An Interstate Compact to End the Economic Development Subsidy Arms Race

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ABSTRACT

Targeted economic development subsidies do not work as advertised. In fact, the balance of economic theory and empirical evidence suggests that they are more likely to undermine development than to enhance it. Yet policymakers face strong incentives to continue to offer subsidies. Because subsidies are economically costly but politically valuable, they create a situation similar to a prisoner's dilemma. An interstate compact offers a solution by changing the political payoffs. Importantly, interstate compacts enable policymakers to credibly commit to ending what many already see as a race to the bottom. Ending the mutually destructive subsidy war would allow state and local governments to repurpose up to $95 billion annually to tax relief and other projects with better payoffs.

JEL codes: H2, H7, O2, O4

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Economic development subsidies have a long history. And, unfortunately, they're as American as apple pie.[1] So too, however, is opposition to these subsidies. The Boston Tea Party was a protest against a similar privilege—a tax break for the British East India Company that effectively gave the crown-chartered firm monopoly power over the tea trade in the New World.[2] Widespread, albeit generally ineffective, opposition to favoritism still exists today: in 2011, 17 business leaders in the Kansas City area wrote a letter to the governors of Kansas and Missouri asking for a cease-fire in the "border war" between the two states.[3] At the time, the states were not able to come to an agreement, and so the border war continued. Between 2011 and 2018, Kansas and Missouri paid a combined $335 million to subsidize the relocation of around 12,000 jobs from one state to the other, with most companies moving only five to seven miles.[4]

More recently, teachers in Columbus, Ohio, marched in protest of a property tax break promised to a single company that was estimated to reduce funding for Columbus schools by $55 million over 15 years.[5] Tradeoffs in public funding and tax relief are one of the biggest problems with targeted economic development subsidies. After all, every dollar spent on a subsidy for one particular

1. As early as 1661, Virginia subsidized woolen cloth producers with bounties of tobacco. David E. Pinsky, "State Constitutional Limitations on Public Industrial Financing: An Historical and Economic Approach," *University of Pennsylvania Law Review* 111, no. 3 (1963): 266.
2. Matthew D. Mitchell, *The Pathology of Privilege: The Economic Consequences of Government Favoritism* (Arlington, VA: Mercatus Center at George Mason University, 2015), 9–10.
3. David Beaham et al., "A Letter to Kansas Gov. Sam Brownback and Missouri Gov. Jay Nixon," April 11, 2011, available at Good Jobs First, https://www.goodjobsfirst.org/kc-business-leaders-demand-cease-fire-wasteful-job-poaching; "The New Border War—Kansas and Missouri," *Economist*, March 22, 2014.
4. Shayndi Raice, "Tired of Fighting for Business, Missouri and Kansas Near Cease-Fire over Incentives," *Wall Street Journal*, June 25, 2019.
5. Bill Bush, "Columbus Teachers March in Protest of City Tax Abatements for Developers," *Columbus Dispatch*, April 29, 2019.

corporation is a dollar that can't be used to reduce all firms' tax burdens or to improve education, infrastructure, or public safety.

Michael Brown, chief of staff to the Columbus City Council president, defended the property tax break as a response to similar subsidies from competing locales. "We don't love incentives," he said, "[but] we will not disarm in competition with the region and national peers who offer deeper deals."[6] Brown's statement highlights the underlying problem that perpetuates the subsidy arms race: despite misgivings, local leaders often feel compelled to offer subsidies out of fear that other cities and states will steal the jobs that would have otherwise been created in their hometowns. Shortly after the Kansas City letter was sent, Sean O'Byrne, vice president of the Downtown Council of Kansas City, made his doubts about subsidies clear in an interview with the *New York Times*:

> I just shake my head every time it happens, it just gives me a sick feeling in the pit of my stomach. It sounds like I'm talking myself out of a job, but there ought to be a law against what I'm doing.[7]

Recent research from the Mercatus Center at George Mason University showcases how the large body of academic research finds that most subsidies don't create net benefits for the local communities that pay for them.[8] However, the fear of being accused of doing nothing to promote development keeps policymakers trapped in what economists call a *prisoner's dilemma*. Counterintuitively, their efforts lead to *less* economic development than if all cities and states forswore corporate handouts.

There are policy reforms that may be able to resolve this conundrum. One of the most promising options is an interstate compact.[9] In this essay we summarize the economic problems caused by subsidies, showing how they are likely to lead to net economic losses at the local level, and how they certainly do so at

6. Bill Bush, "Columbus Teachers Union to March Next Week over Pay, Tax Abatements," *Columbus Dispatch*, April 17, 2019.
7. Louise Story, "As Companies Seek Tax Deals, Governments Pay High Price," *New York Times*, December 1, 2012.
8. Matthew D. Mitchell et al., "The Economics of a Targeted Economic Development Subsidy" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, November 2019).
9. Recent Mercatus research illustrates two other means of ending the interstate subsidy arms race. See Matthew D. Mitchell et al., "Outlawing Favoritism: The Economics, History, and Law of Anti-Aid Provisions in State Constitutions" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, March 2020); Michael D. Farren and John C. Mozena, "Federal Pandemic Relief Could End the Interstate Economic Development Arms Race" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, May 2020).

the national level. We explain that while the economic payoffs from subsidies are negative in most circumstances, the political payoffs encourage policymakers to continue to offer them. This disconnect between political and economic payoffs is what creates the prisoner's dilemma. We illustrate how an interstate compact could provide an effective solution to this economic race to the bottom. We conclude by describing the critical elements of any compact that endeavors to reach a holistic, long-term solution to the interstate subsidy arms race.

1. WHAT ARE TARGETED ECONOMIC DEVELOPMENT SUBSIDIES?

Consensus on what constitutes a targeted economic development subsidy can be difficult to obtain. It's obvious that cash handouts are subsidies, but this limited classification is inadequate for two reasons. First, few economic development programs actually provide cash payments, and even when they do, the subsidy is often framed as something else. For example, most of Wisconsin's recent subsidies for Foxconn Technology Group are characterized as corporate income tax credits. But these tax credits are equivalent to a cash handout because manufacturing firms are excluded from the state's corporate income tax.[10]

Second, many economic development policies create fungible economic benefits that are, *in effect*, subsidies. For example, when a government provides a corporation with publicly owned assets, specialized infrastructure, loans, or loan guarantees for a certain project, it frees up some of the resources that the corporation would otherwise have had to spend on that project.

Because of these factors, we define a targeted economic development subsidy as *any government-granted privilege that creates exclusive economic benefits for its recipient(s)*.[11] The "exclusive" element of the definition is critical because

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10. Mitchell et al., "Economics of a Targeted Economic Development Subsidy"; Cailin R. Slattery and Owen M. Zidar, "New Data on State and Local Business Tax Incentives across the U.S.," *Princeton Economics*, January 6, 2020; Cailin R. Slattery and Owen M. Zidar, "Evaluating State and Local Business Tax Incentives," *Journal of Economic Perspectives* 34, no. 2 (Spring 2020).

11. Our definition is intentionally holistic, but we also recommend the more specific definitions of what constitutes a targeted subsidy in other recent research on interstate compacts and in the legislative text of the Distorting Subsidies Limitation Act of 1999, which was not passed. See H.R. 1060, 105th Cong. (1999); Byron Schlomach, Stephen Slivinski, and James Hohman, *Multilateral Disarmament: A State Compact to End Corporate Welfare* (Midland, MI: Mackinac Center for Public Policy and the 1889 Institute, 2019); Mitchell et al., "Economics of a Targeted Economic Development Subsidy," 5.

exclusive privileges create a host of economic, political, and social pathologies.[12] For this reason we focus on *targeted* economic development subsidies.[13]

2. WHY ARE SUBSIDIES HARMFUL?

Several problems with targeted economic development subsidies show that they typically do not work as advertised. That is, they usually fail to promote net economic development in the jurisdictions that pay for them. In fact, they may actually depress local economic development. Moreover, as we demonstrate at the end of this section, there's good reason to believe that regardless of their local effect, they tend to depress economic development at the national level.

2.1. Subsidies Don't Work

A large body of academic research finds that, while subsidies may benefit the firms, activities, industries, or regions that are privileged, most are not associated with measurable improvements in the broader communities that pay for them.[14] A 2010 study of tax increment financing (TIF) districts by economist Paul Byrne of Washburn University is illustrative.[15] While TIF proponents often evaluate TIFs by looking at employment within the privileged district, Byrne cautions that "improvements within a TIF district can come at the expense of the non-TIF areas of a municipality."[16] He therefore evaluates TIF districts by looking at employment levels throughout the municipalities that pay for these subsidies. As with most other studies that evaluate subsidies in light of their effects on the broader communities that pay for them, Byrne finds no significant positive effects. In fact, he finds that shopping mall TIF districts may simply

12. Mitchell, *Pathology of Privilege*.
13. We explicitly do not consider generally available subsidies, although there may be economic development programs that provide the equivalent. Such programs are rare, and the ones that do exist often end up targeting particular companies, industries, or areas in their implementation. Generally available subsidies would cause some of the same economic distortions that we discuss, but targeted subsidies are the larger issue and cause additional problems.
14. Matthew D. Mitchell, Daniel Sutter, and Scott Eastman, "The Political Economy of Targeted Economic Development Incentives," *Review of Regional Studies* 48, no. 1 (2018): 1–9.
15. Under tax increment financing, the government will designate the geographic area surrounding a current or potential project as a TIF district. If the assessed property value of the district then appreciates, the government will use any increase in property tax revenue to finance subsidies to the firm or for infrastructure and public services that primarily benefit the firm.
16. Paul F. Byrne, "Does Tax Increment Financing Deliver on Its Promise of Jobs? The Impact of Tax Increment Financing on Municipal Employment Growth," *Economic Development Quarterly* 24, no. 1 (February 2010): 17.

shift consumer spending from outside the district to within it, resulting in a negligible net effect across the municipality or region.[17] This corroborates more recent research by Cailin Slattery at Columbia University and Owen Zidar at Princeton University. They find that while subsidies increase employment at subsidized firms, they do not translate into broader economic growth at the state or local level.[18]

Perhaps it is not surprising that the peer-reviewed academic research on subsidies generally contradicts the favorable findings of studies by private consultants. One important reason for the discrepancy is that the consultant studies rarely include the effect of economic harm done by the taxes that fund the subsidy. In essence, they use a "benefits-only" approach rather than a full-fledged cost-benefit analysis.

