to zone, the need for additional taxation within the near future, and willingness to construct new roads and new infrastructure necessary to attract satellite industries of use to the courted firm. Bids allow the jurisdiction credibly to reveal any information that it has about its plans as well as the fit between the firm's demand for productive inputs and the assets available in the community.<sup>28</sup> A high bid in the form of financial incentives serves as a signal that the bidder places an idiosyncratic but realistic value on attracting the courted firm. Should a jurisdiction win an auction on this ba-

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28. See Glenn Platt, *An Efficient War Between the States: A Model of Site Location Decisions Under Asymmetric Information* 23 (April 1997) (unpublished manuscript, on file with author).

sis, the high bid does not reflect overconfidence that will soon be disappointed, but a very different value on winning the auction.

In addition, jurisdictions may have superior information about subsequent action with respect to the firm. Once the firm has made investments in a plant, it will be difficult to extract itself, notwithstanding economists' admonitions about ignoring sunk costs.<sup>29</sup> Thus, the firm is susceptible to strategic behavior by jurisdictions in the form of renegeing on promises, or chiseling at bargains that have been reached, or changing the objectives of the jurisdiction. The possibility that a firm can be lulled into a jurisdiction and subsequently exploited exists not only with respect to political officials who do not intend to live up to promises at the time they are made, but also with respect to shifts in public opinion about the desirability of a firm once it has actually located in a jurisdiction. Nevertheless, bids may be structured in a way that indicates the bidder's valuation by creating precommitments against such shifts. A bid that consists of up-front concessions or enforceable promises may serve as a bonding mechanism by committing the jurisdiction's resources to a long-term relationship in which renegeing is difficult and shirking unprofitable.

### 3. Issues of Equity

Even if incentives solve informational asymmetries and foster more secure bonds, thereby facilitating optimal matches between firms and locations, two objections remain. The first is that investment decisions made on the basis of business incentives will distort the relationship between mobile and im-

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29. See Eric W. Bond & Larry Samuelson, *Tax Holidays as Signals*, 76 AM. ECON. REV. 820, 820 (1986) (observing that countries are able to raise tax rates for firms after a firm has invested sunk costs). Of course, until the firm actually makes a capital investment, it may be able to extricate itself rather easily and may itself renege on the deal, for example, by constructing a smaller plant and hiring fewer workers than promised. See, e.g., Melvin L. Burstein & Arthur J. Rolnick, *Congress Should End the Economic War Among the States*, THE REGION, March 1995, at 10 (describing Northwest Airlines' construction of facility that would employ fewer than half the number of workers originally anticipated when it received low-interest loans from the state). Thus, the attracting jurisdiction may not want to use incentives that require up-front payments, such as issuing general obligation bonds that the jurisdiction is required to pay regardless of revenues generated by the courted firm. On the other hand, firms that provide incentives in the form of multi-year tax-abatements or additions to infrastructure will be able to extricate themselves from the bargain should the courted firm renege.

mobile capital. The second is that the burden of redistributive taxes will be borne unequally, even as total redistributive effort is reduced. The distortion in investment will arise because only mobile capital will be eligible for incentives. The result is that persons who would otherwise invest in immobile enterprises will be less willing to do so because they will be net payors of subsidies and redistributive taxes, while mobile enterprises will be net recipients of subsidies and will be excused from redistributive taxes.

Nevertheless, the situation may be more complicated than first appears. The recipients of business incentives tend to be large plants that, once located, will be difficult to move to another jurisdiction. Thus, although these plants may be mobile at the point that the investment decision is made, once the firm actually locates in a particular jurisdiction, it becomes relatively immobile and may be vulnerable to the decisions of the same jurisdiction to offer subsequent incentives to additional firms for which the firms that first moved in (and that received incentives) will pay. Thus, the distinction between mobile and immobile capital may be less meaningful than critics of subsidies suggest. Yet it is true that firms that are tied to particular geographical locations, such as mines, will systematically be deprived of opportunities for incentives. To that extent, distortions in investment may occur. The more difficult issue is whether those distortions will outweigh any gains that are achieved by attracting firms to particular areas where they might be more productive.

Similarly, the possibility that incentives will shift the burden of redistributive taxes to immobile firms and residents raises issues of horizontal equity, defined as treating similarly situated parties similarly. These concerns exist independently of the distortion effects. Assume, for instance, that a jurisdiction provides \$200 worth of redistributive services annually and that there are two firms in town, X and Y, each of which generates \$10,000 worth of revenues, and each of which pays \$100 in annual taxes towards redistributive services. The jurisdiction now attracts Firm Z to the jurisdiction. Firm Z generates \$10,000 worth of revenues and hires a sufficient number of local residents that the local redistributive budget falls to \$150. Because Firm Z is similarly situated, at least in terms of ability to pay, to the two firms that are already located in the jurisdiction, horizontal equity would require that each pay one-third of the redistributive burden, or \$50. Firm Z, however, located within the

jurisdiction only because it was required to pay no redistributive taxes during the next year, that is, it received a location incentive that bid its tax rate down to pure benefit taxes. Thus, the existing firms, which cannot easily emigrate, must each pay \$75, while Firm Z pays nothing. If what we mean by "similarly situated" is based on ability to pay, the unequal burdens faced by the X and Y on the one hand and Z on the other suggests a violation of horizontal equity. The fact that Firm Z's presence actually *reduces* the total redistributive payment of the existing firms is irrelevant to the issue of horizontal equity. Nevertheless, providing the subsidy to Firm X does raise the issue of whether we are willing to accept a certain amount of horizontal inequity in order to attain a greater social benefit, that is, a reduction of redistributive taxes and an increase in the welfare of the newly employed residents of the jurisdiction. In effect, we are imposing on the existing firms an obligation to bear a greater than proportionate share of the objective of enhancing welfare for the community at large.

There are a number of things to say about this situation. We can first point to the imprecise nature of horizontal-equity claims. While we can agree that horizontal equity demands that similarly situated parties should be treated similarly, there exists no independent metric of what constitutes similarity for these purposes.<sup>30</sup> The firms in the example are "similar" in the sense that they all generate the same revenue, and because we think of taxation as properly based on income, that similarity may be viewed as a proper basis for imposing similar tax rates. They have other characteristics that make them dissimilar, however, such as the fact that two of the firms are already based in the jurisdiction and one of the firms is not. One might claim that this is not a relevant distinction, because if one of the firms that existed in the jurisdiction were to stop production, the loss to the jurisdiction would be the same as the gain to be realized by attraction of the new firm. However, not all firms, and not all firms that generate the same amount of revenue, are of equal value to the jurisdiction. Firms that provide numerous jobs, that are helpful in attracting addi-

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30. See Thomas D. Griffith, *Should "Tax Norms" Be Abandoned? Rethinking Tax Policy Analysis and the Taxation of Personal Injury Recoveries*, 1993 WIS. L. REV. 1115, 1155-59 (1993) (describing the difficulties in the application of the horizontal equity principle); Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139, 140-41 (1989) (outlining the difficulties with defining horizontal equity).

tional employers, or that generate spillover business to firms already located within the jurisdiction will have a value that is different from firms that do not have these characteristics. In that sense, the firms are not similarly situated, so providing incentives to one but not others is not necessarily a deviation from horizontal equity. The absence of any a priori reason to select one of these approaches to "similarity" over the other makes the horizontal equity claim precarious at the start.

Even if we were to agree that the firms in the example were similarly situated, it is not clear how strong of a pull claims of horizontal equity exert on the allocation of social burdens. A variety of situations exist in which we deviate from horizontal equity when doing so provides the most effective mechanism of achieving social objectives. Put to one side the obvious cases in which burdens are indivisible and thus cannot be shared by all equally or cases in which we would not want all to participate—for example, drafts during wartime. There still remain other situations in which burdens are essentially financial, and thus divisible, yet we permit local governments—the entities involved in location incentives—to impose unequal burdens. Think, for instance, of rent-control regulations, through which we impose on landlords a greater than pro rata obligation to subsidize the poor by denying the ability to charge rents that markets would otherwise allow landlords to command.<sup>31</sup> Likewise, consider linkage fees that require developers to construct public goods or offer amenities as part of the price of development.<sup>32</sup> While these efforts may rise to the level of takings if they impose burdens too far removed from the costs they impose,<sup>33</sup> localities remain able to impose obli-

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31. See CLAYTON P. GILLETTE, *LOCAL GOVERNMENT LAW* 317-19 (1994) (describing arguments both supporting and criticizing rent control).

32. See *Russ Bldg. Partnership v. City of San Francisco*, 234 Cal. Rptr. 1 (Cal. Ct. App. 1987) (upholding a development fee as a reasonable fee to compensate the city for increased expenses resulting from development); *Bonan v. City of Boston*, 496 N.E.2d 640 (Mass. 1986) (upholding a Boston zoning code, which required developers to make a linkage payment). See generally ALAN A. ALTSHULER & JOSÉ A. GÓMEZ-IBÁÑEZ, *REGULATION FOR REVENUE: THE POLITICAL ECONOMY OF LAND USE EXACTIONS* (1993) (discussing methods of regulating developers which require contributions to the social infrastructure).

33. See *Dolan v. City of Tigard*, 512 U.S. 374, 374 (1994) (holding that a city's requirement that a property owner dedicate part of her property to the public in exchange for a building permit violates the Takings Clause); *Nollan v. California Coastal Comm'n.*, 483 U.S. 825, 825 (1987) (holding that a requirement that a property owner provide a public easement through his or her property in exchange for a permit to build violates the Takings Clause).

gations as long as they have some nexus to the development. Even though the scope of the required relationship remains undefined, localities retain some discretion to impose conditions that redound to the public benefit. Short of the obscure doctrine of unconstitutional conditions,<sup>34</sup> jurisdictions remain able to offer benefits to parties that agree to provide public goods, such as by selling abandoned homes at deeply discounted prices to individuals who agree to fix them and live in them for a substantial period of time or to parties who agree to construct public ways. Hendrik Hartog's recounting of the development of New York City by the grant of waterlots to those who agreed to make public improvements, including constructing and maintaining wharves, streets, and docks, reveals our longstanding history of placing a disproportionate burden on those who receive the benefits of governmental discretion.<sup>35</sup> The fact that we engage in such activity does not justify it. Indeed, there can be little doubt that horizontal inequity creates distortions in investment, as evidenced by the harsh attacks that claim rent control leads to an undersupply of housing for low-income families and disrepair of the available housing stock for that group.<sup>36</sup> It may suggest, however, that certain forms of disproportionate taxation provide a politically feasible means of conferring redistributive benefits on a particular group that has become acceptable, at least within limited contexts.

