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# A SKEPTICAL VIEW OF FEDERAL CONSTRAINTS ON STATE BUSINESS INCENTIVES

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## I. Introduction

Recent legal literature has begun to address the issue of whether legal doctrine can be employed to constrain certain forms of competition among localities and states for business development.[1] The argument has taken place primarily in the context of whether Congress possesses authority under the Commerce Clause to enact 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 the state.

In this paper, I cast a skeptical look at these arguments. My objective is not to demonstrate that the claims of a "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, the benefits of such competition may be understated, and the proposed remedy of 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.

Initially, the claim that competition for business location will have a negative impact seems

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[1] See Peter Enrich, Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business, 110 Harv. L. Rev. 378 (1996); Walter Hellerstein & Dan T. Coenen, Commerce Clause Restraints on State Business Development Incentives, 81 Corn. L. Rev. 789 (1996); Philip Frickey, The Congressional Process and the Constitutionality of Federal Legislation to End the Economic War among the States, at http://woodrow.mpls.frb.fed.us/sylloge/econwar/frickey.html.

odd. Typically we think of competition as an effective mechanism for allocating scarce social resources to the party that values goods most highly, so that states and localities would signal their desire for business by offering prices in the form of amenities, school systems, taxes, and public goods and services that would be considered attractive to businesses.[2] Tiebout models of the market for residence support similar results in the business setting.[3] 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, so will businesses that seek a particular type of environment, work force, or package of goods and services gravitate to those locations that signal their desire to attract firms with similar preferences. Of course, the package offered by states and localities does not indicate that they have unlimited desire to attract business, 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.[4] Communities below the optimum will use incentives to attract business that may increase the number of residents, and thus decrease average costs, while those above the optimum are likely to reduce services until a sufficient number of residents emigrate.[5] Indeed, there is some reason to believe that states and localities are particularly adept 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,

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[2] See Wallace E. Oates and Robert M. Schwab, Economic Competition Among Jurisdictions: Efficiency Enhancing or Distortion Inducing?, 35 J. Pub. Econ. 333 (1988).

[3] Charles Tiebout, A Pure Theory of Local Expenditures, 64 J. Pol. Econ. 416 (1956).

[4] See Tiebout, supra note, at .

[5] Tiebout expands on this phenomenon in light of the political reality, discussed below, that officials will not want to preside over a shrinking population:

> 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 which the city has to offer.

Tiebout, supra note , at .

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.[6]

Business incentives 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—e.g., access to transportation, infrastructure, education, climate—that many find to be the basis for business location decisions.[7] From this perspective, governmental use of subsidies, exemptions, and abatements simply constitute more explicit prices to the same effect. Indeed, from this perspective, interstate competition in the form of subsidies, exemptions, or abatements seems little more than the business counterpart to well-accepted forms of competition among other state actors bidding for scarce resources. For instance, state universities bid for students by offering scholarships and positions on sport teams. And 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 are characterized by some feature or consequences that distinguishes them from other competitive tools that we think serve a valid allocational function, and those characteristics must be distinguishable in some principled way from these other cases in which we find no outcry against interstate competition. The negative feature of the competition may lie at least partially in the same intuition that underlies the Commerce Clause of the Constitution. Contemporary literature views the Commerce Clause as a response to the fear that states, left to their own devices, would

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[6] See Paul E. Peterson, City Limits, 42-43, 69-70 (1981).

[7] See, e.g., 1 Council of State Governments, Economic Development in the States: State Business Incentives and Economic Growth 9-10 (1989).

regulate trade in a protectionist manner, and thus seek to exploit monopolies or that they held over other states or otherwise impose external costs that the imposing state did not have to internalize.[8] Thus, the regulating state would be likely to regulate where costs exceeded benefits, because those costs would be visited on others. Protectionism would have the additional effect of inviting retaliation so that consumers in the initiating state would also suffer. Whether the adverse effects are visited solely on external jurisdictions, or ultimately on the offering jurisdiction as well, the ultimate result would be a decrease in welfare from the national perspective.