Furthermore, in the large majority of cases economic development subsidies don't actually sway a company's decision about where to locate, whether to expand, or whether to stay put. This may sound counterintuitive, but it has been documented in a large number of academic studies. Timothy Bartik, one of the leading scholars of economic development, surveyed the body of research on this question and concluded that the typical subsidy materially affects a company's decision about where to locate or whether to expand in only about 12.5 percent of cases.[19] In other words, in seven out of eight cases, a granted economic development subsidy was not the deciding factor in the company's final decision. In those situations, the subsidy represents a complete waste of public resources.

Nathan Jensen, a professor at the University of Texas, has found similar results.[20] In some cases, companies had already broken ground and were building

17. Byrne, "Does Tax Increment Financing Deliver?" For similar results, see Richard F. Dye and David F. Merriman, "The Effects of Tax Increment Financing on Economic Development," *Journal of Urban Economics* 47, no. 2 (March 2000): 306–28; David F. Merriman, Mark L. Skidmore, and Russ D. Kashian, "Do Tax Increment Finance Districts Stimulate Growth in Real Estate Values?," *Real Estate Economics* 39, no. 2 (2011): 221–50.
18. Slattery and Zidar, "Evaluating State and Local Business Tax Incentives."
19. Bartik's survey of the incentives-focused academic research concludes that subsidies are likely to tip a company's relocation, expansion, or retention decision only 2 to 25 percent of the time. However, Bartik also argues that the business tax literature should provide a better estimate of the "but for" effect. Bartik concludes that the average granted subsidy only materially affects 12.5 percent of location, expansion, and retention decisions (with a 95 percent confidence interval ranging from 4 percent to 21 percent). Timothy J. Bartik, "'But For' Percentages for Economic Development Incentives: What Percentage Estimates Are Plausible Based on the Research Literature?" (Working Paper, W.E. Upjohn Institute for Employment Research, Kalamazoo, MI, July 1, 2018), 16, 20.
20. Nathan M. Jensen, "Bargaining and the Effectiveness of Economic Development Incentives: An Evaluation of the Texas Chapter 313 Program," *Public Choice* 177, no. 1–2 (October 2018): 29–51.

their new facilities when they requested subsidies from the local government—and public officials granted them anyway![21]

2.2. Subsidies May Depress Local Economic Development

Even worse, a subsidy can actually *depress* local economic development. One reason for this is that subsidies must be funded by taxes, and taxes tend to discourage economic activity. Recent research suggests that state governments that provide more and larger subsidies tend to have higher tax rates.[22] It is difficult, however, to disentangle cause and effect in these situations.[23] It may be that the cost of subsidies is passed on to state residents, or it may be that states with high tax burdens must make up for these burdens with more subsidies.[24] Other research by Bartik—again summarizing the broader body of academic literature—finds that cities and states with higher tax rates tend to experience lower levels of long-run GDP growth.[25] It is possible that the higher taxes needed to pay for the subsidies—which are ostensibly intended to spur economic growth—may have a *larger* negative effect than the presumed positive effect of the subsidy.[26]

Alternatively, policymakers may pay for subsidies by reducing spending on public services such as education, public safety, or infrastructure. Indeed, research by professor Jia Wang of the University of the South suggests that spending on public services generally decreases after subsidies have been granted.[27] Reducing the public services provided to residents would, in general,

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21. Nathan M. Jensen, "The Amazon HQ2 Fiasco Was No Outlier," *Wall Street Journal*, December 14, 2018.
22. Peter Calcagno and Frank Hefner, "Targeted Economic Incentives: An Analysis of State Fiscal Policy and Regulatory Conditions," *Review of Regional Studies* 48, no. 1 (2018): 71–91.
23. Matthew D. Mitchell, Daniel Sutter, and Scott Eastman, "The Political Economy of Targeted Economic Development Incentives," *Review of Regional Studies* 48, no. 1 (2018): 1–9.
24. John Dove and Daniel Sutter find that states that spend more on targeted subsidies tend to experience lower levels of measured economic freedom. John Dove and Daniel Sutter, "Is There a Tradeoff between Economic Development Incentives and Economic Freedom? Evidence from the US States," *Review of Regional Studies* 48, no. 1 (2018): 55–69.
25. This effect is stronger at the municipal level than at the metropolitan and state levels. Timothy J. Bartik, *Who Benefits from State and Local Economic Development Policies?* (Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 1991).
26. This is precisely what we find in our recent analysis of Wisconsin's Foxconn subsidies. Although an exact determination of the net effect is impossible, we show that in realistic scenarios, the subsidy may depress state economic activity by tens of billions of dollars over 15 years. Mitchell et al., "Economics of a Targeted Economic Development Subsidy."
27. Jia Wang, "Do Economic Development Incentives Crowd Out Public Expenditures in U.S. States?," *B.E. Journal of Economic Analysis and Policy* 16, no. 1 (2015): 513–38.

reduce the local quality of life, a factor known to affect firm location decisions.[28] This suggests that even if policymakers avoid raising taxes to pay for subsidies, local companies may still face slower economic growth.

2.3. Subsidies Reduce National Economic Development

The net effect of subsidies on local economic development may be uncertain, but it's a fair bet that subsidies unambiguously reduce economic development at the national level because subsidies waste national resources regardless of their effect on local development.

As we have noted, if a subsidy wasn't the deciding factor in a company's location or expansion decision, then the government has provided a taxpayer-financed handout for no gain. Furthermore, the taxes to fund the subsidy reduce long-run economic growth.

However, the subsidy itself also gives the targeted company a measure of protection from its unsubsidized competition.[29] This sheltered status allows the company to reduce its focus on satisfying customers and controlling costs. To put it plainly, subsidies protect companies from the consequences of laziness.[30] Moreover, the very existence of government-granted privilege tends to encourage firms to expend scarce resources seeking privileged status, which motivates their competitors to expend scarce resources opposing it.[31] Both the inefficient production encouraged by subsidies and the resources spent to win political protection from competition reduce national economic development.[32]

When a subsidy does change a company's decision about where to locate or expand, then the policy has most likely persuaded the company to do something it shouldn't have done. The government has encouraged a nonoptimal

28. Paul D. Gottlieb, "Residential Amenities, Firm Location and Economic Development," *Urban Studies* 32, no. 9 (November 1995): 1413–36.
29. Mitchell et al., "Economics of a Targeted Economic Development Subsidy," 26.
30. "As the economist John Hicks once put it, 'the best of all monopoly profits is a quiet life.'" Mitchell, *Pathology of Privilege*, 20, quoting J. R. Hicks, "Annual Survey of Economic Theory: The Theory of Monopoly," *Econometrica* 3, no. 1 (1935): 8. See also Mitchell, *Pathology of Privilege*, 17, citing Harvey Leibenstein, "Allocative Efficiency vs. 'X-Efficiency,'" *American Economic Review* 56, no. 3 (1966): 392–415.
31. Mitchell et al., "Economics of a Targeted Economic Development Subsidy," 29.
32. Economists call the socially wasteful efforts to curry favor or to protect against favoritism *rent-seeking*. Gordon Tullock, "The Welfare Costs of Tariffs, Monopolies, and Theft," *Western Economic Journal* [now *Economic Inquiry*] 5, no. 3 (June 1967): 224–32; Matthew D. Mitchell, "Rent Seeking at 52: An Introduction to a Special Issue of Public Choice," *Public Choice* 181, no. 1 (October 2019): 1–4.

decision, and the scarce resources in the economy would have been better used elsewhere.[33] The less-efficient production at the chosen location leads to reduced national economic development *in addition to* the diminished economic development at the local level caused by the higher taxes to fund the subsidy and the resources wasted on seeking political privilege.

States and cities that manage to avoid subsidies will be able to have lower tax rates for all businesses and to offer more public services than jurisdictions that offer subsidies. Lower taxes and better public services tend to foster a more diverse set of enterprises that play to a region's natural strengths.[34] Regions that avoid subsidies are also likely to experience more sustainable economic development that is more resistant to external economic shocks. Furthermore, other regions are likely to enjoy spillover benefits from the increased economic development and innovation, in the same way that the harm caused by subsidies spills over onto neighboring regions and reduces overall economic development at the national level.

3. WHY DO STATES CONTINUE TO OFFER SUBSIDIES?

Given that targeted economic development subsidies don't work as advertised—that is, they are likely to lead to less economic development rather than more—why do policymakers continue to dispense them? The answer seems to be threefold. First, a benefits-only analytical method obscures the true effect of the subsidies. Second, it is more difficult for taxpayers to organize to oppose the subsidies than for companies to campaign for them. And third, politicians believe that it is politically advantageous to offer subsidies, especially when other politicians are doing so.

33. An alternative way of thinking about this is that the company picked a less productive and more wasteful location to do business, rather than a location that maximizes the value, net of cost, that the company offers to customers. A more relatable example would be a situation in which you choose to live five miles farther away from your workplace because your housing cost will be subsidized at the new location. Although the effect on your household's finances will be positive, the net effect on society will be negative. First, the cost of taxation to fund the subsidy reduces economic growth. Second, your decision to live farther away than you otherwise would leads you to consume more resources (e.g., fuel or productive time) traveling to work each day, leaving less of those resources to be productively used elsewhere in the economy.

34. Gert-Jan Hospers, Pierre Desrochers, and Frédéric Sautet, "The Next Silicon Valley? On the Relationship between Geographical Clustering and Public Policy," *International Entrepreneurship and Management Journal* 5, no. 3 (September 2009): 285–99.

3.1. Benefits-Only Analysis

Widely reported analyses of economic development subsidies are often flawed because the industry consultants doing the work almost always use a "benefits-only" approach. These analyses ignore the cost of the subsidy and eschew a full-fledged cost-benefit analysis.[35] In essence, this approach implicitly—and incorrectly—assumes that the funding for the subsidy arrives like manna from heaven and does not have to be extracted from other areas of the economy via taxes. And, as already discussed, it ignores the extent to which these higher taxes lead to reduced economic activity.

Furthermore, a proper cost-benefit analysis would evaluate multiple alternative possibilities for investing resources rather than focus on a single option. In other words, an appropriate analysis of economic development subsidies would not only compare the expected benefit of the subsidy against the economic cost of the taxes needed to fund the subsidy, but would also evaluate whether the anticipated effect of spending those funds on other government services such as education, infrastructure, or public safety would provide better bang for the buck.

Finally, the benefits-only approach attributes the entire benefit of the company's location, expansion, or retention decision to the subsidy. However, as previously noted, subsidies typically don't materially influence these decisions. A more comprehensive cost-benefit analysis would also account for the likelihood that a subsidized firm would have made the decision to relocate, expand, or maintain operations *without* the subsidy. This means that the gross economic benefits attributable to the subsidy are much lower (generally 88 percent lower) than those typically reported.[36]

3.2. Imbalanced Political Influence

But even if a subsidy imposes more costs on a community than benefits, the uneven distribution of those costs and benefits may compel a policymaker to pursue the subsidy anyway. The reason is that the benefits of a subsidy tend to be

35. By doing so, they are committing one of the oldest and most often repeated mistakes of economic analysis. They are looking only at the obvious effects and avoiding some of the less obvious ones. See Frédéric Bastiat, "That Which Is Seen, and That Which Is Not Seen," in *The Bastiat Collection*, 2nd ed. (Auburn, AL: Ludwig von Mises Institute, 2007 [1850]).
36. Bartik, "'But For' Percentages."

concentrated on a few well-organized interest groups while the costs are spread across many poorly organized taxpayers.[37]

Most of the benefits of a subsidy, of course, flow to the subsidized firm itself. Some also flow to the construction company that builds its facility, the economic development agency that oversees the project, and any site-selection firm that helped negotiate the contract.[38] Because these groups are relatively few in number and well informed about the particulars of the deal, they are well positioned to organize political support for the plan. The voters and other constituents who pay for the deal, however, are so numerous that they are often unable to organize in opposition.

Furthermore, most of the information that taxpayers receive about the project is provided by the aforementioned boosters. Unsurprisingly, the findings of the benefits-only analyses conducted by private consultants are overwhelmingly positive, thereby taking the air out of any opposition effort before it begins.

3.3. Incentives to Pander

Given that most of the information that the public and policymakers receive about economic development subsidies is solely good news, perhaps it's understandable that a recent survey found that 84 percent of mayors believe subsidies to be beneficial.[39] Furthermore, a recent book by Nathan Jensen and Ed Malesky shows that policymakers believe that offering subsidies improves their standing in the public eye.[40] Just-released research by Cailin Slattery and Owen Zidar finds that the per capita value of economic development subsidies tends to rise in election years, suggesting that the "ribbon-cutting effect" is a real phenomenon.[41] Being able to point to a particular marquee business or project in the community and tell voters "look what I've done" seems to be a winning political strategy.[42]

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37. This important insight has been attributed to a number of thinkers, perhaps most influentially to Mancur Olson. See Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups*, rev. ed. (Cambridge, MA: Harvard University Press, 1971).
38. Cezary Podkul, "Meet the Fixers Pitting States against Each Other to Win Tax Breaks for New Factories," *Wall Street Journal*, May 18, 2019; Nathan M. Jensen, "Delaware Offered Amazon $4.5 Million to Locate a New Facility There. Guess Who Wins?," *Washington Post*, March 10, 2020.
39. Katherin Levine Einstein et al., "Menino Survey of Mayors: 2018 Results" (Boston: Boston University Initiative on Cities, January 22, 2019).
40. Nathan M. Jensen and Edmund Malesky, *Incentives to Pander: How Politicians Use Corporate Welfare for Political Gain* (Cambridge: Cambridge University Press, 2018).
41. Slattery and Zidar, "Evaluating State and Local Business Tax Incentives," 14.
42. Richard Florida, "Why Do Politicians Waste So Much Money on Corporate Incentives?," *CityLab*, May 24, 2018.

Despite the fact that the economic payoffs of subsidies are likely negative, policymakers face political pressure to keep offering them, even if they are uncomfortable with the idea.[43] This is doubly true when politicians in other cities and states are publicly announcing their own subsidy offers. The misplaced fear of missing out on potential economic growth as well as the legitimate fear that rival politicians will criticize them for failing to do enough to promote jobs compels most politicians to dispense targeted subsidies.

4. HOW DO ECONOMIC DEVELOPMENT SUBSIDIES CAUSE A PRISONER'S DILEMMA?

This race to the bottom parallels the prisoner's dilemma in game theory.[44] In this famous thought experiment, two criminals in police custody face a set of incentives that, combined with mutual mistrust, cause them to pursue actions that are against their own interest (see the appendix for details).

To understand how the subsidy arms race is similar to the prisoner's dilemma, assume that there are two neighboring states, A and B, each with one elected official who decides whether to provide subsidies. On the basis of the discussion in section 2 and assuming all else is equal, we posit the following hypothetical long-run economic payoffs from subsidies:[45]

- The economy in each state will perform at its best if neither policymaker provides subsidies.
- Compared with the no-subsidy scenario, the home state economy will be somewhat weaker if the home state policymaker avoids subsidies while the policymaker in the neighboring state provides them. This reflects the fact that subsidies in a neighboring state impose costs on other regions by reducing national economic development.

43. Intriguingly, the apparent support that politicians earn with voters when the politicians provide subsidies evaporates when the costs of the subsidies are presented in the form of tradeoffs, such as increased taxes or reduced education spending. Matthew D. Mitchell, "Why Do Politicians Push for Corporate Welfare?," *The Bridge*, July 27, 2018.

44. Avinash Dixit and Barry Nalebuff, "Prisoners' Dilemma," in *The Library of Economics and Liberty*, accessed October 18, 2018, https://www.econlib.org/library/Enc/PrisonersDilemma.html.

45. In the real world, of course, many other factors can affect economic performance, including global economic conditions, federal macroeconomic policy, own-state and own-city policies, and policies enacted by other states and municipalities. In this case, we are specifically analyzing the marginal effect of economic development subsidies, and thus holding all other policies and factors to be unchanging.

FIGURE 1. THE ECONOMIC PAYOFFS OF THE SUBSIDY WAR

		policymakers in state B: don’t provide subsidies	policymakers in state B: provide subsidies
policymakers in state A	don’t provide subsidies	B payoff: fastest economic growth A payoff: fastest economic growth	B payoff: poor economic growth A payoff: moderate economic growth
policymakers in state A	provide subsidies	B payoff: moderate economic growth A payoff: poor economic growth	B payoff: slowest economic growth A payoff: slowest economic growth

- The home state economy will perform poorly if the home state policymaker provides subsidies while the neighboring state policymaker avoids them.
- The home state and the neighboring state economies will each perform at their worst if policymakers in both states provide subsidies.

These choices and payoffs are illustrated in figure 1—the shaded quadrant represents the logical outcome if state policymakers focus only on economic payoffs.[46]

If policymakers were rewarded solely on the basis of their contribution to long-run economic conditions, they would maximize their chances of reelection by avoiding subsidies. But the real-world political value of such a policy is low. This is because the economic payoffs of good policy accrue over a long period of time, it is difficult for voters to assign credit or blame for these conditions, and much of the public believes that subsidies actually work. As a result, a policymaker who avoids subsidies in order to foster long-run economic development is unlikely to win voters’ support in the next election.

Many factors likely go into a policymaker’s political calculus concerning subsidies, and we don’t pretend to know them all. Nor are these factors likely to be the same for every policymaker. Nevertheless, we suggest that the following political payoffs capture most policymakers’ incentives reasonably well:

46. In formal game theoretic terms, the shaded region represents the likely solution because it is the result of the dominant strategy for each player and because it is a Nash equilibrium. It is a dominant strategy because each player has an incentive to pursue it irrespective of what the other does. And it is a Nash equilibrium because neither player has an incentive to deviate from this strategy, holding the other player’s strategy constant.

- If both policymakers manage to avoid subsidies, each will obtain moderate political support. In this scenario, neither policymaker will reap extraordinary political rewards for outcompeting his or her neighboring policymaker. On the other hand, neither will be punished for being outcompeted by the other. Moreover, each might obtain some moderate support for avoiding favoritism and, perhaps indirectly, for fostering a healthier economy.[47]
- If a policymaker fails to offer subsidies while his or her counterpart in the other state offers them, the first policymaker will bear significant political loss. This reflects the fact that voters want policymakers to do what they can to outcompete other states for economic development. Though voters may care about equity and fairness, and though they may see that the economy is not particularly healthy, they believe that subsidies work and they will punish policymakers who get outcompeted.
- If a policymaker offers subsidies while his or her counterpart in the other state fails to do so, then the policymaker will experience significant political reward for outcompeting his or her counterpart. Most voters will be willing to countenance some local inequity if they believe it is likely to lead to better economic results.
- Finally, if both policymakers offer subsidies, each will experience a moderate political gain. Neither will be rewarded for outcompeting the other or punished for being outcompeted—voters will recognize that the policymakers are at least "doing something" to ensure the local economy is competitive with other regions. On the other hand, each policymaker may be punished somewhat for playing favorites with local special interests. And over the long run, the policymakers might be harmed somewhat by the poor economic conditions that arise when states and their neighbors give out subsidies (though voters need not know the reason for the poor performance).