In the area of business incentives, the horizontal equity issue is complicated by my hypothesis that subsidizing the new firm reduces the net outlay of existing firms, albeit not by as much as would be possible if the new firm both located in the jurisdiction *and* paid its proportionate share of redistributive taxes. We might prefer to have both a lower redistributive burden and horizontal equity. If we must surrender one, it is not clear which we would abandon. I suspect that the matter is one of degree. Tradeoffs between equity and efficiency cannot easily be reduced to formulaic solutions.<sup>37</sup> The greater the de-

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34. See, e.g., Vicki Been, "Exit" as a Constraint on Land Use Exactions: Rethinking the Unconstitutional Conditions Doctrine, 91 COLUM. L. REV. 473, 473 (1991) (analyzing the doctrine of unconstitutional conditions specifically in terms of the *Nollan* decision).

35. See HENDRIK HARTOG, PUBLIC PROPERTY AND PRIVATE POWER 44-59 (1983).

36. See, e.g., Joseph Gyourko & Peter Linneman, *Rent Controls and Rental Housing Quality: A Note on the Effects of New York City's Old Controls*, 27 J. URB. ECON. 398, 398 (1990) (arguing that rent control is bad public policy).

37. One principle of imposing unequal burdens that does not seem to

violation from horizontal equity, the greater the decrease in total redistributive burden we might demand.<sup>38</sup>

This tradeoff between social benefit and imposition of unequal burdens may be reflected in the Supreme Court's test for regulatory takings after *Dolan v. City of Tigard*.<sup>39</sup> In that case, the Court held that a governmental entity could only impose conditions on grants of development permission without violating the Takings Clause if the condition satisfied a "rough proportionality" test. That test examines whether the exactions demanded by the permit conditions are roughly proportional to the projected impact of the petitioner's proposed development.<sup>40</sup> In essence, the test limits the capacity of government to impose on individuals the obligation to provide public goods without offsetting compensation; the negative implication is that we are willing to accept some degree of imposition, notwithstanding that it requires some individuals to bear a disproportionate burden in the creation of public goods.

As long as government operates within constitutional parameters of imposing individualized burdens in the allocation of public goods and tax burdens, resolving tradeoffs between equity and efficiency may ultimately have to be a function of political markets. These markets may decide that absolute equality is necessary, and thus it is worth surrendering some potential social gains if they can be achieved only by an unequal allocation of burdens.<sup>41</sup> The assignment of this function to political markets arises not because they are perfect, but because they have the capacity to consider the variables neces-

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work here is indivisibility. We cannot, for instance, impose an equal burden on all persons to fight wars, so we draft a few. But for redistributive purposes, we are only talking about money and that seems to be the quintessential divisible good. The problem is that the courted firm may not move to the locality if it is required to pay. Thus, much depends upon the assumption that attracting the firm will decrease the total outlay of redistributive dollars.

38. To return to our university example, it is unlikely that any university would admit to selling admissions rather than deciding such matters on meritocratic grounds. Nevertheless, it would be the rare university that would not give extra consideration to the child of a potential multi-million donor, since those dollars would inure to the benefit of all the university's students. While we might suspect a correlation between potential donations and the deviation from meritocracy, we would (hopefully) be surprised if the prospect of large gifts generated too great of a deviation.

39. 512 U.S. 374 (1994).

40. See *id.* at 391.

41. See JON ELSTER, LOCAL JUSTICE 70-71 (1992) (describing the principle of absolute equality which requires that a good which cannot be given equally to all should be given to no one).

sary to making decisions among incommensurables. Delegation to political markets makes a somewhat heroic assumption about the absence of distortions from *that* market, however. Because critics of incentives do not find the political decision-making process to be so pure, it is to that issue that I turn next.

## B. AGENCY COSTS AND LOCATION DECISIONS

The other potential source of systemic miscalculation of value arises from agency costs between those public officials who award the incentives and their constituents. Here, the standard public choice story about the incentives of political actors initially seems quite compelling. Managers or owners of firms that will benefit from subsidies have substantial motivation to lobby vigorously for them because these individuals will be able to capture the gains of their efforts, either in reputation as managers or in residual profits as owners. Thus, they will invest in convincing public officials of the benefits related to a grant of incentives, even if the intrajurisdictional cost of the incentives exceeds the benefits. Other interest groups have similar motivations to advocate business development, regardless of its net effects on the jurisdiction, because it will generate net gains for the particular group. Real estate developers and brokers, for instance, stand to gain from additional development regardless of its effects on the community as a whole.<sup>42</sup>

Those who oppose incentives on the basis of their negative-sum quality have less reason to monitor officials or to invest in convincing those officials not to grant incentives. This group consists primarily of taxpayers who will bear either increased tax burdens or reduced services as incentives whittle away business contributions to redistributive goods. On an individual basis, however, these effects are minute compared to the personal costs of opposition. In addition, because opposing an inefficient subsidy has the characteristics of a public good, any given opponent can receive the same benefit without incurring the related costs if someone else undertakes the opposition effort. Nor will officials who miscalculate (or who knowingly grant negative-sum incentives to favored groups) necessarily suffer electoral redress, since the binary nature of voting means that

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42. See Thomas L. Evans, *The Taxation of Nonshareholder Contributions to Capital: An Economic Analysis*, 45 VAND. L. REV. 1457, 1488-92 (1992) (describing the operation of public choice theory in which a small group is benefited at the expense of a large group).

voters must cast ballots based on the overall performance of officials. A voter who believes, for instance, that a mayor has done a good job paving the streets and running the schools may vote for the mayor's re-election even if he misspent large sums of public money attracting a business to the city. It is in this sense that officials are immune from the consequences of their decisions, a condition that I suggested above has been linked to materialization of the Winner's Curse. They cannot easily be signaled that their actions diverge from what is preferred by their constituents, and by the time officials' errors are discovered, they are likely to have moved from office.

Indeed, residents themselves may favor projects that turn out to generate net costs, at least if those costs will not be realized until some point in the future. To the extent that projects are financed with debt, current residents may favor projects that favor immediate returns (construction jobs, increased demand for housing) over costs that will be imposed only on future generations (excessive demand on city services, obligations to pay for facilities that turn out to be unnecessary because promised job and residential growth did not materialize).

Political officials themselves allegedly have a bias in favor of unchecked business development, regardless of its effects. Such involvement presumably demonstrates a desire to encourage economic growth and allows the officials to take credit for economic successes, while eschewing blame for business defections that might otherwise have occurred (even if they were socially efficient defections).<sup>43</sup> If officials in other jurisdictions are offering similar programs, mimicking their efforts may appear to be a safer course to deflect allegations of inaction, especially in an environment where measurement of the actual effects of incentives is problematic.<sup>44</sup> Creating public works and attracting businesses that construct plants similarly provides officials with concrete and salient evidence of action, and offers a legacy that is more visible, and hence more enduring, than programs that do not require capital expenditures. Hence, it is likely that public officials suffer from an "edifice complex" that causes them to favor expenditures that attract capital investment.

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43. See Enrich, *supra* note 1, at 394 (arguing that politicians will take visible steps to encourage economic growth and then will take credit for economic gains and avoid blame for economic losses).

44. See *id.* (stating that it is easier for politicians to follow the lead of other states in acting to promote economic growth).

As in the case of the Winner's Curse arguments, these contentions from public choice have a ring of truth, but some greater disaggregation of their effects is necessary to distinguish those cases in which they are likely to induce overbidding from those cases in which they are not. There is little doubt that some groups would receive discrete benefits from business development and thus have substantial incentive to invest in capturing the official decisionmaking process. The remaining issue is whether there exist sufficient interests on the other side so that we could conclude with confidence that any ultimate decision to grant incentives was made only after robust debate in which all views were represented. In those circumstances, we would be more comfortable that the ultimate decision was likely to reflect officials' best guess as to the net effects of the incentives.

The arguments presented above suggest that the costs of collective action will be prohibitive to potential opposition groups, such as taxpayers who will be charged higher rates or receive fewer services if incentives allow firms to pay only benefit taxes. Some opposition groups, however, should be able to coalesce against proposed subsidies. For instance, existing firms will face competitive threats from new businesses within the same industry and will be particularly concerned if those new firms are granted competitive advantages such as tax-abatements or tax-exempt financing that reduce their costs.<sup>45</sup> Thus, we are likely to see coalitions of "mom-and-pop" stores form to oppose the entry of a Wal-Mart, or of independent book stores to oppose the entry of a Borders. This type of collective opposition is obviously most likely to arise where the subsidy takes the form of a grant to a specific firm, such as a tax-abatement extended to a courted firm or the issuance of tax-exempt bonds the proceeds of which will be dedicated to the construction of a new plant for the firm.<sup>46</sup> A broad program

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45. See ROBERT S. AMDURSKY & CLAYTON P. GILLETTE, *MUNICIPAL DEBT FINANCE* 49-50 (1992) (arguing that when subsidies are to be given to a new business, already existing businesses in the same industry who cannot receive subsidies will participate in the political process to argue that the subsidy does not generate net social gains).

46. Saul Levmore refers to the possibility of this "conscious funding" to support a general rationale of why courts are more deferential towards subsidies than to other preferences challenged under the Commerce Clause. See Levmore, *supra* note 8, at 485-86 (discussing "conscious funding"). Since subsidies come out of the treasury, "courts might assume that the state legislature has considered the burdens and benefits of its action" in ways that do not

applicable to a large group of recipients, such as a general statutory investment-tax credit, is less likely to be sufficiently salient in its application to a specific firm to overcome traditional collective action problems, even if it subsidizes new competition to existing firms in the jurisdiction. Nevertheless, the possibility that competition may exist in some cases suggests a need to separate those areas in which public choice concerns are less dramatic.

In addition, there are some groups that may have a sufficiently strong interest in monitoring public officials that they are likely to discover and complain about inefficient incentives. First among these are political opponents of incumbents. To the extent that they can demonstrate that current officials are "wasting" public funds, they may be able to increase their own chances of electoral success. A more complicated case exists with respect to the media. Increased population may translate into increased circulation, so that publishers have incentives to support business development.<sup>47</sup> Individual reporters, however, may be able to maximize reputation and job prospects with investigative reporting that, again, points to "wasteful" expenditures or subsidies. By generating information about business incentives, news reports may reduce the costs of investigation to the residents as a whole sufficiently to generate opposition where none would otherwise exist. Thus, these groups may have sufficient incentives to overcome the general collective action problem that suggests proponents will have an unopposed path to the ears of public officials.

Look next at the incentives for voters to ignore costs that can be imposed on future generations because business incentives are funded through debt. This phenomenon is less likely to exist where debts constitute general obligations of the ju-

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apply to state preferences that are not funded by state government. *Id.* at 585. I suggest that the expenditure from the treasury is one way of making the favoritism of a particular firm salient. But it is not the only way. For instance, the issuance of revenue bonds on behalf of a firm will not require a direct expenditure. But the benefit to the firm is as salient as in the case of an explicit subsidy, and it is the salience of the benefit that creates incentives for potential competitors of the benefitted firm to participate in the decisionmaking process and thus causes the decisionmaker to consider the costs and benefits of the subsidy. See also Mark P. Gergen, *The Selfish State and the Market*, 66 TEX. L. REV. 1097, 1135 (1988) (discussing the advantages and disadvantages of pure subsidies such as tax incentives, grants, or loans); Regan, *supra* note 8, at 1194-95 (discussing the advantages of state spending to attract businesses).

