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Federal Pandemic Relief Could End the

Interstate Economic Development Arms Race

Michael D. Farren and John Mozena

Abstract: Recent projections estimate that the state and local budget shortfall caused by COVID-19 will exceed $950 billion. Congressional Democrats have championed a bill containing almost $1 trillion in aid, but Republicans have resisted what they say is a bailout for some states' long-running fiscal difficulties. Restricting state and local expenditures for targeted economic development subsidies offers an easy compromise. The idea is not controversial; many state and local policymakers already want to exit what amounts to a subsidy arms race, but no one wants to be seen as unilaterally disarming. While it wouldn't fully solve states' budget shortfalls, reclaiming the estimated $95 billion spent on subsidies each year would certainly help. Furthermore, academic research finds that subsidies don't contribute to economic development. Getting rid of them would assist the United States' economic and fiscal recovery from COVID-19. The funds spent on targeted economic development subsidies represent the lowest-hanging fruit available to fill holes elsewhere in the budget. Congress should help states collect that harvest.

JEL codes: H2, H7, O4

Keywords: economic development, public finance, subsidies, tax benefits, state government, local government, expenditures, government bailouts, federalism, intergovernmental relations, intergovernmental grants, institutions and growth

Introduction

As the United States continues to struggle with the economic downturn caused by COVID-19, state leaders are turning to Congress for help. State governments, like the federal government, are projecting substantially reduced tax revenues caused by the decline in economic activity.[1] Meanwhile, spending on unemployment insurance, public health programs, and social safety net programs is increasing. This combination of more spending and less revenue is especially

[1] Mary Williams Walsh, "States Are in a Quandary as Taxes Evaporate and Virus Spending Soars," *New York Times*, April 15, 2020.

problematic given that almost all state governments are required to balance their budgets or have limited ability to carry a budget deficit.[2]

The federal government, however, can borrow against future tax revenues in ways that state governments cannot. This ability is why the leaders of the National Governors Association are requesting that the federal government provide $500 billion in fiscal relief for states and territories.[3] City leaders are requesting another $500 billion in dedicated funding for local governments.[4] These amounts are in line with recent research, which projects the combined state and local government budget gap to be $950–$975 billion.[5] The state and local governments seem likely to get the requested funds, however: the House has already passed a fourth phase of coronavirus-related legislation that includes $1.1 trillion in cash for state and local governments.[6]

However, some congressional leaders have indicated reluctance to provide what amounts to a bailout for state and local governments, especially those already facing fiscal challenges because of pension obligations. For example, Senate Majority Leader Mitch McConnell recently

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[2] National Conference of State Legislatures, "NCSL Fiscal Brief: State Balanced Budget Provisions," October 2010, https://www.ncsl.org/documents/fiscal/StateBalancedBudgetProvisions2010.pdf; Kim Rueben and Megan Randall, *Balanced Budget Requirements: How States Limit Deficit Spending* (Washington, DC: Urban Institute, November 2017).

[3] Note that this request is in addition to the $150 billion Coronavirus Relief Fund for expenses related to COVID-19 that the CARES Act established. US Department of Treasury, "The CARES Act Provides Assistance for State and Local Governments," accessed April 24, 2020, https://home.treasury.gov/policy-issues/cares/state-and-local-governments; National Governors Association, "Governors' Letter Regarding COVID-19 Aid Request," April 21, 2020, https://www.nga.org/policy-communications/letters-nga/governors-letter-regarding-covid-19-aid-request/; National Governors Association, "State and Local Government Associations Urge 'Robust, Flexible' Federal Relief during Pandemic," April 21, 2020, https://www.nga.org/news/press-releases/state-and-local-government-associations-urge-robust-flexible-federal-relief-during-pandemic/.

[4] National League of Cities, "Cities Are Essential: New Campaign Calls for Immediate, Direct Funding to Support Local COVID-19 Response and Recovery," press release, May 5, 2020, https://www.nlc.org/article/cities-are-essential-new-campaign-calls-for-immediate-direct-funding-to-support-local-covid.

[5] Timothy J. Bartik, "An Updated Proposal for Timely, Responsive Federal Aid to State and Local Governments during the Pandemic Recession" (Research Highlights, W. E. Upjohn Institute for Employment Research, Kalamazoo, MI, May 8, 2020); Ryan Zamarripa, "Federal Funding is Essential to Saving State and Local Public Services," Center for American Progress, July 10, 2020, https://www.americanprogress.org/issues/economy/news/2020/07/10/487191/federal-funding-essential-saving-state-local-public-services/.