47. Despite the common perception, there is actually little evidence that voters routinely vote in their self-interest. Instead of being rationally self-interested, they appear to be *irrationally* publicly interested. For details, see Bryan Caplan, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies*, new ed. (Princeton, NJ: Princeton University Press, 2008). Moreover, anthropologists find that humans have a strong desire for fairness and equity, and this may translate into some political reward for those who manage to avoid subsidies. See Paul Bloom, *Just Babies: The Origins of Good and Evil*, repr. ed. (New York: Broadway Books, 2014). These views can be reconciled with Jensen and Malesky's work if we interpret voter support for subsidies as arising not out of self-interest but out of a belief that the local economy will benefit if its leaders offer subsidies that outcompete other regions. Jensen and Malesky, *Incentives to Pander*.

FIGURE 2. THE POLITICAL PAYOFFS OF THE SUBSIDY WAR

policymakers in state A	policymakers in state B	don't provide subsidies	provide subsidies
	don't provide subsidies	B payoff: moderate political gain A payoff: moderate political gain	B payoff: significant political gain A payoff: significant political loss
	provide subsidies	B payoff: significant political loss A payoff: significant political gain	B payoff: moderate political gain A payoff: moderate political gain

These choices and their political payoffs are shown in figure 2. As in figure 1, the most likely outcome is indicated by the shaded quadrant.[48] Though each policymaker would be best off if he or she could somehow offer subsidies without the other one doing so, neither is able to control the actions of the other. They would each reap a moderate political payoff if they could both commit to eliminating subsidies, but again, neither can compel the other to do this. Instead, each feels compelled to offer subsidies in order to avoid the significant political loss that results from unilateral disarmament in the subsidy war. As a result, like the prisoners in the famous thought experiment, policymakers are stuck with a suboptimal outcome in which all policymakers offer subsidies even though all would be better off not doing so.

It's important to recognize that around 90 years ago states were generally in the top-left quadrant of figure 2. But Mississippi fired the first shot of the modern subsidy war during the Great Depression, choosing to "betray" the previous implicit cooperation by offering subsidies to encourage manufacturing firms to move to the state.[49] This was seen as an effective use of government resources by many officials at the time, but it launched the current era of wasteful spending we

48. As with the shaded region in figure 1, the shaded region in figure 2 is a likely equilibrium because it is the result of the dominant strategy for each player and because it is a Nash equilibrium.
49. Connie Lester, "Economic Development in the 1930s: Balance Agriculture with Industry," *Mississippi History Now*, May 2004. An earlier subsidy war in the 19th century had largely been ended through the adoption of anti-aid clauses in state constitutions. Over time, however, these clauses have been either weakened or ignored. See Mitchell et al., "Outlawing Favoritism."

see today. The next section addresses the question of how to unwind the past 90 years of "betrayal" to return to a cooperative agreement and a stronger economy.

5. WHAT ARE POTENTIAL SOLUTIONS TO THE SUBSIDY ARMS RACE?

A subfield in economics known as constitutional political economy is well suited to address the collective action and commitment problems inherent in the subsidy arms race. Developed by the late Nobel laureate James Buchanan, the field studies the optimal choice of rules that constrain policymakers. In Buchanan's words, while economists typically analyze human choice within constraints, constitutional political economy "directs analytical attention to the *choice among constraints*."[50] What constraints might limit or eliminate the subsidy arms race?

One solution to the subsidy arms race would be to enforce the anti-aid clauses that are already part of 45 state constitutions. These clauses prohibit the expenditure of public funds for private purposes. Enacted after a spate of ill-conceived subsidies brought several states to fiscal ruin in the 19th century, a plain reading of these provisions would seem to make most of the subsidies offered today illegal. Starting in the last quarter of the 19th century, however, courts began to ignore or weaken these provisions by assuming a public purpose to subsidies even when one was lacking.[51] The simplest path forward for reform may be for states to strengthen the provisions that are already on the books. And because these clauses are constitutional, this approach offers state policymakers the benefit of credibly committing to a politically difficult future course of action, which might inspire similar responses from other states.

Given that achieving 50 simultaneous, unilateral solutions may prove prohibitively difficult, we see three potential avenues through which multilateral policy reform might take place: federal action, interstate and intercity agreements, and an interstate compact.

A federal prohibition on state economic development subsidies represents one possible solution, albeit a compulsory one. Such a prohibition would seem

50. James M. Buchanan, "The Domain of Constitutional Economics," *Constitutional Political Economy* 1, no. 1 (December 1990): 3. Italics in the original.
51. The public purpose doctrine should have been a complement to antisubsidy provisions. This common-law doctrine, which dates back to Sharpless v. Mayor of Philadelphia, 21 Pa. 147 (1853), makes it illegal for states to levy taxes for private instead of public purposes. Courts have tended to construe the public purpose quite broadly, however. Moreover, they often allow governments to circumvent antisubsidy provisions by simply declaring a subsidy to be in the public's interest. For more details, see Mitchell et al., "Outlawing Favoritism."

to be authorized by the US Constitution's commerce clause, and has been previously suggested as a solution.[52] However, federal action doesn't appear likely. Few in Congress seem interested in solving this problem, and there are plenty of other problems that demand federal attention. Furthermore, this kind of top-down solution would likely offend many state policymakers.

Alternatively, states and cities could enter into agreements with each other to not offer subsidies to poach companies from one another. A short-lived agreement between New York City, New Jersey, and Connecticut in 1991 aimed to do just that.[53] A recent agreement between Kansas and Missouri—inspired by the business leaders' letter that we mentioned at the beginning of this paper—offers a promising model.[54] Under the terms of the agreement, Missouri has passed legislation and the Kansas governor has issued an executive order agreeing not to use incentives to lure firms across the state border in the region of Kansas City. The agreement marks the first time in US history that states have adopted multilateral binding legislative or executive action to disarm in a subsidy war.[55] Still, it has limitations.[56] It only applies to firms in the Kansas City area, does not prohibit local governments from offering subsidies, and—because there are no penalties for violating the agreement—there is nothing to keep the states from passing subsequent laws or executive orders reversing it. If agreements such as this one were full-fledged contracts with enforcement mechanisms and penalties for breach, they would offer more assurance that they provide a reliable solution.

The third option, an interstate compact, preserves the voluntary nature of interstate agreements while adding the potential for an effective enforcement mechanism.

52. Arthur J. Rolnick, "Congress Should End the Economic War among the States" (Congressional Testimony, Domestic Policy Subcommittee, Washington, DC, October 10, 2007); Distorting Subsidies Limitation Act of 1999, H.R. 1060, 105th Cong. (1999); Farren and Mozena, "Federal Pandemic Relief Could End the Interstate Economic Development Arms Race."
53. Joseph F. Zimmerman, *Interstate Economic Relations* (Albany, NY: State University of New York Press, 2004), 151; Sarah Bartlett, "Cooperation Treaty Is Signed to Bolster Regional Economy," *New York Times*, October 8, 1991.
54. Editorial Board, "The Kansas-Missouri Subsidy Armistice," *Wall Street Journal*, August 14, 2019; Mo. Rev. Stat. online § 135.1670 (accessed June 3, 2020), available at https://revisor.mo.gov/main/OneSection.aspx?section=135.1670; State of Kansas Executive Order No. 19-09, Governor Laura Kelly, August 2, 2019, 19, https://governor.kansas.gov/wp-content/uploads/2019/08/EO-19-09_Executed.pdf.
55. Greg LeRoy, "First-Ever Ban on 'Interstate Job Fraud,'" Good Jobs First, August 2, 2019.
56. Patrick Tuohey, "Is the Missouri-Kansas Border War Truce Already Falling Apart?," *The Hill*, December 9, 2019.

6. WHAT IS AN INTERSTATE COMPACT?

Interstate compacts aren't well known, even though they're part of the original US Constitution.[57] There are currently more than 200 compacts, and most states are members of dozens of such agreements.[58] In essence, interstate compacts represent a continuation of the treaties between colonies that existed before America's founding.[59]

Interstate compacts allow the states to work together to resolve interstate disputes and solve common policy problems without intervention by the federal government. They're particularly useful on issues in which the states did not cede powers to the federal government in the Constitution, such as the determination of state borders or the fair apportionment of common water resources. In this way, interstate compacts allow the states to act as sovereign entities.

Compacts also carry the weight of law, meaning that a state cannot unilaterally decide to ignore a compact.[60] As a result, compacts offer a unique way for states to commit to a given course of action. The potential for long-term commitment is especially important given some of the controversies that interstate compacts settle, such as the definition of state borders, and some of the common policy problems they address, such as mutual recognition of professional licenses.

But compacts are not inflexible—there are ways to build adaptability into compacts since they are direct agreements between the states rather than one-size-fits-all federal regulations. One option is for states to cede some of their sovereign authority to a compact-created entity in order to manage a common resource or address a mutual problem. The Port Authority of New York and New Jersey is one example of such an entity.[61] Compacts can also be amended (although this is unusual), as demonstrated by the Enhanced Nurse Licensure Compact, which repealed and replaced the original Nurse Licensure Compact to

57. National Center for Interstate Compacts (website), Council of State Governments, accessed March 16, 2020, https://www.csg.org/ncic/; fact sheet of the National Center for Interstate Compacts, Council of State Governments, accessed December 10, 2019, https://www.csg.org/knowledgecenter/docs/ncic/FactSheet.pdf; Michael L. Buenger et al., *The Evolving Law and Use of Interstate Compacts*, 2nd ed. (Chicago, IL: American Bar Association, Section of Adminisitrative Law and Regulatory Practice, 2016); Jeffrey B. Litwak, *Interstate Compact Law: Cases and Materials*, 3rd ed. (n.p.: Semaphore, 2018); Richard L. Masters, "Interstate Compacts" (presentation at the Council of State Governments National Conference 2014, Anchorage, AK, September 16, 2016), https://www.youtube.com/watch?v=2xDIRlj2jmE.