47. See Evans, *supra* note 42, at 1489 (stating that the media benefits from population growth).

risdiction, an increasing phenomenon since Congress restricted the capacity of jurisdictions to fund industrial development with revenue bonds.<sup>48</sup> Because virtually all jurisdictions are subject to debt limitations, as state and localities bump up against those limitations, prospective projects compete with each other for scarce dollars. Debt incurred to fund industrial development reduces the possibility that debt can be incurred for road construction, libraries, or schools. If those other potential projects are supported by discrete groups (such as road building firms, librarians, and teachers' unions), those groups are likely to scrutinize proposed indebtedness to support industrial development. Homeowners in general may analyze proposed debt payable from property taxes because increased tax rates may reduce the sales prices of their homes.

For much the same reason, even nongeneral obligation bond debt, secured solely by the revenue stream generated by operation of the business financed with bond proceeds, may generate scrutiny. For most purposes, current law grants a tax exemption for the interest on such debt for industrial development purposes only if it fits within a "volume cap" allocated to each state.<sup>49</sup> As long as the total financing for all proposed projects threatens to exceed the state's volume cap, proponents of competing projects have incentives to scrutinize or force scrutiny of business incentives that take the form of tax-exempt financing because financing those projects risks the accessibility of these other groups to scarce tax-exempt borrowings.

Of course, not all incentives will be similarly susceptible to monitoring. Explicit subsidies may be more salient than tax-abatements or other tax expenditures, such as exemptions.<sup>50</sup> Ad hoc incentives negotiated with individual companies will be more salient than statutory incentives that apply to a wide range of firms. Those subsidies that are more susceptible to intrajurisdictional political review may require less centralized intervention. Interestingly, however, that analysis seems to be lacking in much of the Commerce Clause jurisprudence, a conclusion that seems consistent with Chief Justice Rehnquist's recent comment that "[a]nalysis of interest group participation in the political process may serve many useful purposes, but

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48. See 26 U.S.C. §§ 103, 141 (1994).

49. See 26 U.S.C. §§ 142-46 (1994); DENNIS ZIMMERMAN, *THE PRIVATE USE OF TAX-EXEMPT BONDS* 287-323 (1991) (discussing the purposes, applications, advantages, and disadvantages of the "volume cap" as applied to states).

50. See, e.g., Gergen, *supra* note 46, at 1110.

-serving as a basis for interpreting the dormant Commerce Clause is not one of them.<sup>51</sup> For instance, the form of incentive that seems most likely to generate monitoring, explicit subsidies to specific firms, may be the form to which courts respond most restrictively.<sup>52</sup> In addition, explicit subsidies have generated the greatest outcry from critics, some of whom contend that congressional intervention is necessary only to prevent subsidies to specific firms while leaving intact state policies that offer the same tax breaks to all businesses that locate within the state.<sup>53</sup>

Finally, even if public officials are susceptible to capture and thus overinvest in incentives, it is not clear that proposals for incentives, particularly inefficient ones, will be successfully implemented. Legal doctrines restrict the capacity of public officials to engage in particular activities, and the parameters of these doctrines seem suited to check the possibility that public officials will grant benefits to a discrete group at the expense of a broader constituency. For instance, the "public purpose" requirement limits the scope of expenditures that can be made by public officials. Although the definition of "public purpose" is inherently vague (if not vacuous), courts have applied it to restrict expenditures that appear intended solely to grant discrete benefits to a group that appears to have captured political decisionmaking processes. Indeed, courts have taken this action even when they recognized that the jurisdiction is gaining at the expense of some out-of-state constituency. For instance, in *State ex rel. McLeod v. Riley*,<sup>54</sup> the court rejected, on public purpose grounds, revenue bond financing for computer and office facilities. The court recognized that the sole reason for obtaining public financing was the tax savings granted by the federal Internal Revenue Code. The costs generated by the federal subsidy on tax-exempt financing would presumably be shared nationwide, while the benefits of the program would be localized within South Carolina. One might imagine that the South Carolina state court, therefore, would

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51. *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 212 (Rehnquist, C. J., dissenting).

52. See Levmore, *supra* note 8, at 584-86 (discussing conscious funding).

53. See Burstein & Rolnick, *supra* note 29, at 3; Thomas J. Holmes, *Analyzing a Proposal to Ban State Tax Breaks to Businesses*, FED. RESERVE BANK MINNEAPOLIS Q. REV., Spring 1995, at 29 (proposing an economic model which demonstrates that discriminatory tax breaks should be banned).

54. 278 S.E.2d 612 (S.C. 1981).

have welcomed the project, notwithstanding that the transaction appeared to confer substantial benefits on a distinct party, the developer of the project. Nevertheless, the fact that the state was attempting to take advantage of a federal subsidy appears to have been a factor in the decision to find that the project did *not* satisfy a public purpose.

The monitoring capacity of courts may be thought to be limited. After all, courts can only adjudicate disputes brought before them, and if the collective action problems I have mentioned above discourage parties from initiating costly litigation, even activist courts will not have opportunities to supervise the political process. Moreover, even with respect to litigation that is brought, courts have recently become more deferential to legislative decisions about what satisfies a public purpose. Even in South Carolina, courts appear to monitor subsidies of discrete interests less rigorously than the *Riley* case suggests.<sup>55</sup> Further, it is by no means clear that courts enjoy the institutional competence to distinguish among transactions that actually serve the public interest and those that have been supported because discrete beneficiaries have captured the political decisionmaking process.<sup>56</sup> Nevertheless, the continuing presence of litigation challenging public subsidies does raise two issues that complicate the public choice story about subsidies. First, the fact that individuals or groups are willing to challenge subsidies suggests that the organizational obstacles to opposition are not insurmountable. Many of the lawsuits that have arisen in recent years do not involve those groups most likely to resist subsidies, such as competitors, but involve, instead, individual citizens or groups that appear motivated by concerns about government expenditures generally.<sup>57</sup> Second,

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55. See, e.g., *Hucks v. Riley*, 357 S.E.2d 458, 459 (S.C. 1987) ("In our opinion, legislation authorizing the issuance of industrial revenue bonds to finance the construction of public lodging and restaurant facilities primarily to foster tourism, the second largest industry in the State, improves the economic welfare of the State, and therefore serves a valid public purpose. Additionally, the facts indicate that the project in this case will serve the public interest by creating jobs and increasing the tax revenues of both the State and local governments."); see also *Maready v. City of Winston-Salem*, 467 S.E.2d 615 (N.C. 1996) (upholding expenditure of tax money for economic development as a public purpose and distinguishing prior state decisions that rejected similar programs).

56. See Einer R. Elhauge, *Does Interest Group Theory Justify More Intrusive Judicial Review?*, 101 YALE L.J. 31, 67 (1991) (explaining the shortcomings of judicial review).

57. See, e.g., *Libertarian Party of Wis. v. State*, 546 N.W.2d 424 (Wis.

the occasional success of these challenges indicates that courts are not unable or unwilling to intervene in appropriate cases. For example, in *Opinion of the Justices*,<sup>58</sup> the Alabama Supreme Court rejected a plan to subsidize a Mercedes-Benz plant, the attraction of which had been heralded as a major victory for the state economy. The court concluded that the plan would constitute debt in violation of the state's debt limitation.<sup>59</sup>

Again, my claim here is not that public choice explanations for political action cannot explain how some business incentives would be granted even though those incentives fail to generate net benefits for the grantor. Rather, my more modest claim is that the public choice effects are less pervasive than the literature to date suggests. Thus, the possibility of systematic biases in favor of negative-sum incentives is less certain than it appears, and should be considered in less sweeping terms.

### C. SUMMARY

To this point, I have suggested that neither the Winner's Curse nor the public choice explanations for business incentives has theoretical backing as robust as the attack on subsidies assumes. Instead, there exist plausible explanations for localities to bid for firms, even though the amounts bid initially appear to invite destructive competition and to constitute overpayments relative to the value of the attracted firm. Many of the principles that I have discussed may be illustrated by considering a common target of locational incentives: the public financing of sports stadiums. These enterprises come under attack for all the reasons I have discussed. They are believed to impose costs on the financing community in excess of the local economic benefits they generate.<sup>60</sup> They are considered politically

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1996) (exemplifying cases in which a citizens' group has brought suit against the state); *Pike v. Gunyou*, 491 N.W.2d 288 (Minn. 1992); *Citizens for More Important Things v. King County*, 932 P.2d 135 (Wash. 1997); *CLEAN v. State*, 928 P.2d 1054 (Wash. 1996).

58. 665 So.2d 1357 (Ala. 1995).

59. See also *City of Hartford v. Kirley*, 493 N.W.2d 45, 47 (Wis. 1993) (invalidation of tax-increment financing to subsidize commercial facilities in blighted areas).

60. See, e.g., Robert A. Baade & Richard F. Dye, *The Impact of Stadiums and Professional Sports on Metropolitan Area Development*, 21 GROWTH AND CHANGE, Spring 1990, at 2 (explaining how revenue is often insufficient to cover operating costs); see also ARTHUR T. JOHNSON, MINOR LEAGUE BASEBALL AND LOCAL ECONOMIC DEVELOPMENT 245 (1993) (explaining that a minor-league baseball team's contribution to the local community is relatively

attractive by officials because a local sports team is salient in the minds of many voters and owners of sports teams who may be in a position to assist the campaigns of officials who provide public subsidies.<sup>61</sup> Finally, a sports team attracted from one jurisdiction to another would appear to cause a sense of loss in the former jurisdiction that offsets any increased civic pride in the latter jurisdiction. Thus, sports stadium subsidies seem to be perfect examples of expenditures that suffer from miscalculation of benefits, susceptibility to agency costs, and dead-weight losses.

Nevertheless, it is unclear that the case against public funding of sports stadiums is so strong. From the public choice perspective, it is noteworthy that lawsuits challenging these expenditures are quite common, suggesting the presence of an organized opposition group than can gain access to the decisionmaking process and that is willing to make significant expenditures in its own behalf.<sup>62</sup> From the perspective of calculating the economic benefits of a stadium, many of the studies are inconclusive concerning the effects of the economic activity that may be induced by the stadium (rather than the direct benefits at the stadium itself) or the less monetizable benefits that a stadium might generate, such as psychic benefits that residents may associate with loyalty to a local major league team.<sup>63</sup> At least one study suggests that, looking at major league baseball revenues alone, stadiums generate substantial consumer surplus in numerous communities.<sup>64</sup> Treating ticket prices and attendance as measures of consumer surplus, the study concludes that the net welfare gains of a stadium to the city range from minus \$19.1 million to \$32.8 million in the absence of any economic activity that might be attracted by the

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small). An analysis of multiple stadium construction projects, concluding that subsidies sometimes are efficient and sometimes not, can be found in DEAN V. BAIM, *THE SPORTS STADIUM AS A MUNICIPAL INVESTMENT* (1994).