[6] "What's in the $3 Trillion HEROES Act?," Committee for a Responsible Budget, May 27, 2020, https://www.crfb.org/blogs/whats-3-trillion-heroes-act;; "The Heroes Act: A Bold Response to the Coronavirus Pandemic and the Economic Collapse," May 2020, https://appropriations.house.gov/sites/democrats.appropriations.house.gov/files/documents/Heroes%20Act%20State%20and%20Local%20Relief%20Funds.pdf.

said, “I think this whole business of additional assistance for state and local governments needs to be thoroughly evaluated,” and “We’ll certainly insist that anything we’d borrow to send down to the states is not spent on solving problems that they created for themselves over the years with their pension programs.”[7]

Although the senate majority leader’s remarks have sparked heated responses from state leaders, he may have a good point.[8] In some cases, states have dug their own financial hole.[9] If Congress is to provide relief, it has the duty and authority within the scope of its enumerated powers to insist on fundamental changes that would help stop states’ fiscal bleeding and decrease the potential for additional bailout rounds in the future.

One reform in particular would improve states’ finances as well as assist their economic recovery. Using the coronavirus relief as motivation, Congress could assert its authority under the commerce clause of the US Constitution and require state and local governments to contractually forswear future targeted economic development subsidies. Doing so would allow state and local governments to reclaim some of the estimated $95 billion they collectively waste every year on targeted economic development subsidies.[10]

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[7] In fact, McConnell has even suggested allowing states to declare bankruptcy to provide a financial haven to restructure their debt. “I would certainly be in favor of allowing states to use the bankruptcy route,” he said. “It saves some cities. And there’s no good reason for it not to be available.” Carl Hulse, “McConnell Says States Should Consider Bankruptcy, Rebuffing Calls for Aid,” *New York Times*, April 22, 2020.

[8] Michael S. Greve, “Bailouts or Bankruptcy: Are States Too Big to Fail?” (Legal Outlook, American Enterprise Institute, Washington, DC, March 2011).

[9] Andrew G. Biggs and Eileen Norcross, “Public Sector Pensions and the COVID-19 Shock” (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, April 13, 2020; Eileen Norcross and Olivia Gonzalez, “Ranking the States by Fiscal Condition: 2018 Edition” (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, October 2018); Eileen Norcross and Andrew G. Biggs, “The Crisis in Public Sector Pension Plans: A Blueprint for Reform in New Jersey” (Mercatus Working Paper No. 10-31, Mercatus Center at George Mason University, Arlington, VA, June 2010); Eileen Norcross and Benjamin J. VanMetre, “Illinois’s Fiscal Breaking Points” (Mercatus Working Paper No. 11-40, Mercatus Center at George Mason University, Arlington, VA, October 2011).

[10] Many of the subsidies that state and local governments currently provide are contractually obligated, so some future spending is impossible to avoid. But a congressional prohibition of such subsidies may help to free state and local governments from noncontractual agreements, as well as free up future funding that would have been allocated to subsidies. 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

This reform would free states and cities from the burden of pursuing a wasteful subsidy arms race, which many state and local policymakers have already stated they would like to abandon. It would also ensure that the federal government is not helping to fund an increasingly expensive race to the bottom.

We suggest that a market-based enforcement mechanism for these contracts would perform better than a central regulator. A properly motivated self-enforcing agreement would maximize the likelihood of enforcement, which in turn would minimize the likelihood that governments would try to cheat by finding new ways of offering subsidies.

The result would be the equivalent of a small but long-term increase in revenue (equivalent to 2.2–4.5 percent of fiscal year [FY] 2019 total state expenditures) for state and local governments that would allow them to better weather the reduced tax revenue during the economic downturn as well as to reduce long-term indebtedness. Reducing the economic distortions caused by subsidies also would encourage more efficient economic development that would help the United States recover more quickly from the coronavirus pandemic.

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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 *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" (W.E. Upjohn Institute for Employment Research, Kalamazoo, MI, February 2017); Kenneth Thomas, *Investment Incentives and the Global Competition for Capital* (London: Palgrave Macmillan, 2011); Kenneth Thomas, "Estimates of Total State and Local Subsidies," personal communication with Michael D. Farren, May 4, 2020; Louise Story, "As Companies Seek Tax Deals, Governments Pay High Price," *New York Times*, December 1, 2012.

The Definition of a Targeted Economic Development Subsidy

We define a targeted economic development subsidy as *any government-granted privilege that creates exclusive economic benefits for the recipients*.[11]

This definition is intentionally broad because many economic development policies provide fungible benefits, displacing resources that would otherwise be spent on the project, creating the same effect as a cash subsidy for the recipient. It is easier for politicians to frame gifts of public property, infrastructure, special services, tax credits, or protections from competition as being in the public interest, as opposed to direct corporate handouts.

The "targeted" nature of economic development subsidies is emphasized because exclusive benefits and privileges create a host of economic, political, and social pathologies, as discussed later.[12]

Why Are Targeted Economic Development Subsidies a Problem?

The modern era of targeted economic development subsidies began during the Great Depression with states and cities attempting to stimulate growth in their local economies.[13] The use of subsidies grew over time and has increased dramatically in recent decades. By one measurement, the value of subsidies has tripled as a share of the national economy since just 1990.[14]

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[11] A more detailed explanation of this definition is provided in these papers: Michael D. Farren and Matthew D. Mitchell, "An Interstate Compact to End the Economic Development Subsidy Arms Race" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 2020); Matthew D. Mitchell et al., *The Economics of a Targeted Economic Development Subsidy* (Arlington, VA: Mercatus Center at George Mason University, November 2019).

[12] Matthew D. Mitchell, *The Pathology of Privilege: The Economic Consequences of Government Favoritism*, 2nd ed. (Arlington, VA: Mercatus Center at George Mason University, 2015).

[13] In fact, the practice goes back much farther and was responsible for a wave of state credit defaults in the mid-1800s. Connie Lester, "Economic Development in the 1930s: Balance Agriculture with Industry," *Mississippi History Now*, May 2004; 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).

[14] Bartik, *A New Panel Database on Business Incentives for Economic Development Offered by State and Local Governments in the United States*.

These subsidies are intended either to sway the location decision of new businesses (and the jobs that accompany them) or to encourage already-established companies to expand or maintain their current operations. The practice allows politicians to send voters a highly visible signal that they are committed to improving the local economy and are taking steps to do so.[15] However, academic research indicates that most such subsidies are a waste of money.

First, the research consistently finds little association between targeted economic development subsidies and broad improvements in community or economic welfare.[16] In fact, some research suggests that the typical subsidy is strongly correlated with *diminished* employment growth at the subsidized businesses.[17] This counterintuitive result is understandable if subsidies distort the economic factors that naturally drive job creation, as discussed by recent Mercatus research.[18]

Second, the average subsidy is likely to sway only one out of every eight business location, expansion, or retention decisions.[19] This means that, in addition to the lack of benefit to the community, the subsidy generally is not needed in the first place. Excellent evidence for this

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[15] Richard Florida, "Why Do Politicians Waste So Much Money on Corporate Incentives?," *CityLab*, May 24, 2018.
[16] Matthew D. Mitchell, Jeremy Horpedahl, and Olivia Gonzalez, "Do Targeted Economic Development Incentives Work as Advertised?" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, forthcoming); Slattery and Zidar, "Evaluating State and Local Business Tax Incentives"; Dennis Coates, "Growth Effects of Sports Franchises, Stadiums, and Arenas: 15 Years Later" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, 2015); John Charles Bradbury, "Do Movie Production Incentives Generate Economic Development?," *Contemporary Economic Policy* 38, no. 2 (April 2020): 327–42; Timothy J. Bartik, *Who Benefits from Economic Development Incentives? How Incentive Effects on Local Incomes and the Income Distribution Vary with Different Assumptions about Incentive Policy and the Local Economy* (Kalamazoo, MI: W. E. Upjohn Institute for Employment Research, March 1, 2018); Alan Peters and Peter Fisher, "The Failures of Economic Development Incentives," *Journal of the American Planning Association* 70, no. 1 (2004): 27–37.
[17] Mary Donegan, T. William Lester, and Nichola Lowe, *Striking a Balance: A National Assessment of Economic Development Incentives* (Kalamazoo, MI: W. E. Upjohn Institute for Employment Research, August 1, 2018).
[18] Mitchell et al., *The Economics of a Targeted Economic Development Subsidy*.
[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.

comes from Amazon's high-profile "HQ2" competition. The Washington, DC, suburbs of Bethesda, Maryland, and Arlington, Virginia, only 10 miles apart, were two of the finalist sites. Maryland offered more than $8.5 billion in subsidies, while Virginia's combined package totaled barely more than $1 billion.[20] But Amazon chose Arlington, citing the availability of tech talent, as well as Virginia's better business environment.[21] As Amazon's vice president for public policy Brian Huseman explained it, "It's not just monetary incentives, but it's looking at the comprehensive environment to allow companies to flourish."[22]

In addition to being ineffective, subsidies—like any policy decision—inherently come with tradeoffs.[23] Tax dollars spent on subsidies are not available to shore up public pension programs, which would improve future government finances by reducing borrowing costs. Similarly, funds spent on subsidies cannot provide wider tax relief or improved public services, both of which are more likely to assist long-run economic development.[24]

Subsidies naturally inhibit competition, which motivates producers to find increasingly better ways to provide goods and services. The economic distortions caused by subsidies lead to inefficient production, inattention to customer desires, and reduced innovation. Widespread use of targeted economic development subsidies decreases business innovation (measured by patent

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[20] Erin Cox, "Maryland OKs $8.5 Billion in Incentives to Lure Amazon, Biggest Offer in Nation," *Baltimore Sun*, April 4, 2018; Michael D. Farren and Anne Philpot, "What Could States and Municipalities Have Done with That Amazon HQ2 Money?," *The Bridge*, December 6, 2018.
[21] Amazon.com, "Amazon Selects New York City and Northern Virginia for New Headquarters," *Day One Blog*, November 13, 2018.
[22] Scott Cohn, "Amazon Reveals the Truth on Why It Nixed New York and Chose Virginia for Its HQ2," *CNBC*, July 10, 2019.
[23] Matthew D. Mitchell and Tamara Winter, "The Opportunity Cost of Corporate Welfare" (Mercatus Center at George Mason University, Arlington, VA, May 22, 2018); Farren and Philpot, "What Could States and Municipalities Have Done with That Amazon HQ2 Money?"
[24] Mitchell et al., *The Economics of a Targeted Economic Development Subsidy*, 24; Jia Wang, "Do Economic Development Incentives Crowd Out Public Expenditures in U.S. States?," *B.E. Journal of Economic Analysis & Policy* 16, no. 1 (2015): 513–38.

filings) and artificially concentrates control of a local economy in the hands of large corporations.[25]

Subsidies also serve as a barrier to entry that protects entrenched businesses and industries. Also, there is consistent evidence that government officials who have invested in the success of established companies are motivated to use regulatory powers to erect barriers that inhibit competition, regardless of the potential benefits to consumers or to the economy as a whole.[26]

As with other attempts at central economic planning throughout history, politicians and economic development officials are unlikely to make the correct bets on which companies and endeavors to subsidize.[27] First, they do not have access to the wealth of information available through market signals of price, profit, and loss. Furthermore, they are relatively insulated from the consequences of choosing wrong. Even worse, the political discrimination inherent in providing targeted subsidies also helps to create a policy trap, where the privileged constituencies resist attempts to shift back to better and more equitable policies.[28] Research has demonstrated that the more businesses or industries spend on lobbyists and campaign contributions, the more they receive in subsidies.[29]

Local subsidies inevitably have an effect at the national level as economic and political distortions cascade through businesses' complex webs of supply chains, customers, and competitors. This means that local subsidies inhibit economic development across the entire country. And in the rare instance when a subsidy does sway a business's location decision, the

[25] Meg Tuszynski and Dean Stansel, "Targeted State Economic Development Incentives and Entrepreneurship," *Journal of Entrepreneurship and Public Policy* 7, no. 3 (2018): 235–47.
[26] Adam Thierer, "How Regulation Wrecks Innovation," *AIER*, July 11, 2019.
[27] Mitchell et al., *The Economics of a Targeted Economic Development Subsidy*, 32.
[28] *Mitchell et al., The Economics of a Targeted Economic Development Subsidy*, 35.
[29] Joshua M. Jansa and Virginia Gray, "Captured Development: Industry Influence and State Economic Development Subsidies in the Great Recession Era," *Economic Development Quarterly* 31, no. 1 (2017): 50–64; Mitchell, *The Pathology of Privilege*, 31–32.

negative effect is compounded. The resulting production will be even more inefficient for having chosen a suboptimal subsidized location instead of the site that offered the best combination of factors for long-term business success. This inefficient production wastes scarce resources that otherwise would have contributed to national economic activity.

The potential to profit from government subsidies rather than from competition for customers creates political dysfunction by shifting business competition from the marketplace to the political sphere.[30] It also motivates businesses to waste time and resources on currying political favor, further reducing productive economic activity as well as contributing to the corruption of the political system.[31]

The combination of high-value discretionary grants, intentionally inadequate transparency, and insufficient oversight from auditors can give rise to significant episodes of public corruption. Recent examples of corruption include the following:

- Former St. Louis County Executive Steven V. Stenger pleaded guilty to three federal felonies involving the St. Louis Economic Development Partnership while in office.[32]
- Former chief operating officer of the Department of Economic Development of Montgomery County, Maryland, Byung Il "Peter" Bang, admitted to embezzling $6.7 million from the county in that role.[33]

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[30] Mitchell et al., *The Economics of a Targeted Economic Development Subsidy*, 32.
[31] Mitchell et al., *The Economics of a Targeted Economic Development Subsidy*, 24.
[32] Eastern District of Missouri, US Attorney's Office, "Former St. Louis County Executive Seven V. Stenger Sentenced to Federal Prison for 'Pay to Play' Bribery Scheme," Department of Justice August 9, 2019, https://www.justice.gov/usao-edmo/pr/former-st-louis-county-executive-seven-v-stenger-sentenced-federal-prison-pay-play.
[33] Jennifer Barrios, "Ex-Montgomery County Official Gets 4 Years in Federal Prison for Embezzling $6.7 Million," *Washington Post*, February 22, 2019.

- Multiple public servants in Virginia are under indictment regarding a $21.3 million embezzlement scandal at the Front Royal–Warren County Economic Development Authority.[34]

History has shown that when some politicians start using subsidies, policymakers in other cities and states feel pressured to follow suit, if for no other reason than to signal to their voters that they are similarly committed to improving the local economy.[35] But many policymakers are quite open about being uncomfortable with the interstate subsidy arms race, arguing that they are only doing it because they feel they have to.[36] As Jim Edgar, former governor of Illinois, said, "If you've got some states doing it, it's hard for the others not to do it. It's like unilaterally disarming."[37]

Even state leaders who have incontrovertible data showing the uselessness of targeted subsidies find it difficult to end their programs while neighboring states continue to offer them. In 2019, New Jersey Governor Phil Murphy presented evidence for the ineffectiveness of his state's targeted economic development incentive programs:

> The simple fact remains that, while we were handing out incentives to the tune of roughly $11 billion in total obligations, and at per-job award amounts multiple times that of our competitor states, those incentives were returning minimal overall economic benefits. This fact is not up for debate. From 2010 through 2018, New Jersey paid five times more

[34] Josh Gully, "Embezzlement Scandal Leaves Dark Cloud over 2019," *Northern Virginia Daily*, December 20, 2019.
[35] Richard Florida, "Why Do Politicians Waste So Much Money on Corporate Incentives?," *CityLab*, May 24, 2018; Jackson Brainerd, "Tax Break Tug-of-War" (National Conference of State Legislatures, Washington, DC, September 25, 2019), https://www.ncsl.org/research/fiscal-policy/tax-break-tug-of-war637050154.aspx.
[36] "The policy of the Governor and the Lt. Governor are absolutely solid. I've heard him state it on a number of occasions: nobody likes incentives in the state of Utah. I think if we had the ability to do away with all incentives, I think that would be the better policy position. Our reality is that there is that competition factor, and we do have to compete against the other states that we're working with, whether it's a Utah-grown business or outside. And so, in terms of an interstate compact across the country, I think it's a very intriguing idea. I think, and I can speak for the governor when I say this, if we could get to something like that, I think that would be the best possible approach to incentives. " Michael D. Farren and Ben Hart, "Statements by Ben Hart, Deputy Director, Governor's Office of Economic Development, at the Economic Development and Workforce Services Interim Committee" (Testimony before the Utah Economic Development and Workforce Services Interim Committee, Salt Lake City, UT, September 18, 2019).
[37] