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# 1 Introduction

## The Global Competition for Capital Meets Local Politics

Kansas City, Missouri, may sound like an unconventional place to begin examining the dynamics of the global competition to attract investment. Despite the city's warm Midwestern feel and its location near the geographic center of the United States, it has recently become embroiled in intense economic warfare. The opponent in this fiscal battle is not a major US metropolis or a booming, emerging market like India or Brazil, but is actually the city's namesake – Kansas City, Kansas. Separated only by a porous, artificial state division, the two cities are locked in an intense border war for millions of dollars in investment generated by the relocation of foreign and domestic companies. The primary arsenal in the battle is the multitude of location-specific incentives targeted at foreign and domestic investors. What are these "incentives" that have fueled the conflagration and why did the two Kansas Cities rely so heavily upon them? These are the questions we take up in the pages below.

Throughout this book we use the broad definition of incentives to cover a wide range of policies targeted at individual firms, which critics refer to cynically as "corporate welfare." We base our definition of incentives on the United Nations Conference on Trade and Development (UNCTAD), which describes incentives as "measurable advantages provided by government to particular companies or groups of companies with the goal to force them to behave in some way."[1] In most cases, we examine incentives aimed at shaping the location of a firm's investment projects, which can include: a new project, an expansion of an existing plant, or the retention of an existing company that considered relocating to another administrative jurisdiction.

Incentives can be discretionary allotments, including "deal-closing funds," such as the Texas Enterprise Fund (TEF), which provides cash incentives to attract new investments. Other incentives can be statutory, providing incentives to any firm that qualifies for government support. In most cases, such as the Promoting Employment Across Kansas (PEAK)

[1] UNCTAD (1996, 11) cited in Tavares-Lehmann (2016, 17).



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and Missouri Quality Jobs Program, discussed in the border war above and described in more detail in Chapters 4 and 9, the programs are a mixture of statutory requirements to qualify for incentives and discretion regarding which firms receive incentives and how much money they are worth. Only some firms qualify for incentives, and within this subset of firms, politicians ration the allocation of tax credits, cash, or other benefits. Central to our definition, however, is that these benefits are precisely targeted at some firms, and are not general economic policies which bestow benefits on all companies like broad-based corporate tax reductions or infrastructure rollouts.

As we discuss in more detail in Chapter 4, one of the most common types of incentives is providing tax relief to individual firms, while maintaining generally higher rates on the books. Such relief usually takes the form of exemptions from national taxes, common in developing countries to reductions in state and local taxes, which comprise the majority of incentives in the United States. Countries, states, and local governments also provide additional incentive types, including worker retraining grants, relocation funds, free or highly subsidized land, and infrastructure improvements.

Comparing these widely varying forms of incentives has its challenges, yet the common theme across all incentive programs is that government officials allocate scarce resources or forgo vital future tax revenue to attract, retain, or promote the expansion of a small number of firms. In the United States, competition across states, counties, and cities have led to a proliferation in the amount and an escalation in the volume of these programs.

The competition has grown so intense in the Kansas Cities that the twins were the subject of an exposé on investment incentives by the *New York Times* (Story 2012), which suggested that the area was one of the best examples in the United States of the socially costly competition for investment. Indeed, the article claimed that these incentives did little more than subsidize companies to shift back and forth across the border. Our own data analysis in this book finds that from 2010 to 2012, no less than sixty-seven companies in the Kansas City border war received a total of $312 million dollars in tax reductions and other targeted inducements, such as land clearance or infrastructure outlays, to either remain on, or relocate to, one side of the state line.

Counted among the border jumpers is Applebees for its 2011 decision to move its corporate headquarters and 390 jobs to Missouri from Kansas after receiving $12.9 million in investment from the Kansas City Development Corporation (*Wichita Eagle* 2011). Those 390 jobs were soon whittled down to ninety, however, as the family restaurant chain

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abandoned the Kansas City metro entirely for the warmer climate of Glendale, California, in 2015 (Davis 2015). Importantly for our arguments in this book, Glendale did not offer Applebees any incentives at all to induce this last move (Masunaga 2015). The city cut some red tape, but the relocation was entirely driven by a broader consolidation exercise of DineEquity – Applebee's parent company – which sought to move the marketing, operations, and culinary departments closer to those of the International House of Pancakes, DineEquity's other major chain (Davis 2015).