61. Although this is a common conception, one study suggests that stadium construction has rarely been an issue in mayoral elections. See BAIM, *supra* note 60, at 189-90.

62. See cases listed *supra* note 57. See also *Ginsberg v. City and County of Denver*, 436 P.2d 685 (Colo. 1968); *Kelly v. Marylanders for Sports Sanity, Inc.*, 530 A.2d 245 (Md. 1987); *Lifteau v. Metropolitan Sports Facilities Comm'n*, 270 N.W.2d 749 (Minn. 1978).

63. See Benjamin A. Okner, *Subsidies of Stadiums and Arenas*, in *GOVERNMENT AND SPORTS BUSINESS* 325, 327-30 (Roger G. Noll ed., 1974).

64. See Darius Irani, *Public Subsidies to Stadiums: Do the Costs Outweigh the Benefits?*, 25 *PUB. FIN. REV.* 238, 239 (1997) (explaining that rent not captured by the sports franchises accrues to the city in the form of net consumer surplus).

stadium. The fact that most cities in the study have positive benefits suggests that public subsidies are not necessarily overpayments or inconsistent with resident preferences. The fact that the net benefits vary over a significant range suggests that different communities will value the same team differently, so that attracting a team from one locality to another does not necessarily create a zero-sum result. In short, competition for sports teams supports the claim that bids may signal the different values that jurisdictions place on hosting firms generally, based on residential preferences and the differential earning capacity that the firm will have in different markets.

## II. THE FEDERAL ROLE IN LIMITING COMPETITION

Assume, however, that the intrajurisdictional effects of business incentives are as problematic as the critique assumes. It still does not follow that federal intervention to save states from themselves is warranted. Little in Commerce Clause jurisprudence suggests that federal intervention would be appropriate to cure purely intrajurisdictional political defects. Given the Supreme Court's recent restrictive readings of that power,<sup>65</sup> Congressional intervention must presumably be predicated on state action that either generates negative externalities or exploits a jurisdiction's monopolistic position. By itself, miscalculating the benefits of business incentives, either as a result of the limited rationality embodied in the Winner's Curse or the consequences of capture, does not fall into either of these categories.<sup>66</sup> Thus, the argument for federal intervention must rest

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65. See, e.g., *Printz v. United States*, 117 S. Ct. 2365, 2378 (1997) (invalidating part of the Brady Act as a violation of the Commerce Clause); *United States v. Lopez*, 514 U.S. 549, 567 (1995) (holding that the Commerce Clause does not empower Congress to ban gun possession within 1,000 feet of a school).

66. Even in those cases in which courts have approved congressional intervention to solve intrajurisdictional political problems they have found a relationship between the underlying problem and interstate commerce. In *Blount v. SEC*, the court upheld a regulation of the Municipal Securities Rulemaking Board restricting political contributions by underwriters and brokers of municipal securities. 61 F.3d 938, 948 (D.C. Cir. 1995), *cert. denied*, 116 S. Ct. 1351 (1996). The regulation was intended to ensure the award of underwriting contracts on the basis of merit rather than politics, an objective that one might have thought lay within the exclusive realm of state conflict-of-interest law. Nevertheless, the court concluded that there was an obvious link between maintaining the confidence of the public, and that such contracts had been awarded on the basis of merit and the Commission's role of perfecting markets and promoting just and equitable principles of trade. The court noted that state politicians who benefitted from the practice were unlikely to stop it of their own volition and bond dealers would be unable to initiate re-

on some basis other than the purely intrajurisdictional effects of business incentives. That argument, typically phrased in race-to-the-bottom terms, contends that business incentives generate net negative effects from the *national* perspective, even if they return net benefits to particular localities. Professor Enrich summarizes the argument as follows:

As many participants and spectators have recognized, the incentives competition is, for the states collectively, at best a zero-sum game. Even when incentive packages do influence location decisions, the business that one state attracts is a business that otherwise would have gone to another state.

From the states' collective vantage point, the net effect of the incentive competition is, in fact, far worse than zero-sum. For, although the states can expect to achieve no overall gain in business activity or jobs, they do incur a very substantial loss of tax revenues. Even a tax break that succeeds in attracting a business investment to a state will represent a net loss for the states collectively, as long as that investment . . . would have occurred in some state in the absence of the incentive.<sup>67</sup>

The argument may be strengthened with allegations that far-reaching incentives, for example, investment tax credits that are granted to a broad scope of businesses, reduce net revenues available for public expenditures in that they are also available to immobile firms already located within the jurisdiction. Thus, at most, incentives constitute wealth transfers from one jurisdiction to the next or from public treasuries to private ones, while the transaction costs of effecting those wealth transfers create a net-negative result. Nevertheless, no state, aware of the incentive programs offered by other jurisdictions, can escape from the cycle of offering subsidies for fear that doing so will place it at a competitive disadvantage in the search for economic development. It is in this sense, as much as in the sense of intrajurisdictional effects of misjudgment, that the states must be "saved" from themselves. While in theory states could agree not to compete for firms, such agreements usually break under the competitive pressure.<sup>68</sup> The only way out, according to this argument, is the traditional solution to prisoner's dilemmas or chicken games: a centralized authority that is capable of imposing and enforcing a commitment among the states not to compete.<sup>69</sup> That, apparently, is the role that

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form for fear of retribution from officials who made contract awards.

67. Enrich, *supra* note 1, at 398-99 (citations omitted).

68. See *id.* at 397 (describing the circumstances under which agreements to halt competition have failed).

69. This is essentially the story told in Enrich, *supra* note 1, at 392-97

Congress or the courts can exercise through the Commerce Clause.

The story is more complicated than much of the literature suggests. I will make three inquiries to press the point: 1) To what extent should we believe that business incentives induce a race-to-the-bottom among the states? 2) To what extent is centralized decisionmaking a necessary solution if the problem exists? 3) To what extent does use of the Commerce Clause impose additional costs that must themselves be weighed against the benefits of federal intervention?

#### A. DOES A RACE TO THE BOTTOM EXIST?

The claim that jurisdictions may use business incentives in a manner that creates net negative effects from a national perspective is, of itself, completely plausible. Assume, for instance, that milk producers in State A successfully lobby for a subsidy that can only be allocated to those producers. Although cast as an incentive to attract and retain in-state producers, the effect of the subsidy would include restricting in-state sales by out-of-state milk producers and artificially increasing milk prices in State A. Even if milk producers in State A gain from the program, those gains may be outweighed by the combination of adverse effects on consumers in State A and out-of-state milk producers. Thus, if courts were willing and able to examine the effects of individual subsidies, we might expect to see such a program, which could be characterized either as exploitation of a monopoly within the state or as an action that generated significant negative externalities, invalidated under the Commerce Clause.<sup>70</sup>

Alternatively, other incentives might readily be characterized as generating net negative social effects, even if they return clear positive returns from the perspective of the offering jurisdiction. For instance, the tax-exempt status of interest on industrial revenue bonds may have attracted new business development to offering states. Even if that business did not simply replace business that would have existed in other jurisdictions, however, the tax exemption could generate net negative results if the exemption cost the federal government more than it gained

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(outlining the issues involved in enforcing a noncompete commitment among the states).

70. See, e.g., *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994) (exemplifying cases in which this scheme has been found to be unconstitutional).

the states.<sup>71</sup> The federal treasury works as a commons in this situation, with each issuing jurisdiction having an incentive to "overgraze" because doing so benefits it more than holding back while others utilize the tax exemption, even if marginal participation reduces the benefits of participation to the group as a whole.<sup>72</sup>

These examples suggest that business incentives may indeed have the adverse effects attributed to them. There exist counterexamples, however, in which we do not think that governmental intervention is necessary to prevent downward spiraling competition, and the existence of those cases gives pause to any effort to speak in broad strokes about the negative effects of incentives. Return, for example, to the partly rhetorical illustration that I suggested at the outset of the Article. Assume that B State Law School pays professors on a lock-step scale based on year of graduation from law school. Assume further that the law school believes that it can enhance its market position among law schools by building a strong tax faculty, on the understanding that numerous students are likely to select among law schools on the strength of tax offerings, and that tax faculty strength will be reflected in the reputation of the school as measured by practitioners and academics. The law school further believes that attracting a well-respected tax faculty member will create interactions with other tax faculty and increase both the quality and quantity of tax publications at the school. Thus, B State Law School offers Professor A, a renowned tax teacher and scholar at Z Law School, a position on the faculty, informing her, "If you join our faculty, our lock-step salary would place you at \$x. Nevertheless, we believe that your addition to the faculty will generate sufficient benefits to us that we are willing to pay you \$1.5x." All the arguments about location subsidies seem to be operating here. Paying Professor A more than her pre-incentive wage decreases her contribution to other parts of the law school budget, relative to what is paid by other professors. There are no assurances that her subsequent productivity will justify the pay differential. Moreover, bidding her away from Z Law School is likely (I hope) to start bidding wars among other law schools for professors and increases in salaries in order to retain

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71. See AMDURSKY & GILLETTE, *supra* note 45, at 430 (discussing the efficiency effects of federal tax exemption on municipal bonds).

72. See Clayton P. Gillette, *Fiscal Federalism and the Use of Municipal Bond Proceeds*, 58 N.Y.U. L. REV. 1030, 1052-59 (1983).

professors. In other words, there would be wealth transfers to professors without any necessary gain in productivity. Nevertheless, I would be surprised to hear anyone claim that B State ought to be constrained by the Commerce Clause from bidding for Professor A's services. Similarly, the omnipresent advertisements for tourism dollars, replete with discounts for travelers, have the potential effect of both distorting vacation decisions and increasing total expenditures for vacations above what would be advocated by from a national perspective.<sup>73</sup> Finally, statutes that require the state to favor its own residents in purchasing decisions necessarily disadvantage nonresidents, but there is at least substantial sentiment for their legitimacy on the understanding that the state can prefer its own residents when spending money it receives from those residents.<sup>74</sup>

What distinguishes these cases from those in which we believe there is greater reason for intervention? It is not clear that there is a single theory that can reconcile all the situations. In-state preferences may be justified in part because the funds expended came from tax moneys received from the beneficiaries; but that rationale has less application to our law professor case. Preferences may also reflect a somewhat general notion, explicit in the literature relating to subsidies in international trade law, that there are certain "legitimate" comparative advantages enjoyed by nations that justify subsidies and that do not trigger the imposition of countervailing duties.<sup>75</sup> Some commentators have suggested that a combination of tradition

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73. See Levmore, *supra* note 8, at 577 (explaining how some actions, such as those promoting tourism, are permitted even though their results may be contrary to national interests).

74. See Benjamin C. Bair, Note, *The Dormant Commerce Clause and State-Mandated Preference Laws in Public Contracting: Developing a More Substantive Application of the Market-Participant Exception*, 93 MICH. L. REV. 2408, 2422 (1995). But see *W.C.M. Window Co. v. Bernardi*, 730 F.2d 486, 498-549 (7th Cir. 1984) (invalidating state-preference law that mandated local governments to favor firms that hire state residents for construction projects). The Third Circuit rejected the reasoning of *W.C.M. Window Co.* in *Trojan Technologies, Inc. v. Pennsylvania*, 916 F.2d 903, 905 (3d Cir. 1990), *cert. Denied*, 501 U.S. 1212 (1991). The Ninth Circuit followed in *Big Country Foods, Inc. v. Board of Educ.* 952 F.2d 1173, 1174 (9th Cir. 1991). The Seventh Circuit has subsequently upheld local-preference laws for contracts involving expenditures of the locality's own funds. See *J.F. Shea Co. v. City of Chicago*, 992 F.2d 745, 750 (7th Cir. 1993) (exemplifying cases in which preference laws have been upheld).

75. See David W. Leebron, *Lying Down with Procrustes: An Analysis of Harmonization Claims*, in 1 FAIR TRADE AND HARMONIZATION 72 (Jagdish Bhagwati & Robert E. Hudec eds., 1996).

and redistributive interests can justify what might otherwise be considered an interference with commerce.<sup>76</sup> The argument that I wish to make with respect to business incentives, however, ties the acceptability of those forms of subsidy to the function of the Commerce Clause as a means of ensuring economic union.<sup>77</sup> At the very least, incentives seem to be not only appropriate, but consistent with the federalizing bargain implicit in the Commerce Clause if they satisfy this last objective.

If there is any substance to what Professor Heinzerling has called the "ritual quotation"<sup>78</sup> in Commerce Clause cases of Justice Jackson's pronouncement that "our economic unit is the Nation,"<sup>79</sup> it must mean more than allowing free trade among the states. An economic union would instead evaluate actions undertaken by individual states by reference to their effects upon the union as a whole, rather than on the acting state alone. That objective is explicitly involved in the standard Supreme Court doctrine for evaluating nondiscriminatory laws that have an effect on interstate commerce. That doctrine provides that such laws are approved only if a court finds that, from a national perspective, their benefits exceed their burdens.<sup>80</sup> Thus, the Commerce Clause should tolerate state policies that benefit the union as a whole, even though the effect is to reduce wealth in some subset. If this reduction results from the loss of a firm that migrates to a jurisdiction where it can be more productive, rather than from the use of anticompetitive

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76. See Gergen, *supra* note 46, at 1132-37 (explaining some justifications for interfering with the flow of commerce).

77. See *id.*

78. Lisa Heinzerling, *The Commercial Constitution*, 1995 SUP. CT. REV. 217, 227.

79. *H.P. Hood & Sons v. Du Mond*, 336 U.S. 525, 537 (1940).

80. See *Pike v. Bruce Church*, 397 U.S. 137, 142 (1970) ("Where the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.") (citing *Huron Cement Co. v. Detroit*, 362 U.S. 440, 443 (1960)). Notwithstanding this formula, Donald Regan has argued that the Supreme Court has not been involved in balancing, and Lisa Heinzerling has questioned the capacity of courts to engage in balancing even if they desired to do so. See Regan, *supra* note 8, at 1092; Heinzerling, *supra* note 78, at 247-51. At best, the test involves an odd sort of balancing insofar as external costs are considered, but external benefits are not. See Daniel A. Farber, *State Regulation and the Dormant Commerce Clause*, 3 CONST. COMMENTARY 395, 398 (1986). Concentrating on external burdens, however, emphasizes that any calculus must consider national effects on a state's policies.

devices such as duties or requirements of in-state processing,<sup>81</sup> then the objectives of union seem to be enhanced, rather than frustrated, by subsidies that facilitate that move. The result is the economic equivalent to measures that seem to be clearly consistent with practices that are acceptable under the Commerce Clause, notwithstanding that they interfere with free flow of goods, because the effects are so likely to create net social gains from a national perspective. Even if we are skeptical that courts can make highly tailored inquiries into the costs and benefits of individual programs, we might take a categorical approach to the Commerce Clause and approve or disapprove of state policies depending on whether the category of regulation into which they are placed tends to enhance or diminish national wealth. Mark Gergen, for instance, suggests that permissible embargoes on infected goods can be defended largely as a means for providing a net social benefit by preventing the spread of disease.<sup>82</sup> On the other hand, the most obvious illegitimate restrictions on the flow of goods in commerce, for example, tariffs, seem unlikely to be welfare-enhancing from a national perspective and thus are virtually *per se* invalid.

This analytical structure suggests why we have little objection to B State Law School's efforts to raid other faculties. If the school is correct in its assumptions about what would attract more students and enhance its reputation, it is simply responding to market demand in structuring its incentive package to Professor A. It has presumably calculated that it can create a market niche for itself in tax-law education and is taking those steps necessary to implement its vision. Creating a strong tax faculty for itself, however, is not necessarily zero-sum with the losses imposed on raided schools, since concentrating a community of tax scholars on one faculty may create a more productive environment than those same professors would if they were spread among multiple schools. There is nothing inexorable about this conclusion; it might be, for instance, that diffusely situated tax professors would be more productive because they would be more likely to interact with professors from other substantive areas and would be introduced to novel concepts that would not be recognized by tax professors simply talking among themselves. There is, however,

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81. See, e.g., *C. & A. Carbone v. Town of Clarkstown*, 511 U.S. 383, 386 (1994) (finding that a similar arrangement involving solid-waste processing was unconstitutional).

82. See Gergen, *supra* note 46, at 1110.

nothing inherently unproductive about a school attempting the strategy of building specialties and trying to create a fit between itself and professors in that specialty, and there is a plausible chance that both the school and the legal academy will be better off as a result. Simultaneously, nothing precludes other law schools from taking similar measures to bid away tax professors or from developing other specialties that would entail raiding other law schools. Indeed, if B State Law School is successful, we would expect other law schools to adopt its strategy. Nor does it prevent other schools from attracting the same professor by demonstrating that the fit between that person and the school is better than at any alternative.

The analogy to attracting industries should be clear. If national wealth enhancement was a primary objective of the federalizing bargain, then efforts to increase the size of the social pie, by matching firms with their most productive jurisdiction, is not inconsistent with that bargain. To the contrary, it is entirely consistent as long as those economies, once realized, are available to all. Policies that have this purpose or effect are qualitatively different from a statutory scheme that merely transfers wealth or that creates an artificial monopoly that frustrates transactions that would otherwise occur. Contrast, for instance, an effort by Illinois to compel in-state utilities to use coal mined in the state rather than lower-sulphur coal mined elsewhere.<sup>83</sup> The restrictions on using out of state products in that case<sup>84</sup> simply interfered with competitive markets that we anticipate will allocate goods to their highest valued use. In the place of markets, the state simply exploited its own monopoly over higher sulphur coal in a manner that would increase its own wealth, but only at a cost imposed on others (its citizens, low sulphur coal producers, and those who value tradeoffs between financial costs and the environment that would have favored non-Illinois coal). Even if we accepted a balancing test for evaluating statutory constraints on commerce, it seems implausible that the benefits to be realized by

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83. See *Alliance for Clean Coal v. Miller*, 44 F.3d 591, 595-96 (7th Cir. 1995) (striking down the Illinois Coal Act as a violation of the dormant Commerce Clause).

84. The state law required large utilities to install scrubbers so they could continue to use Illinois coal and required approval by the state's Commerce Commission for any 10% or greater decrease in the use of Illinois coal by a utility. See *id.* at 594-95. The law also permitted utilities to pass the compliance costs of scrubbers into the rate base, even though cheaper alternatives may have been available. See *id.* at 595-96.

Illinois would either outweigh those costs or would be shared with other jurisdictions. Instead, the statute looks too much like exploitation of a domestic monopoly, preservation of which seems inconsistent with the federalizing bargain.

Perhaps the likelihood that a particular scheme will create net social benefits by matching producers and jurisdictions or by encouraging entrepreneurship informs our intuitions about those situations that offend the Commerce Clause and those that do not. Think, for instance, of *Boston Stock Exchange v. State Tax Commission*.<sup>85</sup> In that case, the Court invalidated a New York statute that imposed a higher transfer tax on securities transactions involving out-of-state sales than transactions involving intrastate sales. The explicit objective of the distinction was to encourage securities trades to be effected in New York in the face of competition from out-of-state exchanges.<sup>86</sup> The Court held that this effort to reduce out-of-state competition with an in-state business invalidly discriminated against interstate commerce. Doctrinally, the rationale of the Court centered on the allegation that "[p]ermitting the individual States to enact laws that favor local enterprises at the expense of out-of-state businesses 'would invite a multiplication of preferential trade areas destructive' of the free trade which the Clause protects."<sup>87</sup> Such a doctrine, however, does little to distinguish express subsidies from the ones implicit in New York's preferential tax. Local companies that receive subsidies in the form of low-interest loans, tax-abatements, or tax credits enjoy a competitive advantage over firms in the same industry in other jurisdictions if those companies do not receive similar subsidies in their jurisdictions.

There may be a rationale behind the doctrine, however, that permits a more principled distinction. I have suggested above that locational subsidies may be viewed as signals of comparative advantage or as bonding mechanisms. Each of these strategies can solve an informational asymmetry which could interfere with firms locating in the jurisdiction where they will be most productive. The Court in *Boston Stock Exchange* intimated that strategies directed at this objective were consistent with the Commerce Clause when it concluded that the offensive element of the New York tax was that it caused

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85. 429 U.S. 318 (1977).

86. See *id.* at 327-28.

87. *Id.* at 329 (quoting *Dean Milk Co. v. Madison*, 340 U.S. 349, 356 (1951)).

“the flow of securities sales [to be] diverted from the most economically efficient channels and directed to New York.”<sup>88</sup> A firm already located in a jurisdiction is less likely to suffer from an informational asymmetry about the benefits of that location. Firms already located in New York are likely to be aware of any synergies that New York offers. In addition, their presence will likely be a sufficient signal of an appropriate focal point to attract other firms that would benefit from geographical proximity. It is conceivable that in some situations, attracting additional firms that would benefit from network externalities could be facilitated by a subsidy; for instance, the jurisdiction might contain some, but less than a critical mass of firms necessary to realize network benefits. But that explanation certainly does not fit the location of securities firms in New York. Instead, the tax differential in that case appears to be a means of preserving an existing monopoly, even if there is no reason to believe that doing so will generate a surplus over what would exist if the same services were performed elsewhere. A statute that subsidizes an existing industry therefore looks presumptively like one that is intended to serve the prominence of that industry within the state rather than an effort to increase the social pie. That strategy would offend the federalizing bargain because it only effects a transfer of wealth from one jurisdiction to another rather than an increase in the amount of wealth available for distribution throughout the nation.