58. Fact sheet of the National Center for Interstate Compacts.

59. Buenger et al., *Evolving Law and Use of Interstate Compacts*.

60. Green v. Biddle, 21 U.S. (8 Wheat.) 1 (1823).

61. Litwak, *Interstate Compact Law*, 115.

motivate greater participation in the agreement.[62] Twelve of the fourteen states that have recently introduced interstate compact legislation to address targeted economic development subsidies seem to be counting on future amendments. Their legislation explicitly starts with mild restraints on subsidies and creates an advisory board to suggest future reforms to the compact.

Compacts can be tailored to the specific problem under consideration. For example, during the compact drafting process, states can decide what enforcement mechanisms to put in place and what penalties should be imposed on states that violate the compact. The scope of an interstate compact is limited only by what measures the states themselves can agree to, what Congress will consent to (according to the Supreme Court, congressional consent is required in cases where the compact addresses authority that the states delegated to the federal government in the Constitution), and what the US Constitution permits (for example, states could not enter into a compact that abridges rights guaranteed by the Fourteenth Amendment).[63]

During the past two years there have already been several initiatives to develop multiple interstate compacts that would address some of the problems created by economic development subsidies.[64] The progress is promising, but the

62. State legislatures' willingness to amend the Nurse Licensure Compact suggests that the states saw substantial value in the compact. An interstate compact to address the problem of economic development subsidies might well be similar, but it should be noted that the process of amending an interstate compact is still complex and lengthy, as it involves many state legislatures, and thus it should not be taken lightly. There is certainly a tradeoff between a compact that is simple and therefore easier to pass but requires future amendments and a compact that is already "complete" but whose holistic nature may make it harder to pass. James Puente, "The Enhanced Nurse Licensure Compact," *American Nurse Today*, October 30, 2017; Litwak, *Interstate Compact Law*, 112.

63. Virginia v. Tennessee, 148 U.S. 503 (1893); U.S. Steel Corp. v. Multistate Tax Comm'n, 434 U.S. 452 (1978); New York v. U.S., 505 U.S. 144 (1992); Litwak, *Interstate Compact Law*, 37.

64. Jeffrey B. Litwak and Katherine O'Keefe, "Intergovernmental Relations," in *Developments in Administrative Law and Regulatory Practice 2019* (Chicago, IL: American Bar Association, 2020); Ally Schweitzer, "Republicans and Democrats Finally Agree on Something: Foiling Redskins Owner Dan Snyder," *WAMU*, January 24, 2019; Chad Reese, "Will Interstate Compacts Change the Stadium Subsidies Game?," *The Bridge*, February 5, 2019; Interstate Compact on Washington Area Professional Football Team Franchise Facility Incentives, H.B. 1886, Gen. Assemb., 2019 Sess. (Va. 2019); Company-Specific Subsidy Interstate Compact, S.B. 643, W. Va. Leg., 2019 Reg. Sess. § 9, 12 (2019); Michael D. Farren, "Ending the Economic Race to the Bottom: An Interstate Compact Is a Win-Win Solution to Subsidies" (testimony before the Economic Development and Workforce Services Interim Committee, Utah State Capitol, September 18, 2019); Erica York, "Legislator Calls on ALEC to Help End Taxpayer-Funded Stadiums," American Legislative Exchange Council, October 12, 2017; Lindsey Curnutte, "Arizona Senate Considers Compact Prohibiting Stadium," Heartland Institute, March 9, 2018; Ron Kim, "We Beat Amazon. Now Let's End the Corporate Subsidy Bidding Wars," *BuzzFeed News*, February 14, 2019; An Act to Amend the State Finance Law, in Relation to Creating an Inter-state Compact Prohibiting Company-Specific Subsidies, A. 05249, N.Y. Assemb.,

critical elements that such a compact should include to be fully effective have not yet been completely identified.

7. WHAT ELEMENTS SHOULD BE INCLUDED IN AN INTERSTATE COMPACT TO SOLVE THE SUBSIDY WAR?

We have assembled an informal working group to analyze this policy reform. From our discussions, we've identified eight critical elements for an interstate compact to help end the subsidy arms race.[65] We discuss each below. We contend that, if successful, an interstate compact would achieve the following:

- provide policymakers with the mechanism to make a principled stand against subsidies, which many already want to do;[66]
- enable economic development officials to focus on broad-based economic development initiatives that benefit every resident and business rather than be administrators for handouts to specific corporations;[67]
- repurpose the estimated $95 billion in public funds misspent on subsidies each year by states and cities, redirecting the money to prosperity-increasing endeavors that will provide greater benefits to future generations;[68]

2019–2020 Reg. Sess. § 250–57, 17 (2019); S.B. 203, 101st Gen. Assemb., 2019 and 2020 Sess. (Ill. 2019); Schlomach, Slivinski, and Hohman, *Multilateral Disarmament*.

65. Since this is an evolving area of study, various aspects of these suggestions may be reformulated and other elements may also be included as the understanding of this issue develops. These brief suggestions represent our best current understanding of the possible compact elements.

66. Coalition to Phase Out Corporate Tax Giveaways (website), accessed February 5, 2020, https://endtaxgiveaways.org/; Sam Liccardo, "Why I'm Not Bidding for Amazon's HQ," *Wall Street Journal*, October 4, 2017; Ron Nirenberg (mayor of San Antonio, TX) and Nelson W. Wolff (Bexar County judge) to Jeff Bezos (Amazon chairman and CEO), October 11, 2017, https://www.mysanantonio.com/file/247/8/2478-Wolff%20Nirenberg%20letter.pdf.

67. Story, "As Companies Seek Tax Deals."

68. There have been various estimates of annual state and local spending on targeted economic development subsidies: $30 billion (see Slattery and Zidar [2020], accounts for tax-related subsidies only), $16 billion (see Thomas [2019], includes state-only, investment-motivating subsidies), $45 billion (see Bartik [2017], only considers export-base industries and does not include TIF [tax increment financing] subsidies), and $70 billion (see Thomas [2011], provides an estimate of total state and local subsidies using state program data from 2005). Thomas's 2011 estimate of total subsidies is the most comprehensive. Adjusting for inflation, it is equivalent to $95 billion in 2020 dollars. Thomas's 2019 research reanalyzed 2012 research by the *New York Times* to correct for mischaracterized expenditures. In personal correspondence, he estimates that the *New York Times* data showed total state and local spending on subsidies to be about $41.2 billion (this value is the sum of the estimated $16 billion in state-provided, investment-motivating subsidies, combined with an assumed equivalent amount of local subsidies, as well as another $9.2 billion in other forms of state subsidies). Adjusting for inflation, this estimate is equivalent to $48.2 billion in 2020 dollars. However, Thomas argues that his 2019 research underestimates total subsidy spending because the

- reduce the difficult-to-quantify economic resources wasted in the pursuit of subsidies;[69] and
- increase the interstate benefits that arise from greater economic development and innovation.[70]

7.1. Transparency Requirements

First and foremost, any interstate compact should require full transparency for all economic development subsidy deals, both future negotiations and (when legally possible) those previously agreed to.[71] Transparency would help remove some of the harmful spillover effects from subsidies by making the costs spread out across present and future taxpayers more tangible, empowering the auditors and critics of economic development subsidy programs while providing additional public motivation to address the issue.[72] It would also help ensure that those tasked with interstate compact enforcement have the information needed to do their jobs successfully.

Most subsidy deals are developed in secret, away from the public eye, which leads to more-excessive subsidies and worse deals for taxpayers and constituents. In particular, the current practice whereby policymakers sign nondisclosure agreements or conduct negotiations through a private third party (such as a local chamber of commerce, which is not subject to sunshine laws or

New York Times data lack cost estimates for multiple subsidy programs. Therefore, the research in Thomas's 2011 book remains the best comprehensive estimate of total annual spending by state and local government on subsidies. Cailin Slattery and Owen Zidar, "Evaluating State and Local Business Tax Incentives," *Journal of Economic Perspectives* 34, no. 2 (2020): 90–118; Kenneth Thomas, "The State of State and Local Subsidies to Business" (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, October 2019); Timothy J. Bartik, *A New Panel Database on Business Incentives for Economic Development Offered by State and Local Governments in the United States* (Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, February 2017); Kenneth Thomas, *Investment Incentives and the Global Competition for Capital* (London: Palgrave Macmillan, 2011); Kenneth Thomas, consultation with Michael D. Farren, "Estimates of Total State and Local Subsidies," May 4, 2020; Louise Story, "As Companies Seek Tax Deals, Governments Pay High Price," *New York Times*, December 1, 2012.

69. Mitchell et al., "Economics of a Targeted Economic Development Subsidy," 29.
70. Mitchell et al., 26.
71. Some contracts that states have signed in the past may not permit transparency.
72. See section 3.2 in this paper and Mitchell et al., "Economics of a Targeted Economic Development Subsidy," 32.

Freedom of Information Act requests) allows companies to play states against one another.[73]

These loopholes mean the new transparency standards will have to enshrine in unassailable law a requirement that every type of communication between government officials and any corporation or organization that pertains to a targeted economic development subsidy (as previously defined and as elaborated on in the next section) should be subject to the strictest of freedom of information requirements and sunshine laws. This standard should be as contemporaneous as possible, meaning that video and audio recordings of meetings and calls, as well as all written communications, must be retained and made immediately publicly available (if they are not also required to be livestreamed) by publishing them in a central repository not controlled by the government agency conducting the communications.

And because previous subsidy deals have used private organizations to get around such requirements already in place, the transparency regulations should also specifically include any entity, private or public, acting on the government's behalf, directly or indirectly, during these communications. These new legal rules will need to clearly articulate that when private groups or representatives conduct business on behalf of government organizations (even when it is without the explicit permission of the government), they are subject to the same transparency standards required for the government organizations, and are subject to the same legal liability for failure to comply.

7.2. Definition of What Constitutes a "Targeted Subsidy"

Any compact that would solve the subsidy dilemma will have to clearly identify what constitutes a compact-violating subsidy.