Opponents of business incentives attribute this same negative-sum result to efforts attract firms from other jurisdictions. Each state, on this view, must retaliate against raiders by offering their own incentives to retain or attract business. The result is allegedly a traditional "race-to-the-bottom" in which businesses, which might be best positioned to share some of the redistributive tax burden imposed by states, are able to bid down taxes to the point where they become subject only to benefit taxes. As a corollary, states that seek to attract businesses might underinvest in redistributive programs, the financing of which would be borne by business that would therefore fail to locate within the state.[9] Presumably, all states would elect to prevent this scenario, but none can act unilaterally, 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, here, 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. This claim is perhaps more interesting for it assumes systematic miscalculation by state and local officials about the benefits of attracting businesses. Here, the culprits are 1) cognitive error manifested in the form of the "winner's curse," which posits that

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[8] See William N. Eskridge, Jr. and John Ferejohn, The Elastic Commerce Clause: A Political Theory of American Federalism, 47 Vand. L. Rev. 1355, 1363-64 (1994); Saul Levmore, Interstate Exploitation and Judicial Intervention, 69 Va. L. Rev. 563 (1983); Cass Sunstein, Constitutionalism and Secession 58 U. Chi. L. Rev. 633, 640 (1991); Donald Regan.

[9] See, e.g., Jerry L. Mashaw & Susan Rose-Ackerman, Federalism and Regulation, in The Reagan Regulatory Strategy: An Assessment 111 (George C. Eads & Michael Fix, eds. 1984).

winners of common-value auctions will tend to bid an amount in excess of the return they receive from their investment; and 2) the capture of the decision making process about providing incentives by those who benefit from them.

The empirical studies that have been used to evaluate these allegations are inconclusive.[10] 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 target firm.[11] Different states mean different things by "economic incentives" making comparisons difficult, and some benefits may also resist measurement. It may be useful, therefore, to ask whether there are reasons to believe that the adverse effects suggested for business incentives will exist and whether there are competing reasons to suggest that they will either be more moderate than some profess.

## II. Intrajurisdictional Effects of Incentives

Begin with the claim that these programs harm the offering jurisdiction, wholly apart from any interjurisdictional effects. These claims center on the contention that officials who offer incentives miscalculate the benefits to be generated by attracted or retaining plants. The result is that total revenues collected by the jurisdiction decline, with the consequence that fewer public goods are provided. 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. Thus, they are able to shift the tax burden for redistributional efforts to less mobile entities. Thus, these claims deny the basic premise of the competitive story about incentives, i.e., that they constitute signals that facilitate an optimal matching of firms and jurisdictions, and suggest that incentives are self-defeating in that they hurt the very jurisdictions

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[10] See, e.g., Joseph M. Phillips & Ernest P. Goss, The Effect of State and Local Taxes on Economic Development: A Meta-Analysis, 62 S. Econ. J. 320 (1995); Joe Mattey & Mark Spiegel, On the Efficiency Effects of Tax Competition for Firms, at http://woodrow.mpls.frb.fed.us/site_collection/sylloge/econwar/mattey.html; Chris Farrell, The Economic War among the States: An Overview, at http://woodrow.mpls.frb.fed.us/sylloge/econwar/farrel.html.

[11] See Dick Netzer, An Evaluation of Interjurisdictional Competition through Economic Development Incentives, in Competition among States and Local Governments 221, 232-34 (Daphne A. Kenyon & John Kincaid, eds. 1991).

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.[12] But anecdotal evidence proves only the possibility of miscalculation, not its systemic presence; and carried to its extreme, miscalculation would undermine the argument for private sector competition, since miscalculation is hardly unique to public sector investments.[13] Thus, legal intervention would be warranted, at best, if there were reasons to think that states and localities systematically miscalculated the value of the incentives they offered.

Two explanations for systematic miscalculation have been offered. The first takes the form of the Winner's Curse. The term describes a cognitive phenomenon of systematic 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.[14] Both field studies and experimental data reveal that the Winner's Curse is "a general phenomenon exhibited by most agents."[15] In addition, there is some evidence that the phenomenon persists with experience, although its magnitude and frequency may decline, i.e., those subject to the effect learn little from their mistakes.[16] Worse from the perspective of business incentives, the judgmental error that the "Winner's Curse" represents may be worse in situations where the estimator has limited liability for mistakes.[17] As I suggest below, there are public choice reasons to believe that state and local

[12] See, e.g., Enrich, supra note , at 389 ("Five years later, the cost for Tennessee to attract GM's Saturn plant, with its 6000 jobs, had risen to $150 million in state and local incentives").