Efforts to attract business (or to create market niches among law schools), therefore, may, but need not, serve a sorting function that enhances, rather than frustrates, federalism objectives. Even if bidding wars begin among law schools, they may generate greater, not less, social welfare if they lead to sorting among law schools that develop specialties, among law students who seek training in those specialties, and among faculty with different preferences for academic environments (commercial law professors who want to write theoretical articles are attracted to School C, while those who want to write black letter law articles are attracted to School Y). The result should be the very type of efficient satisfaction of preferences that we think at least partially underlies federalist structures.<sup>89</sup> Unlike a state that attempts to exploit others by tax-

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88. *Id.* at 336. The Court continued: “This diversion of interstate commerce and diminution of free competition in securities sales are wholly inconsistent with the free trade purpose of the Commerce Clause.” *Id.*

89. See Michael McConnell, *Federalism: Evaluating the Founders' Design*,

ing resources over which it has a monopoly,<sup>90</sup> or attempts to frustrate competition for services already located within its boundaries,<sup>91</sup> a state that sought to attract credit-card issuers by eliminating usury rates, or that enacted corporate law attractive to corporate boards may be less likely to be exploiting, rather than creating an advantage equally open to other states.<sup>92</sup> From this perspective, the evidence that business incentives do not dramatically alter the locational preferences of businesses<sup>93</sup> is not necessarily bad news. If these incentives had a major impact on locational decisions, we might believe that the amounts offered were sufficiently great to induce firms away from locations where they would be most productive, that is, that the subsidies offset at least short-run profits that the firms would receive from locating elsewhere. If firms are using subsidies as tie-breakers or as a second-level basis of making a decision after first narrowing the field to areas in which other factors suggested high profitability, however, then there may be a greater likelihood that the local preferences for the firm will coincide with national interests in siting in the most productive jurisdiction.

Even if the distinction I have tried to draw is valid as a theoretical matter, it is open to the criticism that it is based on

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54 U. CHI. L. REV. 1484, 1493-94 (1987) (arguing the framers believed a decentralized decisionmaking structure would best meet the needs of a diverse population).

90. See *Commonwealth Edison Co. v. Montana*, 453 U.S. 619, 636-37 (1981) (upholding Montana Coal Severance Tax despite its heavy burden on out-of-state utility companies).

91. See *Boston Stock Exch. v. State Tax Comm'n.*, 429 U.S. 318, 319 (1977) (describing New York's tax on securities transactions, which burdened out-of-state sales more than in-state sales).

92. See Levmore, *supra* note 8, at 570-75 (drawing a distinction between "exploitation" of, and mere "interference" with interstate commercial activities). Some commentators, however, suggest that competition for corporations does create a race-to-the-bottom in corporate law doctrine, transferring wealth from shareholders. See, e.g., Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992) (advocating heightened federal regulation of charter competition by comparing it to corporate contractual freedom); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974) (decrying as destructive and inappropriate attempts by Delaware to attract corporate citizens). But see Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540 (1984) (suggesting that increased government regulation of management may be unnecessary because market forces may provide sufficient incentives to protect the interests of investors).

93. See Enrich, *supra* note 1, at 390-92 (citing studies which suggest that fiscal incentives do little to alter business location decisions).

rather heroic assumptions that, as a practical matter, jurisdictions do compete in ways that indicate their relative productivity and preferences. To the extent that states are involved in competition for industry, but make rational judgments about tradeoffs between attracting business and the costs related to that activity, no race to the bottom will exist. Instead, each state will simply engage in the competition up to the point when the marginal benefits of additional industry no longer exceed the marginal costs.<sup>94</sup> On the other hand, if those who win contests for firms are simply trying to maximize jobs or revenues without attention to fit with courted firms or the preferences of constituents, then the presumption that bids solve information asymmetries or constitute appropriate signaling and bonding devices is less warranted. Instead, we would be more likely to have the naked contest for firms that underlies the race-to-the-bottom argument.

Some commentators find evidence that no such rational race occurs in the fact that all states participate in the competition, as evidenced by the legal authority that states have granted to themselves or to their political subdivisions to grant business incentives.<sup>95</sup> However, the fact that all states have authorized such activities does not mean that they use that authorization equally or that they use it without regard to the costs that such incentives generate. The race-to-the-bottom claim depends not on the possibility that states would compete destructively, but that they are induced to do so by rational self-interest because unilateral nonparticipation leaves them worse off. There is, however, at least some evidence that states select how much and when to spend on economic development programs independent of the activities of other states. If states are caught in a race, we might expect to see states spending equivalent amounts per capita or as a percentage of their budget. Substantial variations in these figures would be more

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94. For an elaboration of these conditions in the context of a race-to-the-bottom in environmental regulation, see generally Richard L. Revesz, *Federalism and Interstate Environmental Externalities*, 144 U. PENN. L. REV. 2341 (1996) [hereinafter Revesz, *Federalism & Externalities*] (arguing that federal environmental laws inadequately redress the problem of interstate externalities); Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the "Race-to-the-Bottom" Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210 (1992) (arguing that race-to-the-bottom theories are empirically weak and do not logically necessitate federal environmental legislation).

95. See, e.g., Enrich, *supra* note 1, at 390-92 (discussing business incentives).

consistent with the claim that states were seeking an optimal amount of business development, as predicted by the claim that competition among states was less a war of attrition than a contest among competitors from which each could withdraw when it achieved an independently defined objective.

Paul Peterson has examined expenditures by each state's government and local government paid from their own resources for economic development and determined the coefficient of variation in different years.<sup>96</sup> The coefficient of variation measures the extent to which states differ from one another on any particular characteristic. The higher the coefficient of variation, the greater the diversity among the states on the characteristic being measured. Thus, Peterson reports that "[e]ven a coefficient of 0.33 indicates substantial variation among the states."<sup>97</sup> Peterson concluded that the "amount that state governments and the localities within them spent per capita on developmental programs varied markedly among the states."<sup>98</sup> Looking at five year intervals from 1967 to 1987, the coefficient of variation ranged from .31 to .57, although it decreased from .50 in 1987 to .34 in 1991. Even that last figure, however, demonstrates that a third of the states differ from the average state by about one-third the expenditure in the average state. Note that the coefficient of variation would not vary if all states were increasing or decreasing their expenditures on economic development at the same rate. Thus, the variation among the states seems to be a feature of conscious and independent decisions by some states to favor significantly more spending than others on economic development, rather than a consequence of practical coercion induced by the policies of others. This is not to say, of course, that states will not make expenditures to protect their interests in existing industries or to attract others. The expenditures of some states on business incentives are undoubtedly higher than they would be if other states did not similarly have incentive programs to lure businesses away. It is simply to say that the expenditures made for this purpose may be dictated by normal practices that generate efficient sorting among competitors to achieve optimal size or to take advantage of the fit between particular businesses and the

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96. See PAUL E. PETERSON, *THE PRICE OF FEDERALISM* 87-89 (1995).

97. *Id.* at 87.

98. *Id.* at 88.

business programs developed by an individual state rather than a destructive race to the bottom.

Nor is this to say that even if locations are predicated on synergies between firms and states that signal (through use of incentives) their willingness to accommodate certain industries, that no redistributive consequences follow. As long as mobile firms can take advantage of incentives in ways that immobile firms cannot, the use of subsidies and abatements *will* cause either a shift of tax burden for nonbenefit charges to the immobile or a decrease in services within the jurisdiction. Nevertheless, if those who bear a greater burden do, in fact, believe that they enjoy net benefits from attracting or retaining the mobile businesses on which they depend, then they may be willing to accept some redistribution as the price of achieving those benefits.

The highly tailored subsidies that some jurisdictions employ may support this data. The fact that different states appear to court different firms or industries suggests that some matching is occurring. When a jurisdiction favors a particular industry, it can be difficult to know whether that industry has been courted because the state is engaged in matching or whether representatives of that industry have simply captured the legislature. The specificity of some programs seems to indicate the latter. When we see state-supported programs directed expressly at such ventures as "promoting the planting of grain crops and the development of a substitute for gasoline,"<sup>99</sup> or cold fusion,<sup>100</sup> our instinct may be to think in terms of interest group dominance. Legislators may believe, however, that their support for particular firms or industries simply places them ahead of the curve, so that they have a competitive advantage over other jurisdictions. Even where subsidies are offered at the behest of particular firms or industries, legislators may be convinced by the claims that those subsidies will generate local wealth, and thus are not simply engaged in rent-seeking donations of the public treasury.<sup>101</sup>

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99. State *ex rel.* McLeod v. Riley, 278 S.E.2d 612, 615 (S.C. 1981) (quoting the South Carolina General Assembly's finding as to the effect of a targeted bond issuance statute).

100. See *Utah OKs Cold-Fusion Research Funds*, THE SACRAMENTO BEE, August 1, 1989, at A6.

101. Note, for instance, that Utah's support for cold fusion deteriorated when the project failed to produce results. If the subsidies for the project were simply generated by capture, then one would have anticipated that they would have continued even without successful results, whereas one would

Finally, note that the race-to-the-bottom argument assumes that locational decisions of courted firms have no positive national wealth effects because the firm is limited to choices between State A and State B. In the current open economy, incentives offered by State A may prevent plants from locating in another country, rather than in another jurisdiction in this country.<sup>102</sup> Alternatively, incentives may attract plants from another country that would otherwise have located in their home jurisdiction or in some third nation. Indeed, the fear that nations will engage in tactics that generate a race-to-the-bottom from an international perspective provides at least the theoretical justification for GATT Subsidy rules.<sup>103</sup> The possibility that high labor costs in the United States will induce exporting of jobs suggests that, absent fear of retaliation by other countries, there is less reason for the federal government to impede states from retaining or attracting these same firms.

#### B. THE COMMERCE CLAUSE AS AN ANALYTICAL TOOL

If we now understand that 1) states may or may not be miscalculating benefits of attracting plants, but that there is little reason to believe that miscalculation is systemic; 2) states may be involved in a race to the bottom, but may be involved in sorting preferences along the lines desired for jurisdictional competition; and 3) localized interests opposed to subsidies can be represented in local decisions concerning subsidies, then one must be skeptical of congressional or judicial intervention that sweeps broadly to prohibit business incentives. Any prohibition on these practices may be counterproductive and unnecessary to achieve the economic union envisioned by the Commerce Clause. At the same time, the possibility that occasional uses of incentives may create net losses suggests that case-by-case adjudication of the conditions and consequences of any particular incentive program is an appropriate mechanism to check the risks that the Commerce Clause is intended to avoid. This is a position that the Supreme Court has thus far rejected, opting instead for broad protection of formal subsidies granted by

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predict that the subsidies would be eliminated if expected gains in employment or revenues did not materialize.

102. See Netzer, *supra* note 12, at 226 (pointing out the potential worldwide effects of state economic development efforts).

103. For a skeptical view of the accuracy of race-to-the-bottom logic in international trade and in government regulation generally, see Alvin K. Klevorick, *The Race to the Bottom in a Federal System: Lessons from the World of Trade Policy*, 14 YALE L. & POL'Y REV. 177 (1996).

states acting as "market participants."<sup>104</sup> Notwithstanding the difficulties in distinguishing the economic effects of permitted subsidies from prohibited trade barriers,<sup>105</sup> bidding for firms constitutes the kind of purchase that the Court has immunized from Commerce Clause scrutiny. Bidders are essentially attempting to "purchase" the location of the firm, and the Court has made clear since *Hughes v. Alexandria Scrap Corp.* that the state's conduct "as a purchaser, in effect, of a potential article of interstate commerce [the location]" does not create a burden upon commerce.<sup>106</sup> Like the abandoned cars at issue in *Hughes*, firms that are attracted to a state by incentives respond "to market forces, including that exerted by money from the State."<sup>107</sup> In this Part, I suggest that deviating from this categorical treatment in favor of ad hoc adjudication of particular subsidies injects courts into areas where we would anticipate high levels of judicial error.

One point on which commentators agree is that our Commerce Clause jurisprudence is confused.<sup>108</sup> There is general agreement on the objectives that the Clause seeks to serve, typically phrased in terms of creating a "national market,"<sup>109</sup> or preventing one jurisdiction from discriminating against another.<sup>110</sup> Application of the doctrine, however, has proven more

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104. See *Hughes v. Alexandria Scrap Corp.*, 426 U.S. 794, 794 (1976). The Court has expressed similar sentiments in subsequent cases. See, e.g., *Metro-politan Life Ins. Co. v. Ward*, 470 U.S. 869, 879 (1985) (noting "a State's goal of bringing in new business is legitimate and often admirable"); *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 199 ("A pure subsidy funded out of general revenue ordinarily imposes no burden on interstate commerce, but merely assists local business.").

105. See *West Lynn Creamery, Inc.*, 512 U.S. at 210-12 (Scalia, J., concurring) (attempting to distinguish between discriminatory "refunds of" and "exempting" from nondiscriminatory taxes).

106. 426 U.S. at 808.

107. *Id.* at 810.

108. See, e.g., Revesz, *Federalism & Externalities*, *supra* note 94, at 2398 (noting "[t]here is widespread agreement that doctrinal confusion surrounds the Dormant Commerce Clause"); Edmund W. Kitch, *Regulation and the American Common Market*, in *REGULATION, FEDERALISM, AND INTERSTATE COMMERCE* 9, 47 (A. Tarlock ed., 1981) (pointing out the apparent lack of any consistent rationale in the Supreme Court's modern dormant Commerce Clause cases).

109. See, e.g., *West Lynn Creamery*, 512 U.S. at 210 (Scalia, J., concurring) (declaring that the negative Commerce Clause forbids "any state law that facially discriminates against interstate commerce").

110. See Enrich, *supra* note 1, at 424-33 (analyzing case law which construes the dormant Commerce Clause as an "antidiscrimination" provision). *But see* Regan, *supra* note 8, at 1137, 1143-45 (advocating the more limited

problematic. Policies with equivalent economic effects have generated quite different legal results, leading Professors Hellerstein and Coenen to inquire whether pure distinctions among form constitute an appropriate basis for differences in legal effect.<sup>111</sup> Even advocates of federal constraints on incentives understand that courts have demonstrated little facility with making the highly contextualized review of state programs that ad hoc adjudication requires. Thus, Professor Enrich refers to Commerce Clause jurisprudence as “tortured,”<sup>112</sup> and “never . . . a model of consistency,”<sup>113</sup> and its embodiment in an antidiscrimination standard as “clumsy.”<sup>114</sup> He suggests that an “antidistortion” standard may prove more workable and consistent with the objectives of the Commerce Clause. I have suggested, to the contrary, that distortion may be exactly what we desire, because distorting location decisions may actually enhance efficiency from a national perspective. More to the current point, Professor Enrich’s suggestion that all we need is a different or more refined standard reveals a faith in the capacity for judicial distinctions for which his own analysis of traditional dormant Commerce Clause cases provides little support. If high levels of judicial error are inevitable in making the distinctions such analysis would require, it might be best not to start down that road in the first place.

There is little reason to believe that courts would have an easier time administering the validity or propriety of a particular subsidy. Courts are simply not equipped to undertake the analysis necessary to determine whether a particular subsidy is likely to generate benefits in excess of its costs. If one criticism of such subsidies is that political officials are unable after substantial study to forecast with accuracy the extent to which attracting firms will generate additional jobs and revenue for one jurisdiction, it is difficult to perceive how courts would be able to discern whether any specific incentive program would generate net gains from a national perspective. One might respond that judicial analysis is never perfect, but that the risks inherent in subsidies make judicial intervention worthwhile. After all, one might contend, the cacophony of dormant Com-

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objective of preventing only “purposeful” protectionism).

111. See Hellerstein & Coenen, *supra* note 1, at 794-824 (surveying recent Supreme Court dormant Commerce Clause decisions).

112. Enrich, *supra* note 1, at 460.

113. *Id.* at 462.

114. *Id.* at 453.

merce Clause decisions has not generated substantial claims that the courts should stay out of that business.<sup>115</sup> I want to suggest, however, that even if there exists a rationale for intervention in other Commerce Clause cases, judicial review of locational incentives warrants little more than the categorical approval that the Supreme Court has heretofore applied to subsidies generally. If my argument is correct, then blanket approval of incentives would avoid the doctrinal confusion and costs of judicial error (approving inefficient subsidies and invalidating efficient ones) without incurring substantial risks of destructive interstate competition. This would be so because there will be some natural tendency for such programs to return net benefits, and there exist nonjudicial institutions capable of preventing the use of negative-sum business incentives. This possibility distinguishes business incentives from other activities that allegedly run afoul of the dormant Commerce Clause, but that may be more susceptible to judicial review and not easily reviewed by other institutions.

The first reason to distinguish business incentives stems from the characteristics of more traditional dormant Commerce Clause cases. The typical cases in this area concern somewhat idiosyncratic facts and (from a national perspective) small stakes.<sup>116</sup> Mudflaps, milk levies, and liquor exemptions do not easily fall within the same general classification. They instead represent efforts by particular jurisdictions to act in a protectionist manner with respect to those industries in which they have a monopoly or a strong vested interest. The result is that any proposed *ex ante* prohibition would have to be drafted so broadly that it would do little more than recite explicitly the implicit constitutional restriction on state regulation of commerce, or so narrowly that it would be unlikely to generate sufficient support in a national forum. Congress is unlikely to devote attention to what are essentially parochial concerns directed against the conduct of individual states.<sup>117</sup> The idiosyncratic

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115. *But see* Kitch, *supra* note 108, at 46-47 (predicting that the Supreme Court's dormant Commerce Clause methodology will produce results that are "confused, limited, and of small importance"); Heinzerling, *supra* note 78, at 223 (advocating outright abandonment of the antidiscrimination principle). Professor Farber, who doubts the courts' capacity to balance effectively, does advocate a more limited role in which courts intervene only when an intent to discriminate against interstate commerce can be established. *See* Farber, *supra* note 80, at 414.

116. *See* Farber, *supra* note 80, at 413.

117. *See* Ernest J. Brown, *The Open Economy: Justice Frankfurter and the*

nature and effects of individual state protectionist statutes similarly makes state policies that would cause harm in other jurisdictions less susceptible to agreements with other jurisdictions. Thus, if state practices that contravene the dormant Commerce Clause are to be prohibited, the courts must do the prohibiting.

The more generic nature of locational incentives leaves them more open to congressional regulation. Congress theoretically could speak in terms of tax-abatement programs, investment-tax credits, use of tax-exempt bond proceeds, or state grants and thereby regulate large numbers of state incentive programs. The similarity among these programs, however, simultaneously facilitates implicit or explicit agreements among states. The possibility of the latter makes a centralized regulatory approach less necessary. As indicated above, the call for federal intervention is based on the traditional response to the prisoner's dilemma that involves creating of a centralized overseer. Prisoner's dilemmas, however, are famously susceptible to alternative solutions where the players engage in repeat play and thus defectors are vulnerable to retaliation. That solution consists simply of acting cooperatively, at least until other players defect, because mutual cooperation produces higher payoffs than defection where each player has an opportunity to impose costs on the other in subsequent iterations of the game.<sup>118</sup> States that are geographically locked in to dealing with each other and that have constant interactions with each other in various fora (Congress, meetings of state officials, etc.) may have substantial opportunities to retaliate should one of their number act opportunistically. In a system composed of fifty states located over thousands of miles, interactions among some are likely to be greater than interactions with others. Ohio and Michigan may be more prone to cooperate than Arizona and Michigan. The very geographical distance between Arizona and Michigan that frustrates agreements, however, may simultaneously signal that when the former induces relocation from the latter, it is not simply engaged in a zero-sum competition, but is appealing to very real differences between the jurisdictions and that those differences truly generate net benefits from the

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*Position of the Judiciary*, 67 YALE L.J. 219, 222 (1957); Jesse H. Choper, *The Scope of National Power Vis-a-Vis the States: The Dispensability of Judicial Review*, 86 YALE L.J. 1552, 1586 (1977); Julian N. Eule, *Laying the Dormant Commerce Clause to Rest*, 91 YALE L.J. 425, 435 (1982).

118. See ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* 109-23 (1984) (describing methods of escape from the prisoner's dilemma).

national perspective. Thus, it is conceivable that when (implicit or explicit) agreements are not reached, or when agreements are breached,<sup>119</sup> the reason lies in a significant advantage that one of the players enjoys and that increases welfare.

The prisoner's dilemma model creates a powerful basis for believing that states will not enter into a destructive race to the bottom as long as other states can impose costs on them, and that federal intervention is thus superfluous. Nevertheless, there are two reasons to be suspicious of the iterated or repeat-play prisoner's dilemma model as a solution to interstate competition. The first arises from the public choice problem. The constraining effects of retaliatory possibilities diminish as players approach the end of their relationship and the capacity for reprisal is reduced. While it is unlikely that this "endgame" problem will arise among geographically proximate states, it is highly likely to arise among the politicians through whom the states act. The governor of Michigan may prefer to obtain the short-term benefits of attracting firms from Ohio if he anticipates that any retaliation will take effect only after he leaves office. Of course, if constituents have a time horizon beyond the next election, they may prefer officials who do not engage in behavior that returns only short-term rewards, but it is at least plausible that repeat-play models will not be as effective as I have suggested.