Given the skepticism that state leaders may have about limiting their own economic development tools, it may make sense to start with politically palatable, easy-to-pass restrictions. For example, a simple initial approach might prohibit subsidies designed to poach companies and jobs from other compact-member

73. For example, Tesla made several western states sign nondisclosure agreements in order to compete against each other for its proposed gigafactory. That leverage allowed Tesla to go to each state in turn and request a $500 million cash subsidy up front, implying that the state needed to sweeten the deal to stay in the running. Nevada eventually capitulated and provided Tesla with $195 million in transferable tax credits (out of a total of $1.4 billion in subsidies). But Nevada had no idea that the other states had also refused the $500 million cash subsidy request. Elkind Peter, "Inside Elon Musk's $1.4 Billion Score," *Fortune*, November 14, 2014.

states.[74] In other words, states would agree to forswear subsidies to motivate companies to move assets, operations, or property from another compact state.[75] As of winter 2020, a dozen states had already proposed such legislation.[76] If this approach works, the compact might subsequently be amended to prohibit harder-to-define subsidies or those designed to expand or retain businesses that already have a presence in a state. However, it's worth noting that interstate compact experts advise against an approach that relies on subsequent improvements, since reforms have proven difficult in previous compacts.[77]

Alternatively, an initial compact might simply prohibit some of the worst varieties of subsidies, such as subsidies for professional sports and their stadiums or subsidies for film production companies.[78]

However, an ideal compact will eventually have to apply the definition of a targeted economic development subsidy proposed earlier in this paper ("any government-granted privilege that creates exclusive economic benefits for its recipients"). Subsidies, grants, loans, and loan guarantees are relatively easy to identify. Tax and regulatory privileges, however, will be much more difficult to identify.[79]

Given the differences in tax policy between states and given that state tax codes already contain a plethora of carve-outs that would count as subsidies under a holistic definition, tax privileges may be difficult to remove. Moreover, there are honest differences of opinion about what constitutes a tax privilege.

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74. It's important to note (and we further discuss elsewhere) that firms should be allowed to write off the costs of doing business, including relocation expenses.
75. If a firm already has a nexus in both states, the agreement could prohibit subsidies to the firm for drawing down activities in one state and ramping them up in the other. The antipoaching approach would unfortunately allow many current economic development subsidies to continue. For example, a subsidy to encourage a firm *not to move* might be difficult to identify and stop.
76. The legislative language of the compacts proposed so far doesn't specifically address firms with a nexus in multiple compact states (as discussed in the previous footnote), but such an application seems reasonable given the spirit of the antipoaching clause. Aaron Davis, "States Push for Cooperation over Competition," *Tax Notes*, March 10, 2020.
77. It required multiple years to develop the reforms to the Nurse Licensure Compact and a clear motivation to expand its membership (the federal government was being urged to consider national licensure of nurses to mitigate restrictions on telemedicine created by state licensing laws). Perhaps an antisubsidy compact would be different, however, given the surge in interest the idea has produced (evidenced by the shift from 5 states introducing broad antisubsidy legislation in 2019 to 14 states introducing similar legislation as of winter 2020). Jeffrey B. Litwak, consultation with the authors, March 18, 2020.
78. Dennis Coates, "Growth Effects of Sports Franchises, Stadiums, and Arenas: 15 Years Later" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, September 2015).
79. See other research for more specific definitions of what constitutes a targeted subsidy. Schlomach, Slivinski, and Hohman, *Multilateral Disarmament*, 24; Distorting Subsidies Limitation Act of 1999, H.R. 1060, 105th Cong. (1999).

For example, progressivity in the tax code is likely to be an area of controversy. A clear argument could be made that different marginal tax rates subject otherwise similar companies to unequal *effective* tax rates, creating a privilege for some companies. In our view, each city's and state's policymakers should strive for uniformity in their local business taxation. This is important because a neutral tax code, in which all companies face the same tax rate on all interest, dividends, and profits, provides the least opportunity for privilege-seeking.

However, some readers may object to the idea that a lower marginal tax rate on lower levels of income constitutes a subsidy. Therefore, at least as a first step, the compact should strive for horizontal equity in the tax code, requiring individuals and firms with similar incomes and assets to face the same rates of taxation within the jurisdiction of each state or municipality.[80]

To be clear, this is not an argument for a tax cartel wherein all taxing authorities adopt identical tax rates or brackets.[81] Interstate and intercity competition on tax rates and public services is critical to providing a diverse environment that addresses differences in residents' preferences concerning the tax–public services tradeoff. Stated another way, locally determined tax rates and public services help to ensure that local taxes and public services reflect the preferences of residents, rather than incorporating the preferences of the residents of other states and cities.

Despite the likely difficulty in achieving consensus, establishing an all-encompassing definition that prohibits all forms of preferential treatment is critical to the long-run effectiveness of a compact because political entrepreneurs will be motivated to search out ways to circumvent half-hearted attempts at reform.

7.3. Definition of What Is Not a Targeted Subsidy

It may be just as important for compact framers to come to an agreement about what is *not* a targeted subsidy. We argue that tax provisions that are designed to

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80. A simpler approach, though more politically difficult, would be to repeal corporate income taxes in total. Objectively speaking, the corporate income tax is an inefficient, inequitable, and volatile source of government revenue. Reforms suggested by economists Robert Hall and Alvin Rabushka would result in tax policy that is less economically harmful: corporations should pay taxes on interest, dividends, and profits, while individuals should pay taxes on earnings. This way, income would be taxed only once. However, these concerns—and related tax reforms—fall outside the scope of the current discussion, and we present them here only for completeness. Robert E. Hall and Alvin Rabushka, *The Flat Tax*, 2nd ed. (Stanford, CA: Hoover Institution Press, 1995).
81. Richard E. Wagner and Akira Yokoyama, "Polycentrism, Federalism, and Liberty: A Comparative Systems Perspective" (Working Paper No. 14-10, George Mason University Department of Economics, 2014).

prevent or lessen the problem of double taxation should not be considered subsidies. These include provisions that exclude business-to-business transactions from taxation, those that allow companies to write off the cost of doing business (e.g., the cost of production inputs), and those that permit lower tax rates on capital income.[82]

Public finance scholars are in broad agreement that business-to-business transactions should not be taxed. This ensures that the same economic value cannot be taxed multiple times as it makes its way through the chain of production. If business-to-business transactions are taxed, on the other hand, it results in a problem known as tax pyramiding, whereby final products or services can face an effective tax rate that is higher than the statutory rate because the system imposes taxes upon taxes.[83]

Relatedly, good tax policy allows firms to write off the costs of doing business. These write-offs should not be considered tax privileges, because failure to account for the cost of producing goods and providing services introduces inequities to the tax code by requiring differently structured businesses to pay the same amount of tax.[84] For example, if a firm makes $100,000 in revenue but must spend $40,000 on inputs in order to make that $100,000, then it should be taxed on the net income of $60,000. This is very different from the situation of a firm that spends $90,000 on inputs and makes the same $100,000 in revenue, achieving a net income of only $10,000. Taxing each firm on the basis of its revenue would be equivalent to requiring someone earning $10,000 per year to pay the same amount of tax as someone earning $60,000 per year.[85]

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82. We understand that the way we answer the question of what constitutes a subsidy is likely to differ from the way others might answer it. For example, other recent interstate compact research suggests another, albeit similar, definition. Schlomach, Slivinski, and Hohman, *Multilateral Disarmament*, 24.

83. Ironically, taxing business-to-business transactions can actually create an indirect privilege benefiting vertically integrated firms, whose internal transactions are untaxed.

84. Taxing only profits also avoids disproportionally burdening firms that are heavily investing in building their capacity to serve customers compared to firms that have already built their business infrastructure. This implicit privilege inhibits the ability of new, growing companies to effectively compete with established corporate giants. Such restrictions on competition result in wide-ranging economic inefficiency and reduce innovation.

85. Failure to allow businesses to subtract their costs from revenue when taxing profits can have substantial unintended consequences, such as inhibiting businesses from investing in more productive technology—leading to slower economic development—or motivating them to switch to labor-saving technology more quickly than they otherwise would, leading to unexpected job losses. An innovation-friendly tax system is neutral enough to allow companies to experiment with different production technologies without facing tax consequences for doing so.

Lastly, lower tax rates on capital income (as long as they are applied to all businesses) should also not be considered subsidies. A lower capital tax rate is simply one way to lessen the problem of double taxation, since capital income was already taxed when it was initially earned.[86] It's more appropriate to treat income from capital as business income, and tax it equivalently.[87]

Our intent here is not to resolve these issues, but to identify elements that will need to be resolved by the framers of an interstate compact (and to state the obvious: that this will be no easy task).[88]

7.4. Rules for How and When the Compact Takes Effect

The compact must also address the process by which it will take effect. Our current preference is for a two-stage trigger clause, with the compact initially applying mutually beneficial subsidy restrictions (such as the previously discussed antipoaching clause) to member states as they join. The compact would take full effect once a certain number of states have joined.[89] After this second trigger, no compact-member states or local governments in compact states would be allowed to offer any subsidies to any companies.

The two-step approach would minimize the perception among policymakers that joining the compact would be akin to unilateral disarmament. As more states join the compact, the member states would benefit from increasing protection from poaching. Meanwhile, as the number of states outside the compact dwindles, the nonmembers would become greater targets for such poaching because the compact states would not be able to target one another. When only one state is outside the compact, the other 49 will only be able to use their subsidy programs to poach from the holdout, providing a strong incentive for the holdout to join the compact.