Applebees is one example of a broader phenomenon of sizable economic development incentives that appear to have little impact on firms' location decisions or longevity. Many of the "incentivized" firms in the border war were planning to expand their business anyway, and the majority of the "new" firms to the area simply shifted their mailboxes a few miles across the border. Civil and company leaders have signed a letter to both governors to stop the fruitless battle, but to no avail (Greenblatt 2011). The states of Missouri and Kansas continue to provide generous incentives to firms, despite scandals,[2] general criticism, and obvious uncertainty over the effectiveness these programs. James Sly, the mayor of Kansas City, Missouri, reflecting on the 2015 Applebees relocation, stated publicly that he hoped the company's exit would convince Kansas officials that the border war has only cost both cities revenue while having little impact on their economies (Davis 2015).

## 1.1 Incentives over Time and Across Borders

The Kansas City imbroglio is only one recent example of the politics of incentives. Investment incentives are sometimes more broadly referred to as place-based economic development policies. As we noted above, they differ from other tax and infrastructure policies in that they are targeted to individual firms, or some subset of firms.

For example, numerous US locations provide tax abatements from state and local taxes as a means of encouraging new businesses. Governments simply forgo potential revenue to encourage local economic activity by reducing corporate income tax (CIT) rates, forgoing tax penalties, or offering rebates on previous payments. Tax abatements, while common, are only one form of economic development. Tax holidays allow firms to avoid payment of taxes, most commonly CIT or property taxes, for a

[2] One example is the Mamtek scandal in Missouri, where an artificial sweetener plant was awarded millions in incentives from Missouri only to declare bankruptcy and default on their economic development bonds (Hancock 2011).

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specified period of time while they start up operations. Another controversial incentive approach, tax increment financing (TIF), provides a subsidy, often in cash, and finances the payment through future tax revenues. These are similar to another incentive called industrial revenue bonds, whereby governments essentially issue debt to provide incentives to firms or subsidize firm-specific infrastructure or land clearance. Throughout this book we will provide myriad examples of the vast array of incentives offered by governments. Central to all of the incentives is that they are a type of private good that by design benefits favored recipients and excludes others.

Investment incentives are not new. The first documented investment incentive package dates back to 1160, when Italian local governments bid for a textile production facility (Wells et al. 2001). Fast-forwarding a few centuries, the first documented incentive in the United States was New Jersey's luring of Alexander Hamilton's manufacturing company in 1791 (Bernstein 1984). Yet, a concern remains that the implementation of incentives has grown in recent years in regards to frequency, cost, and the types of government offering incentives.

The United States has some of the most transparent incentive programs in the world, and the increasing use of sizable incentives is obvious.[3] Individual American states have also provided some of the globe's most generous incentive programs, including at least seventeen packages of over $100 million each over the past ten years (Thomas and Wishlade 2009). Many of these incentives have focused on luring auto producers, so it is fitting that one of the largest of these programs was Alabama's purportedly successful wooing of a Mercedes-Benz plant at the cost of over $200,000 per employee (Moran 1998). New laws are in the pipeline, with a number of US state legislatures debating further changes in incentive programs (Hickey 2013).

Less well known is the aggressiveness of cities and counties in offering incentives to firms. In 1999, 68% of US cities, and most US states, used their own financial incentives to attract capital. This number skyrocketed to 95% of US cities in 2009.[4] While the total number of incentives to firms probably peaked in the early 2000s, the rise of "megadeals" has further increased the resources spent on US incentive programs (Mattera et al. 2013).

[3] US states are generally subject to Freedom of Information requests on their incentive policies. Many of these states have elected to provide information about their incentive allocations in annual reports and on the websites of state economic development agencies. Local governments are less transparent, although a 2015 policy change by the Government Accounting Standards Board has the potential to dramatically increase the transparency of these incentives. We discuss this policy change in Chapter 9.

[4] We discuss this data source in more detail in Chapter 4.

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Incentive use is not confined to the United States. Li (2006) systemically documents incentive programs with his analysis of fifty-eight developing countries. Similar to the United States, evidence shows that the global use of incentives is increasing over time.

An UNCTAD study (2002) demonstrates that thirty to forty *new* incentive programs are created each year across the globe. In one of the most systematic treatments on the topic, Klemm and Van Parys (2012) examine the difference between the statutory tax rate and the "best rate" that is applied to an incentivized sector or individual investment in a large sample of countries. Although the statutory corporate tax rates remained reasonably stable from 1996 to 2007, the difference between the statutory rate and the best rate stood at 5% in 1996 and increased to 8% in 2007.

Our own database of incentives, largely documenting US programs, averages over 3,000 packages per year. One of the larger deals outside of the United States was made by the Abu Dhabi government in 2012, when it offered a $100 million incentive deal to the bankrupt Digital Domain Media Group in an effort to establish a major film studio in the United Arab Emirates. In 2011, Nissan received a fifty-year, $5 billion tax credit for their investment in Rio. As we discuss later in this book, Boeing's incentive to produce the 777X in Washington State amounts to almost $9 billion. While these deals attract international attention, far more common are incentives offered in the range of a couple million dollars.

## 1.2 Political Pandering: Up and Down

What explains the use of incentives as an economic development policy? In this book we argue that incentives, while economically inefficient, give politicians the opportunity to *pander* to voters. We suggest that politicians and voters operate in asymmetric information environments, wherein policy-makers have a better understanding of the optimal policy choices than their constituencies. Tullock (2005, p. 231) famously argued that ignorance regarding highly technical policies, like economic development incentives, is rational for busy voters who never will experience the true costs of the giveaways. As he put it, "The representatives are normally much better informed than the voters, in fact better informed than the voters could be expected to be." In these situations, politicians have an incentive to pander by choosing the policies that are popular even if they are not in the voters' direct interests (Maskin and Tirole 2004; see also Caplan 2007).

In this book, we argue that incentives are the perfect pandering tool. If a firm is going to locate in a politician's district regardless, what better way

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for the politician to claim that he or she was pivotal in the decision than to hand over a check to the firm at a ribbon-cutting ceremony. If the firm is not going to move, no matter what, the politician might as well offer a huge incentive package to show voters that everything possible was done to attract the project.

Indeed, no other policy lever available to politicians can play these key credit-claiming and blame-avoiding roles in the eyes of voters – not even the factors that have been found to have the most sizable influence in statistical models of investment attraction. Proximity to sizable markets is important for attracting investors, but no matter how hard they try, the politicians representing the warring factions in the Kansas City border war cannot move their states any closer to Los Angeles. Politicians may advertise their support for educational reform, but the human capital that investors seek is in the eighteen- to forty-year age range. Changes in primary and secondary school standards will have little impact on human capital stock for an investor currently considering a move. Politicians are stuck with the labor force groomed by their predecessors. Infrastructure and local market size have the same problem. They are important for investment but require medium-term investments that cannot pay off quickly enough to claim credit for an immediate investor's decision. One tool in the box that can be used immediately is incentives. Whether or not they actually pull in investment, they serve a more important political purpose: an incentive directly attaches a politician's name to the new investment project.

Using survey evidence and actual allocations of incentives, we demonstrate in this book that politicians overuse incentives for electoral reasons and that offering incentives is a dominant strategy. It pays to offer incentives whether or not a politician believes that the investor is coming, and whether or not the incentives matter at all in the location decision.

Of course, our theory is not the only story. There are a number of possible explanations for the ubiquitous use of incentives, but upon closer examination, they all fail to provide critical pieces of the puzzle. To simplify, we can group these alternative explanations into two categories: (1) corruption and campaign contributions, and (2) a "race-to-the-bottom" competition for capital, whereby state regulations and taxes continually erode as they attempt to best each other in creating favorable investment environments.

The most popular explanation for escalating incentive activity is that corrupt politicians are simply exchanging campaign contribution dollars for hard-working taxpayers' money; however, our statistical analysis of the PEAK program suggests a different pattern. Only four of the sixty-seven companies provided contributions to the governors' reelection

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campaigns in 2010 and 2012; and in total, employees of these companies contributed only a tiny amount to all state-wide political races in Missouri and Kansas. While the average investment incentive was upward of $4 million, the average total campaign contribution from recipient firms was less than $3,000. This limited involvement of firms in the provision of campaign contributions is consistent with research that has found little evidence of quid pro quo exchanges of campaign contributions and favorable policies (Ansolahebere et al. 2003).

Despite statistical evidence, we cannot definitively rule out an exchange of incentive contracts for political favors. Interest groups can be creative in their approaches to financing campaigns in the United States, ranging from funneling money to parties or to governors' associations, or through various political action committees. There is also the possibility that the quid pro quo is not intended for an election campaign but for an elected politician's wallet. At least one study has found a relationship between a city's use of incentives and federal corruption convictions. It remains unclear, however, whether convictions are a sign of greater corruption or greater efforts to combat it (see Felix and Hines 2013). At the end of the day, there are numerous potential exchanges and not a lot of hard evidence for any one of them. Thus, we argue that an alternative political process is a more likely explanation for the incentive wars.

A second popular explanation is that the rising use of such incentives is an example of mobile capital that is pitting governments against one another in a race to the bottom, as localities continue to water down taxes and regulatory protections in an effort to lure the next marginal firm (Rudra 2008; Volden 2002). If this argument holds, then it must be that politicians find themselves in a classic prisoner's dilemma game, a reference to a stylized game were two rational accomplices in a crime cannot credibly commit to cooperate and end up implicating each other, even though cooperation would have ensured the shortest possible punishment. In the case of competition for multinational investment, the argument goes, rival politicians know that offering an incentive is irrational, but without a credible guarantee, they end up viciously competing against one another. The competition does not end at the water's edge, however, since subnational governments – states, provinces, and even cities – have jumped into the race, attempting to lure investors into their jurisdictions. Politicians supposedly offer these incentives because they have no other option. Failing to play in the fiscal game will lead to both major losses of potential new investment and the defections of existing firms.

One international example of this pattern is the United Kingdom's generous support of BMW. Britain's woes in auto production date

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back as least to the 1960s, when Chrysler purchased distressed carmaker Roots. In 1994, cash-strapped British Aerospace sold the Rover Group, maker of the famous Land Rover, to BMW. This sale was a problematic fit from the beginning, and BMW made threats about moving production to Hungary unless the British government provided a more generous aid package. A £152 million incentive package was authorized by the British parliament in 1999 in the hopes of retaining the company.

Yet, this race to the bottom is more complicated than seems at first blush. In a real race to the bottom, the United Kingdom would have done its due diligence and learned the specific size of the Hungarian program, and then matched it exactly or just marginally improved upon it, up until the point that BMW would change its mind. Instead, the UK government provided the incentive despite the lack of any evidence that Rover had actually contacted the Hungarian government or received any promises of incentives. Not only was this Hungarian offer a bluff, but it was the same bluff that the government fell for in 1975, when Chrysler threatened to leave: Chrysler received a £162.5 million incentive from the government and then divested two years later (Bailey and de Ruyter 2012, p. 15). And just like the Chrysler bluff, in early 2000, BMW announced it was planning on divesting from Rover.

The story provides two reasons to be suspicious about the race-to-the-bottom explanation. First, this story is not simply one of economic competition between countries to lure investment. In both cases, the investments, despite their generosity, could not change the minds of the companies to divest from their acquisitions; hard business calculations meant that the alternative investments were untenable with or without the incentive. This factor leads to the second issue. The same country making the same policy mistake twice, within the working memory of opposition party members and other policy elites, is extremely hard to explain away by myopia. To understand it, we need to look into the political calculations of the British policy-makers. Once we do, we see that political strategy is central to explaining these incentives.

## 1.3 The Puzzling Use of Investment Incentives

In broad strokes, the argument in this book is organized around documenting and answering three puzzles. Below, we provide a brief snapshot of these puzzles and how we answer. Each one of these puzzles could potentially be answered by an alternative theory; but only our theory of political pandering and credit claiming provides a satisfactory answer to all three questions.