[13] See Quaker Oats purchase of Snapple.

[14] See Richard H. Thaler, The Winner's Curse: Paradoxes and Anomalies of Economic Life 50-51 (1992).

[15] Barry Lind & Charles R. Plott, The Winner's Curse: Experiments with Buyers and with Sellers, 81 Am. Econ. Rev. 335, 336 (1991).

[16] Id.

[17] 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 (1991).

officials will be able to insulate themselves from blame for mistaken decisions about subsidies, which constitutes the functional equivalent of limited liability.

Thus, there are reasons to believe that the Winner's Choice heuristic would systematically induce overpayment to attract firms. But there are some countervailing considerations that moderate its effect. First, note that 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 miscalculation will be reduced in those settings. Even if the bid is statutorily based (that is, the incentive takes the form of an abatement granted to all firms by statute rather than an explicitly negotiated deal), so that theoretically all states are bidding, firms are unlikely to weigh all jurisdictions equally, since only a few may offer the other amenities that affect plant location.

Additionally, note that the Winner's Curse is predicated on common-value auctions, that is, auctions in which the rights are the same to all bidders. In some sense, competition among states for the same business might be thought to fall within this category—a plant that will offer 100 jobs might be thought to be of the same value in North Carolina as it is in North Dakota. But if the Tiebout story about optimal size of localities is correct, 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.

Certain firms will also have different value in different jurisdictions. The location of one firm may influence the location of other firms that deal in products related to those of the first firm. Firms that locate along with others can create synergistic networks that reduce transaction costs and that facilitate the sharing of information. Thus, 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.[18] Thus, 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. Alternatively, 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 a prior 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. To the extent that the common-value feature of the auction is diluted, the possibility of a Winner's Curse is similarly reduced. The fact that the winner has, by definition, paid a price in excess of the bids of others may simply reflect that the winner properly attributes a greater value to the asset than other bidders.

The other potential source of systemic miscalculation of the value of incentives 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 incentive to lobby vigorously for them, because they 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 though the intrajurisdictional cost of the incentives exceeds the benefits. Other interests have similar incentives 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.[19]

Those who oppose incentives, however, have less reason to monitor officials or to invest

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[18] See Michael L. Katz & Carl Shapiro, Network Externalities, Competition, and Compatibility, 75 Am. Econ. Rev. 424 (1985); Michael Klausner, Corporations, Corporate Law, and Networks of Contracts, 81 Va. L. Rev. 757 (1995).

[19] See Thomas L. Evans, The Taxation of Nonshareholder Contributions to Capital: An Economic Analysis, 45 Vand. L. Rev. 1457, 1488-92 (1992).

in convincing those officials not to grant incentives, since the increased tax burden they will bear if the business receives the incentive are minute compared to the personal costs of opposition. In addition, because avoiding the incentive has the characteristics of a public good, any given opponent can receive the same benefit without incurring the related costs if some other opponent undertakes the opposition effort. Nor will officials who miscalculate necessary suffer electoral redress, since the binary nature of voting means that voters must cast ballots based on the overall performance of officials. Thus, as long as a voter agrees believes a mayor has done a good job paving the streets and running the schools, the voter may vote for the mayor's re-election, even if he misspent large sums of money attracting a business to the city. An official who is returned to office will be unable to disaggregate those who agreed with all her positions from those who only marginally favored her over her opponent. 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).

Indeed, some claim that, wholly apart from the entreaties of interest groups, political officials themselves have a bias in favor of unchecked business development, regardless of its effects, because such involvement 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).[20] 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.[21]

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[20] See Enrich, supra note, at 394.

[21] Id.

As in the case of the Winner's Curse arguments, the 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 decision making 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 sides were represented. In those circumstances, we would be more comfortable that the ultimate decision was likely to represent officials' best guess as to the net effects of the incentives.

The public choice arguments presented above suggest that the costs of collective action will be prohibitive to potential opposition groups, such as taxpayers as a whole who will be charged higher rates or receive fewer services if incentives to businesses allows them to pay only benefit taxes. In some cases, however, there is less reason to believe that is the case. For instance, existing firms will see competitive threats in attracting new businesses within the same industry, and will be particularly concerned if those new firms begin with competitive advantages such as tax abatements or tax-exempt financing that reduces their costs.[22] 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 Borders. Obviously, this incentive will not exist with respect to firms that do not face current competition (except to the extent that all firms face competition for labor, a cost that is likely to be sufficiently small as to replicate the free riding problem applicable to taxpayers generally), but it does suggest a need to separate those areas in which public choice concerns are less dramatic.

In addition, there are some groups within the public 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 is the group of political opponents of incumbents. To the extent

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[22] See Robert S. Amdursky & Clayton P. Gillette, Municipal Debt Finance 49-50 (1992).

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.[23] Individual reporters, however, may be able to maximize reputation and job prospects with investigative reporting that, again, points to "wasteful" expenditures. By generating information about business incentives, newspaper 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 remove them from the general collective action problem that suggests proponents will have an unopposed path to the ears of public officials.

Look next at the incentives on voters themselves 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 jurisdiction, an increasing phenomenon since Congress restricted the capacity of jurisdictions to fund industrial development with revenue bonds.[24] Since 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 removes 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.

For much the same reason, even non-general obligation bond debt, secured solely by the revenue stream generated by operation of the business financed with bond proceeds, may generate scrutiny. Current law grants tax-exemption to such debt for industrial development purposes only if it fits within a "volume cap" allocated to each state. As long as the total financing for all proposed projects exceeds or threatens to exceed the state's volume cap, proponents of

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[23] See Evans, supra note , at 1489.

[24] See U.S.C. §§103, 141.

competing projects have incentives to scrutinize or force scrutiny of business incentives that take the form of tax-exempt financing since financing of those projects risks the accessibility of these other groups to scarce tax-exempt borrowings.

Finally, even if public officials are susceptible to capture and thus overinvest in incentives, it is not clear that 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 decision-making processes. Indeed, courts have taken this action, even though they appear to recognize that the jurisdiction is gaining at the expense of some out-of-state constituency. For instance, in *State ex rel. McLeod v. Riley*,[25] 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 virtue of 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 have welcomed the project, notwithstanding that the transaction appears 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.

It is certainly the case that courts have recently become more deferential to legislative decisions about what satisfies a public purpose. Even in South Carolina, courts appear to monitor

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[25] 278 S.E.2d 612 (S.C. 1981).

grants to discrete interests less rigorously than the *Riley* case suggests.[26] 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 decision making process.[27] But that does not mean that courts are unable or unwilling to intervene in appropriate cases. For instance, in *Opinion of the Justices,*[28] 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.

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 robust than they appear as analyzed in the literature to date. 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.

## III. The Federal Role in Limiting Competition

Assume, however, that the intrajurisdictional effects of business incentives are as problematic as is assumed. It still does not follow that federal intervention to save states from themselves in this sense is warranted. Little in Commerce Clause jurisprudence suggests that federal intervention would be warranted to cure purely intrajurisdictional costs that arise from

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[26] See, e.g., Hucks v. Riley, 357 S.E.2d 458 (S.C. 1987), where the court concluded:

> 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.

Id. at 458-59. 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 public purpose and distinguishing prior state decisions that had rejected similar programs).

[27] See Einer Elhague,

[28] S.E.2d (1995).

political defects. Of themselves, miscalculating the benefits of business incentives does not generate negative externalities, and certainly does not represent an effort to exploit monopoly positions.

Thus, the argument for federal intervention must rest on some basis other than 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.
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> 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.[29]

The argument may be strengthened with allegations that far-reaching incentives, e.g., tax abatements that are granted to a broad scope of businesses, impose costs in terms of reduced revenues well in excess of benefits because they apply to firms that are already located within a jurisdiction and thus simply reduce funds available for public expenditures. Thus, at most, incentives constitute wealth transfers from one jurisdiction to the next (or from public treasuries to private ones), but the transaction costs of effecting those wealth transfers create a net-negative result. Nevertheless, states, aware of the incentive programs offered by other jurisdictions, cannot escape from the cycle for fear that doing so will place them 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. The only way out,

[29] Enrich, supra note , at 398-99.

according to this argument, is the traditional solution to prisoner's dilemmas or chicken games of a centralized authority that is capable of imposing and enforcing a commitment among the states not to compete on this basis. And that, apparently, is the role that Congress can exercise through the Commerce Clause.

Here, again, I think that 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 decision making a 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 and that therefore has the effect of restricting entry by out-of-state milk producers and thus 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 producers in State A and out-of-state milk producers. Thus, we might expect to see such a program, which might 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.[30]

Alternatively, other forms of 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. But even if that business did not simply replace business that would have existed in other jurisdictions, the tax exemption could

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[30] See, e.g., West Lynn Creamery, Inc. v. Healy, 512 U.S. 186 (1994).

generate net negative results if the exemption cost the federal government more that it gained the states. The federal treasury works much 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 all.[31]

These examples suggest that business incentives may indeed have the adverse effects attributed to them. But there exist counterexamples of cases in which we do not think that governmental intervention to prevent downward spiraling competition is necessary, 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 illustration that I suggested at the outset of the paper, only partly rhetorically. 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 choose law schools to attend based 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. Thus, our 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 at play 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. And 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 professors, i.e., 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.

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

What distinguishes this case from those cases in which we believe there is greater reason for state intervention? If B State Law 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 and is taking those steps necessary to implement its vision. Nothing it has done, however, precludes other law schools from taking similar measures to bid away tax professors or from developing other specialities that would require raiding other law schools. This seems qualitatively different from a subsidy that merely transfers wealth or that artificially raises prices regardless of demand (for out-of-state milk) that would prevail in the absence of the subsidy. Thus, 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 specialities 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 in part, underlies federalist structures.[32] Thus, this does not seem to be the kind of program that violates the objectives of the Commerce Clause. Some states and localities, for instance, will attempt to exploit resources that they have to attract firms that can take advantage of those resources. Pennsylvania, for instance, may not need to provide incentives to attract steel businesses, and any attempt by that state to enact pro-steel industry legislation that adversely affected out-of-state purchasers would seem to fall squarely within the Commerce Clause. A state that sought to attract credit card issuers by eliminating usury rates or that, as in the case of Delaware, enacted corporate law that was conducive to corporations' residing there is less likely to be exploiting, rather than creating, an advantage that was equally open to other states.[33]

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[32] See Michael McConnell, Federalism: Evaluating the Founder's Design, 54 U. Chi. L. Rev. 1484, 1493-94 (1987).

[33] 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. 1435 91992); William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale

Nevertheless, even if the distinction I have tried to draw is valid, both recent Commerce Clause jurisprudence[34] and commentary on the distinctions among incentive programs[35] suggests that distilling the characteristics of any particular incentive is more complicated than my examples indicate. Thus, we might need some theoretical basis for determining, at least as a presumptive matter, whether a particular incentive is likely to display the protectionist or the preference-enhancing side available to subsidies.

The presumption we create might depend on whether we believe, as a general matter, that there is merit to the race-to-the-bottom or prisoner's dilemma argument. To the extent that we believe 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.[36] 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 they have created for the state itself or for its political subdivisions to grant business incentives.[37] But the fact that 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

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L.J. 663 (1974). But see Frank H. Easterbrook, Managers' Discretion and Investors' Welfare: Theories and Evidence, 9 Del. J. Corp. L. 540 (1984).

[34] See, e.g., West Lynn Creamery, Inc. v. Healy, 512 U.S. 186 (1994).

[35] See, e.g., Hellerstein and , supra note .

[36] For an elaboration of these conditions in the context of a race to the bottom in environmental regulation, see Richard L. Revesz, Federalism and Interstate Environmental Externalities, 144 U. Penn. L. Rev. 2341 (1996); 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).

[37] See, e.g., Enrich, supra note 1, at ; Wilson

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 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.[38] 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, however."[39] Peterson concluded that the "amount that state governments and the localities within them spent per capita on developmental programs varied markedly among the states."[40] 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 value in the average state. Note that the coefficient of variation would not itself vary if all states were increasing or decreasing their expenditures on economic development. 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. Thus, 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

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[38] Paul Peterson, The Price of Federalism 87-89 (1995).

[39] Id. at 87.

[40] Id. at 88.

say that the expenditures made for this purpose may be dictated by normal competitive practices that generate efficient sorting among competitors to achieve optimal size or to take advantage of the fit between particular businesses and the 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 redistributional 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 non-benefit charges to the immobile or a decrease in services within the jurisdiction. But 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 there is little reason to believe that they would not accept some redistribution.