It is not clear how many states should need to join before the second stage is triggered. The larger the number, the less the compact will look like unilateral

86. For a simple illustration, see Steven Landsburg, "Getting It Right," *The Big Questions: Tackling the Problems of Philosophy with Ideas from Mathematics, Economics, and Physics*, September 14, 2010.
87. As we mentioned in an earlier note, the reforms suggested by Robert Hall and Alvin Rabushka would result in less economically harmful tax policy: corporations should pay taxes on interest, dividends, and profits, while individuals should pay taxes on earnings. This way, income would only be taxed once. Hall and Rabushka, *Flat Tax*.
88. The intellectual exchange on this topic will be critical to the discussion-and-debate process of policy reform. We look forward to others' feedback.
89. The specific number of states needed to trigger the full enactment of the compact is currently a matter for intellectual discussion. No compact thus far has had a trigger clause larger than 35. Jeffrey B. Litwak, consultation with the authors, March 18, 2020.

disarmament. On the other hand, if all 50 states must join in order for the compact to take full effect, a few states or even one stubborn holdout could prevent the compact from coming to full fruition. Ratification of the US Constitution offers a historical precedent: It took effect among ratifying states once 9 out of 13 colonies ratified it. If we applied this 70 percent rule today, the interstate compact would take full effect among the signatories once 35 states joined. Alternative trigger clauses could be based on similar percentages of national GDP, population, or the proportion of total economic development subsidies offered (although this is difficult to accurately measure). These alternative triggers might substantially reduce the number of states needed to sign on to enact the compact, since the same 70 percent metric could be triggered by only 16 states (share of GDP), 20 states (share of population), or 12 states (share of estimated total value of subsidies).[90] The second stage of enactment could even have multiple such triggers, depending on which supermajority affirmation occurred first.

Border-based compacts offer another option. A border-based trigger clause would activate when a sufficient number of bordering states have signed on to the compact. Small, regionally focused compacts could be aggregated into a larger compact over time. For example, the southwestern states could enter into a compact with each other specifically, and eventually merge with a Great Plains Compact and a Midwestern Compact. Bistate and regional compacts could also focus on addressing specific subsidized industries, such as the oil and gas refining industry in Texas and Louisiana, which commonly play the states off one another to extract greater subsidies.[91]

If an all-in-one approach is deemed politically infeasible, an alternate approach might be to start with a limited-focus compact, such as a prohibition of sports or film subsidies.[92] It might be easier to get states to agree to stop the wasteful competition over those industries, which clearly leverage their ability

90. Thomas, "State of State and Local Subsidies."
91. Richard Fausset, "A School Board Says No to Big Oil, and Alarms Sound in Business-Friendly Louisiana," *New York Times*, February 5, 2019; Naveena Sadasivam, "Texas' Largest Corporate Welfare Program Is Rapidly Ballooning," *Texas Observer*, February 13, 2017; Luana Munoz and Bill Fuller, "Caddo Faring Better after Reforms to Industry Tax Exemption Program," *KTBS 3*, January 2, 2020.
92. These industries arguably represent the worst use of targeted economic development subsidies, and are better able to play states off against each other because of the portability of their operations. Michael D. Farren and Austin Fairbanks, "Hit Film 'Joker' Cost New Yorkers $9.9 Million. Looks Like the Joke's on Taxpayers," *USA Today*, January 29, 2020; Michael D. Farren and Anne Philpot, "NFL Kickoff Game Showcases Right Way to Play Football," *InsideSources*, September 10, 2019; Michael D. Farren and Anne Philpot, "End Taxpayer Subsidies for Sports Stadiums," *Miami Herald*, January 29, 2019.

to move to different destinations to extract the maximum subsidies possible, and which produce some of the worst returns on investment in terms of long-run local economic development.[93] Such a compact could also create an advisory board, as described later in this essay, which would be tasked with supporting adoption of the compact and developing expansions of the compact to eventually include all targeted subsidies.

In short, there's no reason why the solution to the subsidy arms race has to start with an all-in-one solution, if the aggregated local and specific compacts can have the same effect (or else make the eventual case for a final all-in-one compact). But because future reforms to expand an initially limited compact may be difficult, each regional or industry-specific compact could also contain a two-stage trigger clause, with the second stage being complete "disarmament" once every state has signed onto at least one such compact.

A reasonable question is whether a trigger clause is even necessary. Given the harm that economic subsidies cause to the local economy, shouldn't states be eager to get rid of them, even unilaterally? But simple observation suggests that despite extensive, high-quality evidence that subsidies fail to achieve their presumed goals, and that their effect may well be harmful on net, state policymakers do not appear eager to discontinue the practice (at least under current conditions). A reasonable analogy might be the trend toward trade liberalization that occurred in the 20th century through the General Agreement on Tariffs and Trade and World Trade Organization.[94] Although there was a similar consensus about the clear benefits of trade liberalization, even from a unilateral perspective, many countries were slow to join these trade deals. Some research has found that diplomatic ties were more important than pure economic reasoning in explaining which nations joined and when.[95] This experience suggests that

93. Coates, "Growth Effects of Sports Franchises"; Robert Tannenwald, "State Film Subsidies: Not Much Bang for Too Many Bucks" (report, Center on Budget and Policy Priorities, Washington, DC, December 9, 2010); Scott A. Wolla, "The Economics of Subsidizing Sports Stadiums," *Page One Economics*, May 2017; Mark Robyn and Harry David, "Movie Production Incentives in the Last Frontier" (Special Report No. 199, Tax Foundation, Washington, DC, April 2012).
94. "The GATT Years: From Havana to Marrakesh," World Trade Organization (website), accessed March 15, 2020, https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact4_e.htm; "The 128 Countries That Had Signed GATT by 1994," World Trade Organization (website), accessed March 15, 2020, https://www.wto.org/english/thewto_e/gattmem_e.htm; "Members and Observers," World Trade Organization (website), accessed March 15, 2020, https://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm.
95. Christina L. Davis and Meredith Wilf, "Joining the Club: Accession to the GATT/WTO," *Journal of Politics* 79, no. 3 (July 2017): 964–78.

regional or industry-specific compacts, which build on existing relationships between the states, may be a useful way forward.

7.5. Rules for Compact Enforcement

The critical issue of compact enforcement is how to motivate states to avoid returning to the prisoner's dilemma. Economically, this idea is known as a "reciprocity rule" that encourages every player in the game to choose to "cooperate."[96] It requires altering the structure of the payoffs (see section 4) or altering the set of choices that states are able to select from (which is difficult to preempt, and often requires legal challenges to prove that rules have been broken), or both.

Tasking specific agents with the responsibility to enforce the compact will help ensure that the structures supporting the reciprocity rule, such as a requirement that states follow a nondiscrimination rule in how they treat businesses, are maintained. But because future politicians may not want to adhere to the compact and may try to undermine enforcement, we suggest some means of additional, third-party monitoring and enforcement.

In particular, it seems critical to create legal standing for taxpayers in compact states to be able to bring suit against states that offer subsidies.[97] The current lack of legal standing derailed a previous opportunity to address the subsidy arms race. In 2005 the Supreme Court ruled in *Daimlerr Chrysler Corp. v. Cuno* that taxpayers did not have standing to sue when states and cities granted subsidies.[98] Similarly, third parties have faced difficulty in attempting to enforce a compact, and the creation of explicit legal standing would help.[99]

Additionally, we recommend empowering taxpayers to bring suit against the companies that receive subsidies to recapture the value of subsidies that have been provided in violation of the compact. The idea is similar to University of Minnesota economist Art Rolnick's proposal that Congress reform the tax code

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96. Francesco Parisi and Nita Ghei, "The Role of Reciprocity in International Law," *Cornell International Law Journal* 36, no. 4 (2003): 99.

97. Schlomach, Slivinski, and Hohman, *Multilateral Disarmament*.

98. DaimlerChrysler Corp. v. Cuno, 547 U.S. 332 (2006); Brannon P. Denning, "*DaimlerChrysler Corp. v. Cuno*, State Investment Incentives, and the Future of the Dormant Commerce Clause Doctrine," *Cato Supreme Court Review*, 2006, 22; Kristin E. Hickman, "How Did We Get Here Anyway? Considering the Standing Question in *DaimlerChrysler v. Cuno*," *Georgetown Journal of Law and Public Policy* 4, no. 47 (2006): 27; Kristin E. Hickman and Donald B. Tobin, "Taxpayer Standing and *DaimlerChrysler v. Cuno*: Where Do We Go from Here?" (Special Report, Tax Notes, February 20, 2006); Schlomach, Slivinski, and Hohman, *Multilateral Disarmament*, 21.

99. Litwak, *Interstate Compact Law*, 399; Jeffrey B. Litwak, consultation with the authors, March 18, 2020.

to apply a 100 percent tax rate to all such subsidies.[100] Doing so would reduce the incentive for companies to pursue subsidies in the first place by creating a profit motive for deputized enforcement. In essence, the idea is to create a market for enforcement to encourage entrepreneurs to help police the problem of economic development subsidies.

Lastly, in all legal cases between states, the US Supreme Court has original jurisdiction (assuming that the states have requested permission to bring the case).[101] It is under no obligation, however, to exercise this jurisdiction, and so it is possible for compact cases to be tried in other courts. Therefore, it seems important to stipulate that compact-related court cases be heard in federal court to ensure a neutral ground to decide the cases. Previous experience with interstate compact suits has shown that state courts can inappropriately side with the state's interest rather than rule according to what interstate compact law would suggest.[102]

7.6. Penalties for Breach of Contract and Dispute Resolution

A compact state that fails to live up to its obligations will have to face some sort of penalty.[103] The appropriate penalty needs to be strong enough that it will deter states from cheating and offering subsidies, but not so strong that it will dissuade states from signing on to the compact in the first place. This is an area of continuing research and we welcome suggestions about what would be ideal as well as politically palatable.

Any penalty for violating the compact should be known well in advance and be commensurate with the size of the infraction in order to decrease the motivation to betray the other states in the first place. In some other interstate compacts, states have agreed to pay fines in the event that they are found to be in breach of the agreement.[104] Ideally, such fines would be equal in size to the economic damage done by the subsidies, though that can be difficult to determine with precision. A more practical approach would be to require a state found to be in violation of the compact to pay the value of the subsidy to every other state, resulting in a large but appropriately intimidating fine.

100. Rolnick, "Congress Should End the Economic War"; Distorting Subsidies Limitation Act of 1999, H.R. 1060, 105th Cong. (1999).
101. Arizona v. California, *cert. denied*, 589 U.S. ___ (2020) (Thomas, J., dissenting); Litwak, *Interstate Compact Law*, 202.
102. Buenger et al., *Evolving Law and Use of Interstate Compacts*.
103. See *Kansas v. Nebraska*, 135 S. Ct. 1042 (2015), and *Montana v. Wyoming*, 138 S. Ct. 758 (2018), for examples.
104. Buenger et al., *Evolving Law and Use of Interstate Compacts*, 256.

Penalties might instead be designed to counter the perverse political incentives that give rise to subsidies in the first place. For example, a violating state might, for a period of time or up to a certain dollar amount, lose the right to dispute other states' subsidies that poach its firms.[105] But allowing states to engage in bad behavior to punish bad behavior should probably be thought of as an absolute last resort. Normalizing the idea of retaliation could destroy the norms against granting subsidies built up over time by compact adherence, leading to a return to the subsidy arms race the compact was intended to end.[106]

Compacts also commonly provide mechanisms for dispute resolution that help avoid litigation. This can provide the parties with a less costly way to come to mutually beneficial terms. An interstate agency might facilitate the resolution (see the Compact Governing Board subsection below), or an arbitrator might be appointed to negotiate a settlement. This approach is similar to the approach the World Trade Organization uses in trade disputes between nations. However, an interstate compact offers external enforcement mechanisms through the court system and the federal government (if congressional consent is given to the compact), which are not available to settle World Trade Organization disputes.

Because of the perverse political incentives created by subsidies and the ability to offer them, it may be necessary for the compact to specifically forbid certain types of resolutions that might be counterproductive. For example, one could imagine an arbitrated resolution in which the governors of two states allow one another to use subsidies.[107] Arbitrated resolutions of this nature would obviously have to be forbidden to ensure the compact does not devolve until it exists in name only.

7.7. Rules for Compact Exit

Another important question to address is the procedure by which a state may exit the compact. Some recent compacts, such as the Nurse Licensure Compact, have included clauses allowing states to unilaterally exit the agreement with some

105. This strategy would be similar to the process used to resolve international trade disputes at the World Trade Organization.
106. For example, current events suggest that the broad international consensus leading to freer trade and more open markets may be slipping. "Trump's Muscling Has WTO Legal System on the Brink," *Law360*, November 8, 2019; Bryce Baschuk, "U.S. Wielding Budget Ax Sends Shudders through World Trade Watchdog," *Bloomberg*, November 13, 2019; Saheli Roy Choudhury, "India Says No to Joining Huge Asia Pacific Trade Pact," CNBC, November 5, 2019.
107. Such an agreement would be analogous to voluntary export restraint agreements in international trade. Under such agreements, one country will restrict its own exports in exchange for another country restricting its own exports.

advance notice to other compact states. Other compacts, such as those addressing state borders, are clearly meant to be perpetual and may only be exited or revised with the full agreement of the compact members. A compact to end the interstate subsidy war would seem to fit better in the latter group. It is difficult to think of a good reason why states should want to allow themselves to restart this wasteful conflict.

However, if the ability to exit is deemed important enough to include in the compact, it should be difficult to exercise. A multilateral exit clause is one option, wherein a state could request other compact members' permission to exit the compact. Such a requirement could be modeled after the procedure for amending the US Constitution, requiring an affirmative vote by a supermajority of other compact states.

Alternatively, if a unilateral exit clause is deemed necessary, it should include a long delay—equal at least to the length of the longest statewide term of office—so that the entire group of politicians who exercise the exit option must face reelection before they are able to benefit from offering subsidies again.[108] A long delay (or similar restriction) would ensure that current policymakers can't hurriedly exit the compact when the next major interstate economic development competition like Amazon HQ2 comes along. Utah's proposed interstate compact incorporates this idea by requiring four years' advance notice before a party may exit the compact.[109] Regardless of the specific mechanism adopted, the inability to easily exit the compact would diminish specific companies' ability to hold such subsidy-based competitions in the first place.

7.8. Compact Governing Board

Lastly, if drafting and passing an ideal compact at the outset (rather than a flawed interim compact) is politically impractical, a simpler and more palatable compact could be developed that contains an advisory board. The purpose of the board would be to study the compact's effectiveness, educate policymakers about the benefits of the compact, and suggest further reforms as they become politically feasible.

108. Research suggests that the US political system and the lack of objective performance metrics may cause voters (and, by consequence, politicians) to have relatively short time horizons. Adam M. Dynes and John B. Holbein, "Noisy Retrospection: The Effect of Party Control on Policy Outcomes," *American Political Science Review* 114, no. 1 (February 2020): 237–57.
109. Interstate Compact for Economic Development, H.B. 270, 2020 Gen. Sess. (Utah 2020).

Some compact boards are solely advisory. The Nurse Licensure Compact follows this model. Other compact boards are independent regulatory agencies, invested with a portion of the compact states' authority to make policy changes to the areas that they administer. The Midwestern Higher Education Compact is one such entity with independent governing authority.[110]

On one hand, if the board's impartiality could be ensured, a governing board vested with authority to decide what constitutes a targeted subsidy could provide a valuable check to states and cities attempting to slide back toward offering subsidies. On the other hand, an independent governing board with authority to make policy could be an attractive target for those who stand to gain from subsidies. This might make it liable to capture.[111]

This possibility highlights the most important consideration for any compact board: it needs to have a clear mission and explicit restrictions enshrined in the compact's legislative text to prevent its authority from being captured to serve special interests—whether those be the interests of private companies, of individual states, or of the board members themselves.[112] Otherwise the board could suggest revisions to the compact that would water it down. It could potentially even make the subsidy arms race worse by becoming an institution that validates the use of subsidies.[113]

8. CONCLUSION

Economic development subsidies have been around since before the United States was founded, and unfortunately the problem has worsened in recent decades. A broad body of academic research clearly shows that, contrary to the

110. Midwestern Higher Education Compact (website), accessed March 16, 2020, https://www.mhec.org/.
111. George J. Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science* 2, no. 1 (April 1971): 3–21; Ernesto Dal Bó, "Regulatory Capture: A Review," *Oxford Review of Economic Policy* 22, no. 2 (June 2006): 203–25; Brink Lindsey and Steven Teles, *The Captured Economy: How the Powerful Enrich Themselves, Slow Down Growth, and Increase Inequality* (New York: Oxford University Press, 2017).
112. Notably, the Waterfront Commission of New York Harbor has struggled with accusations that it engaged in the same corrupt behavior it was intended to remedy. Ralph Blumenthal, "Panel Meant to Keep New York Docks Clean Was Dirty, Report Says," *New York Times*, August 11, 2009; Tom Robbins, "Whistleblowers on the Waterfront," *Village Voice*, September 15, 2009.
113. Unfortunately, this exact problem previously occurred when Congress attempted to end the federal subsidies for sports stadiums in the 1986 tax reforms. The attempted solution actually made the problem worse. Michael D. Farren and Anne Philpot, "Congress Fumbles Tax Fix to Stadium Subsidies," *InsideSources*, January 3, 2018; Thomas J. Lueck, "Moynihan's Tax-Break Bill Could Foil Dreams of Fields," *New York Times*, July 14, 1996.

claims made by consultants, most subsidies do not improve economic development. In fact, targeted subsidies are more likely to *reduce* long-run economic growth than to enhance it.

Unfortunately, there is widespread public misunderstanding of subsidies, and as a result, policymakers face strong incentives to continue offering them. This divergence between what is economically efficient and what is politically expedient leads to a prisoner's dilemma whereby policymakers continue a self-destructive subsidy war.

Although there are several policy instruments that could address this problem, an interstate compact offers a politically feasible option for a long-term solution. There appears to be strong interest in this idea, given that five states introduced compact legislation in 2019, followed by nine more in 2020. Policymakers would be wise to explore this opportunity, because genuine economic development depends on it.

APPENDIX: THE PRISONER'S DILEMMA

The classic prisoner's dilemma scenario involves two criminals in police custody. The criminals were partners in two crimes, one of which carries a long sentence and one a short sentence. However, the police only obtained evidence connecting the criminals to the lesser crime. The prosecutor approaches each criminal individually and separately and offers a deal. If prisoner A betrays prisoner B, prisoner A will avoid the punishment for the lesser crime in exchange for cooperation, while prisoner B, who kept mum, receives the combined prison sentence for both the greater and lesser crimes. If both betray each other, they will each receive the prison sentence for the greater crime, but avoid adding on the shorter prison sentence for the lesser crime.

As far as the criminals are concerned, the optimal outcome would be for both to keep mum about their crimes and accept the short prison sentence for the lesser crime. But if the criminals do not trust one other, each fearing the other will confess in order to avoid prison completely, both will take the deal and receive the longer prison sentence for the greater crime. The lack of mutual trust (or, equivalently, the inability to credibly commit to cooperation), the structure of their choices, and the payoffs from those choices mean that each criminal's best option is to betray rather than to keep mum, even though that leads to a worse outcome for each compared to cooperating with one another and staying quiet.

Figure A1 shows how these choices and payoffs are represented in a game theory matrix. The rows reflect prisoner A's choices ("cooperate" vs. "betray") while the columns reflect prisoner B's choices (which are identical). Each quadrant shows each prisoner's payoffs arising from the confluence of their choices, and the shaded quadrant indicates the logical conclusion of the game.

FIGURE A1. THE PRISONER'S DILEMMA

		prisoner B	
		cooperates	betrays
prisoner A	cooperates	B payoff: short prison sentence A payoff: short prison sentence	B payoff: no prison sentence A payoff: short + long prison sentence
	betrays	B payoff: short + long prison sentence A payoff: no prison sentence	B payoff: long prison sentence A payoff: long prison sentence

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