The second limitation on iterated prisoner's dilemma as a solution to inefficient competition arises from the fact that there may be more than one equilibrium in a repeated game. Recall that what sustains the practice of cooperation in an iterated prisoner's dilemma is the fact that the expected value of continued cooperation exceeds the expected value of defection (because retaliation will impose expected losses in excess of those expected benefits of short-term defection). It may be, however, that one player's expected payoff from continued cooperation still exceeds the payoff from defection, even though the other party is not cooperating. Assume, for instance, that

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119. Professor Enrich suggests that efforts at cooperation have failed. See Enrich, *supra* note 1, at 397 (noting that several state agreements have succumbed to business pressures). It is difficult to know whether the instances he cites represent a glass that is half-empty or half-full. The fact that agreements are reached lends some support for my claim. The implications of the fact that they are breached depends on whether the breach results in the race that Professor Enrich predicts or location to more productive jurisdictions. See *id.* at 397-405 (characterizing the effects of competitive state tax incentives as negative).

Michigan announces that it is actively seeking to induce industry from Ohio, but is only looking to attract three firms. Michigan also announces, however, that if Ohio attempts to retaliate by attracting Michigan firms, Michigan will seek to attract every Ohio firm it can. If Ohio believes these statements, and also believes that the payoff from continued cooperation even after the loss of a few firms exceeds the payoff from continued battles with Michigan for many firms, it may simply accept some short-term losses but not retaliate. Repeat prisoner's dilemma does not, in these circumstances, require mutual cooperation; it only makes cooperation one of several plausible strategies.<sup>120</sup> Nevertheless, the possibility that the prisoner's dilemma among states will tend to generate cooperation when long-term benefits are anticipated suggests a set of circumstances in which the feared race to the bottom should not materialize.

There is a second reason why judicial intervention is less attractive in subsidy cases than in other dormant Commerce Clause cases. If I am correct that certain forms of subsidies (for instance, explicit ones to particular firms) will trigger participation by a significant group of advocates and opponents, then the decision to pursue the firm may more credibly be thought to reflect both positive value for the bidding jurisdiction, and perhaps a value that cannot easily be replicated elsewhere. Again, the point here is concerned with the salient nature of subsidies directed at particular firms. The difference between payments from the treasury and tax expenditures or protectionist legislation is that there is a discrete set of residents—potential competitors of the favored firm or competitors for the scarce subsidy dollars—who can identify themselves as vulnerable to injury by the governmental action and are capable of seeking redress. The result is that we would expect a fuller debate within the bidding jurisdiction about the propriety of the proposed action. Even if this argument reveals too much faith in the coincidence of local and national interests (because net local gains do not necessarily translate into net national gains), at the very least it suggests that one of the major justifications for the antidiscrimination principle of the Commerce Clause is less readily applicable to business incentives. Dis-

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120. See David M. Kreps, *Corporate Culture and Economic Theory*, in PERSPECTIVES ON POSITIVE POLITICAL ECONOMY 90, 100-103 (James E. Alt & Kenneth A. Shepsle eds., 1990) (explaining that participants in on-going bargaining are repeatedly free to make choices about trust and honor).

crimutory regulations run afoul of the Commerce Clause in part because those who would be adversely affected are not represented in the decisionmaking process of the regulating jurisdiction.<sup>121</sup> Because the regulating state internalizes the benefits and externalizes the costs, some national arbiter (and a federal court qualifies) is necessary to prevent regulations that are negative-sum from the national perspective.<sup>122</sup> On the other hand, if local opponents can be expected to arise, one would anticipate that they would make the arguments of, and therefore serve as effective surrogates for, those unrepresented in the decisionmaking process.

This is not to say that the arguments of in-state surrogates for out-of-state interests would be dispositive. After all, a state may still enact an incentive program that it believes will return positive benefits in-state, even though the state realizes that the program imposes externalities that render it net negative from the national perspective. The risks of underrepresentation, however, must be balanced against the costs that would be incurred by any judicially created or legislatively imposed standard that leaves substantial discretion to courts in an area where history predicts substantial judicial uncertainty.

### CONCLUSION

The argument that I have made suggests a utilitarian approach to the dormant Commerce Clause. Interpreted most broadly, this perspective holds that subsidies do not run afoul

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121. See Heinzerling, *supra* note 78, at 220-21 (arguing against a process-based theory as a justification for the antidiscrimination doctrine). Professor Heinzerling has warned against making too much of political participation arguments in this context because even non-residents may lobby or otherwise participate in political processes. See *id.* at 251-56. Nevertheless, they may have limited capacity to participate relative to residents, and legislators may be wary of claims that they are catering to "foreign" interests. For a still more skeptical view of process justifications for judicial review of legislation alleged to violate the Commerce Clause, see Regan, *supra* note 8, at 1160-67 (disputing the "*Carolene Products* theory" of the dormant Commerce Clause).

122. The focus on costs of regulation to outsiders not represented in the decisionmaking process is an important feature of the analysis in Eule, *supra* note 117, at 425. Of course, it may be that in-state residents are also adversely affected by the regulation. As I noted above, if in-state milk producers obtain a subsidy not available to out-of-state producers, the artificially increased prices for milk that results will adversely affect in-state consumers. Traditional-collective action problems among a diffuse population composed of individuals with a small stake in the outcome of the political debate explains why milk producers may still be able to dominate decisionmaking.

of dormant Commerce Clause doctrine if, as a whole, they tend to induce firms to locate in jurisdictions that permit greater productivity than the same firms would achieve in other jurisdictions. The test, then, reflects the decisions that would be made by a single legislator acting in the national interest without regard to the interests of individual states, and taking into account the costs of decisionmaking that preclude highly individualized analyses of the effects of particular subsidies. I do not think that this test necessarily entails balancing in all its implications. There may be conditions in which we would want to preserve the interests and identities of states sufficiently that we would not want to allow some to extract wealth from others, even if the nation as a whole benefited. This would especially be the case if it turned out that the same region was consistently bearing the burden necessary to generate benefits for others. Subsidies, however, do not create those difficulties. All states can enter the competition, so that exploitation of monopoly positions is less likely. Of course, the fact that all states can compete is what underlies the claims that they will race to the bottom of the economic ladder. But because different states are likely to compete for different firms, it is unlikely that the same jurisdictions will systematically be winners and losers.

If I am correct that interstate competition will cause firms to be more productive, or will cause states to attract firms that confer benefits in excess of the benefits that would be conferred on alternative jurisdictions, our reaction to business incentives tests our choice between relatively harmonious and competitive economic policies for individual states. This choice is familiar to anyone who has thought about the contest between harmonization and diversity that underlies federal systems generally. Harmonization avoids destructive competition and fosters a sense of larger community, but at the cost of impeding sorting and specialization that might enhance national economic growth. Diversity encourages competition, but at the expense of increasing sectionalism and the risk of destructive conflict. The risks of pursuing either of these policies, however, are not necessarily equal. If states are not simply involved in a race to the bottom, but instead have idiosyncratic reasons to pursue specific firms or industries, then the economic role that states may play with greater success than the federal government will be enhanced. Federalism becomes important on this vision because states and localities *are* different from one another, not only in natural resources that can be exploited to the

detriment of other jurisdictions (one primary concern of the Commerce Clause<sup>123</sup>), but in attitudes and values towards economic development and of economic development of particular sorts.<sup>124</sup> Thus, in their attack on our apparent psychological commitment to federalism, Professors Rubin and Feeley conclude:

In a truly federal system, some sub-units might not be interested in economic efficiency at all; they might be primarily motivated by the desire to preserve an agrarian lifestyle, to protect the environment, or to encourage individual spirituality. These particular sub-units might lose out in the competition for factories and chemical engineers, as the economic analysis predicts. But rather than perceiving their losses as a chastening lesson that induces them to change their laws, they might regard them as a necessary cost or as a positive advantage.<sup>125</sup>

While Rubin and Feeley write to advocate reduced attention to the concerns of federalism, their argument suggests the very reasons why business incentives are unlikely to generate a detrimental nationwide policy on economic development—that is, some jurisdictions simply will not join the race. They may pursue other objectives that generate substantial benefits for other members of the federation, while enjoying economic benefits generated by jurisdictions that pursue economic objectives.

If there is sufficient variation among jurisdictions in seeking firms, then the risks of external effects caused by states with high preferences for attracting firms must be balanced against the risks of harmonizing economic development policy through a broadly construed Commerce Clause. As Alvin Klevorick has pointed out, it cannot be that we desire harmonization for its own sake; that result could be achieved simply by allowing each participant in the race to reach the bottom.<sup>126</sup> Nor is harmonization costless. If jurisdictions have conflicting preferences, harmonization will force some of them to abandon their preferences, and it is by no means clear that

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123. See Levmore, *supra* note 8, at 570-72 (providing examples of detrimental economic exploitation by states of natural resources).

124. See, e.g., EDWARD L. AYERS ET AL., *ALL OVER THE MAP: RETHINKING AMERICAN REGIONS* 11-37 (1996) (recounting the historical rise of American Sectionalism).

125. Edward L. Rubin & Malcolm Feeley, *Federalism: Some Notes on a National Neurosis*, 41 U.C.L.A. L. REV. 903, 921 (1994).

126. See Klevorick, *supra* note 103, at 181 (arguing that attempts to “level the playing field” inadequately address problems presented by international competition).

harmonization will be pegged to those jurisdictions that would suffer the greatest should their preferences be abandoned.

Ultimately, the question may come down to the game of "Whom Do You Trust?" The more we believe that local decisionmakers are caught in cognitive error or political capture, the less we are willing to accede to their decisions about the propriety of incentives. The more we think that rational jurisdictions will ignore external effects that outweigh internal benefits, the more we need some centralizing arbiter to intervene. The more we think that courts have difficulty distinguishing among development programs that generate different economic effects from a social perspective, the less willing we are to assign them the task of arbitrating.

The issue of interstate competition, therefore, may simply illustrate the limits of legal intervention. Nothing in the doctrine of the Commerce Clause to this point suggests that, outside the obvious cases of monopoly exploitation, adjudication is a good mechanism for distinguishing among state policies that advance net social welfare and those that foster protectionism. Perhaps law serves as a last resort in the absence of social norms that constrain antisocial conduct. But if the fears of retaliation that drive the race-to-the-bottom logic are correct, interstate competition for firms may be particularly ripe for regulation through extralegal constraints. While current practice suggests that such constraints are imperfect, the implicit claim that law will not cause greater distortions requires more thorough investigation.