Finally, note that the race-to-the-bottom logic depends on a belief the locational decisions of firms induced by incentives have no positive national wealth effects, that is, it depends on location in State A being fungible with location in State B. I have already suggested that firms may be more productive in one jurisdiction than another, either because of network externalities or by virtue of fit with a state's efforts to specialize. But in the current open economy, there is an additional reason to doubt the zero-sum nature of locational decisions from a national perspective. Incentives offered by State A may prevent plants from locating in another country, rather than in another jurisdiction in this country.[41] 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.[42] But the possibility that high labor costs in the United States will induce exporting of jobs elsewhere suggests that, absent fear of retaliation by other countries, there is less reason to believe that federal government should intervene to stop states.

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[41] See Netzer, supra note , at 226.

[42] 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).

B. The Commerce Clause as an Analytical Tool

One point on which commentators appear to agree is that our Commerce Clause jurisprudence is confused.[43] There is general agreement on the objective that the Clause seeks to serve, typically phrased in terms of creating a "national market,"[44] or preventing one jurisdiction from discriminating against other.[45] Application of the doctrine, however, has proven more problematic. A rigidly applied antidiscrimination principle that prohibits states from offering benefits to businesses that only locate within the offering state would have similar effects with respect to tourist discounts offered by a state that induces them to vacation in the offering state rather than some other area.[46] Nevertheless, my intuition is that would look askance at efforts to prohibit states from providing such inducements, just as we would at efforts to restrain states from hiring away highly prized employees from other jurisdictions. Devices 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.[47]

Indeed, in one sense, the antidiscrimination principle of the Commerce Clause appears particularly inapplicable to business incentives, by virtue of the very argument that is relied on to advocate Commerce Clause restraints. Discriminatory regulations that run afoul of the Commerce Clause are presumably possible because those out-of-staters who would be adversely affected are not represented in the decision-making process of the regulating jurisdiction. Since the regulating state internalizes the benefits and externalizes the costs, some national arbiter is necessary to prevent the creation of regulations that are negative-sum from the national

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[43] See, e.g., Richard L. Revesz, Federalism and Interstate Environmental Externalities, 144 U. Penn. L. Rev. 2341, 2398 (1996).

[44] West Lynn Creamery, Inc. v. Healy, 512 U.S. 186, (Scalia, J., concurring).

[45] Enrich, supra note 1, at 424-26.

[46] See Levmore, supra note , at 577.

[47] See Hellerstein and Coenen, supra note 1.

perspective.[48] But the argument that business incentives create net in-state losses as well as induce a negative-sum activity from the national perspective suggests that incentives are not obtained solely at the expense of those unrepresented in the decision-making process. Instead, one would expect that in-state groups adversely affected by the subsidy would serve as surrogates for the interests of out-of-staters as well as their own. Of course, in-state groups can only play this role if they arise to represent their own interests. Thus, we return to the arguments above about whether, at least under some discrete conditions, in-staters can be expected to overcome collective action problems and protest inefficient (from the in-state perspective) subsidies.

This is not to say that the arguments of in-state surrogates for out-of-state interests would be determinative. After all, a state may still enact an incentive program that it believes will return net-positive benefits in-state, even though the state realizes that the program imposes externalities that render it net negative from the national perspective. Perhaps it is this possibility that explains Justice Rehnquist's puzzling comment that "(a)nalysis of interest group participation in the political process may serve many useful purposes, but serving as a basis for interpreting the dormant Commerce Clause is not one of them."[49] But that comment also raises two other, albeit related prospects. The first is the question of institutional competence and the second goes to the costs of using the Commerce Clause to invalidate incentives.

The question of institutional competence arises from the confusion that prevails in interpretation of the Commerce Clause. If we now understand that 1) states may or may not be miscalculating the benefits, but that there is no reason to believe that miscalculation is systemic across all incentive programs; 2) states may or may not be involved in a "race-to-the-bottom," but may with similar probability be involved in sorting preferences along the lines desired for

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[48] The focus on costs of regulation to outsiders not represented in the decision-making process is an important feature of the analysis in Julian Eule, Laying the Dormant Commerce Clause to Rest, 91 Yale L.J. 425 (1982). 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 decision-making.

[49] West Lynn Creamery, Inc. v. Healy, 512 U.S. 186, (Rehnquist, Ch. J.., dissenting).

jurisdictional competition; 3) out-of-state interests may or may not be represented in localized decision-making, then case-by-case adjudication of the conditions and consequences of any particular incentive program appears to be the only mechanism by which to determine whether a particular incentive creates the risks that the Commerce Clause is intended to avoid.

But 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. Instead, the Commerce Clause represents a hatchet where a scalpel is required. Thus, Professor Enrich refers to Commerce Clause jurisprudence as"tortured,"[50] and "never . . . a model of consistency,"[51] and its embodiment in an antidiscrimination standard as "clumsy."[52] He suggests that an "antidistortion" standard may prove more workable and consistent with the objectives of the Commerce Clause. But much of what I have tried to suggest is that distorting decisions of firms may actually enhance efficiency from a national perspective.

That leads me to the final point about the costs of federal constraints. Much of the resistance to constraints rests on values of federalism. Federalism is often invoked to advance relatively vague objectives such as fostering experimentation within one jurisdiction from which other jurisdictions can learn, or permitting autonomy within smaller jurisdictions in order to maximize preference satisfaction of individuals or participation in self-government,[53] or, to advance lofty goals such as "liberty, community, and utility."[54] My immediate concern about federalism, however, has less to do with lofty goals than with the possibility that federalism plays the sorting role that actually enhances national economic growth. If states are not simply involved in a race to the bottom, but instead are attempting to specialize in the industries that they attract

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[50] Enrich, supra note , at 460.

[51] Id. at 462.

[52] Id. at 453.

[53] For a critical view of the need for federalism to achieve these objectives, see Edward L. Rubin & Malcolm Feeley, Federalism: Some Notes on a National Neurosis, 41 U.C.L.A. L. Rev. 903 (1994).

[54] Peter H. Schuck, Introduction: Some Reflections on the Federalism Debate, 14 Yale L. & Pol. Rev. 1, 11 (1996).

and to create network externalities by attracting synergistic industries, then the economic role that state may play with greater success than the federal government will be enhanced. Federalism becomes important on this vision because states and local jurisdictions *are* different, not only in natural resources that can be exploited to the detriment of other jurisdictions (one primary concern of the Commerce Clause[55]), but in attitudes and values towards economic development and of economic development of particular sorts.[56] Thus, 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.[57]

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 homogenized and detrimental nationwide policy on economic development—i.e., some jurisdictions simply won't join the race.

If there is sufficient variation among jurisdiction in seeking firms, then the risks of external effects by those 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.[58] Thus, what we prefer is harmonization at some level that may also permit regional variation.

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[55] See Levmore, supra note .

[56] See, e.g., Edward L. Ayers, Patricia Nelson, Limerick, Stephen Nissenbaum, and Peter S. Onuf, All Over the Map: Rethinking American Regions 11-37 (1996).

[57] Rubin and Feeley, supra note , at 921.

[58] Klevorick, supra note , at 181.

## IV. Conclusion

Ultimately, the question may come down to the game of "Whom Do You Trust?" The more we believe that local decision makers 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.

In the presence of doubt about the effects of business incentives, questions about the capacities of courts to sort the suboptimal from the efficient, and the values of federalism that are potentially captured by state economic development, I think there is at least one reason to defer to states in cases that do not display clear exploitative or net-negative discriminatory effects. The call for federal intervention is based on the traditional response to the prisoner's dilemma that involves creating of a centralized overseer. But prisoner's dilemmas 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 actors defect.[59] States that are locked in geographically to dealing with each other and who 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 50 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. But the very geographical distance between Arizona and Michigan may mean that when the former seeks industry to relocate from the latter, it is not simply engaged in a zero-sum competition, but is able to offer benefits that truly generate net benefits from the social perspective.

The issue of interstate competition, therefore, may simply illustrate the limits of legal

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[59] See Robert Axelrod, The Evolution of Cooperation (1984).

intervention. Nothing in the doctrine of the Commerce Clause to this point suggests that, outside the obvious cases of monopoly exploitation, law 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 anti-social 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.