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### *Puzzle 1: Why Use a Policy That Is Uncertain, Expensive, Distortionary, and Usually Ineffective?*

Academic economists do not agree on much, but there is one area of apparent professional consensus: the broad use of incentives to attract investment is bad policy. Markusen and Neese (2007, p. 1) claim in their popular book on investment competition: "Incentive competition is on the rise. It is costly, generally inefficient, and often ineffective even for the winning regions." Their insight provides us with a starting point for the criticisms of incentive programs. In addition, considerable evidence in economics supports the ineffectiveness of tax incentives, which we outline in Chapter 2. A quote by Easson (2004, p. 63) summarizes the basic logic:

> According to the conventional wisdom, tax incentives for investment – in particular for foreign direct investment (FDI) – are not recommended. That is the view held almost universally by theorists and by the international bodies that advise on tax matters. Tax incentives are bad in theory and bad in practice.

Perhaps most illustrative of the limited importance of incentives for firms is a study of incentives in North Carolina, which found that only 30% of executives from the companies that participated in an incentive program were aware that they had received such inducements (Jolley et al. 2015).

Even if incentives are important in some cases, the complication for economic development officials is that the evaluation of effectiveness of incentives requires the precise understanding of counterfactual logic, which asks the following: (1) Would the investment have come without the offering of incentives? (2) What are the benefits of the incentive to the state relative to the costs of providing incentives?

The first consideration is much more complicated than it appears on the surface. Take the example of foreign investment. The literature on multinational enterprises and FDI is based on models of market imperfections. Firms are not just comparing the after-tax return between sites; rather, firm-specific factors drive location decisions. For example, foreign firms often locate in order to better reach customers in the host country. Indeed, the predominant claim for why countries like the United States and China attract so much investment is that their large domestic markets pull in investment. Natural resource extraction also requires physical proximity. Other factors, such as labor costs, levels of human capital, and proximity of intermediate goods can affect investment patterns as well.[5] Given that taxes are only one element of a firm's investment decision, scholars have struggled to evaluate the relationship between firms and national tax policy. Yet the limited evidence suggests that the majority of these incentives are

[5] Dunning (1977) is the classic work on the topic.

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funneled to firms that would have invested anyway, based on the structural factors outlined above. We document this evidence in Chapter 4.

Given the well-documented complexity of correctly assessing the effectiveness of incentive programs, we are skeptical of government officials' ability to price discriminate; offering some firms large incentives to swing their investment decisions and others no incentives is questionable. Our review of the literature on incentives finds that roughly two-thirds of incentive dollars are allocated to firms that would have invested or expanded regardless of any received incentives. Shockingly, we find almost the same "redundancy" ratio in original surveys in both Kansas and Vietnam. A supermajority of incentive dollars is going to firms that have already made up their minds to invest. Even in hindsight, well-trained scholars cannot document if taxes were essential for a firm to relocate. Can we really expect politicians to make real-time decisions on how pivotal incentives are to attracting a firm?

Even if we allow that governments can properly target incentives and that these packages have a direct impact on investment location decisions, incentives can still be problematic for host governments. Illustrating the classic "winners curse," the "winning" government is the one that offered the most incentives and therefore suffers most the burden of paying the highest cost for the investment (Easson 2004). As a result, a number of studies have documented how the size of many incentive packages actually leads to a net loss to communities, where the benefits of the investment are swamped by the huge fiscal cost of the incentives. Numerous renewable energy companies went bankrupt or laid off workers in the wake of the post-2008 global economic recession, providing some sensational news stories of failed incentive programs.

Finally, the use of incentives can lead to issues of adverse selection – that is, when governments attract investments that would not otherwise locate in the country. This may sound like the exact goal of government policy, but scholars have documented the disastrous consequences of many government policies to attract investment (Moran 1999). Firms that cannot profitably operate without subsidies will intentionally seek to locate in a district offering continuous support from the government (Moran 2002).

An alternative distortion that can be damaging to a country's development prospects is the tendency of incentives to attract multinational corporations that have the ability to be profitable relatively quickly and can therefore amortize the full value of tax holidays. Countries or states that rely on tax incentives may find themselves with a disproportionate number of low-end manufacturing and retail outlets rather than high-value-added, technology-based incentives that must invest in labor

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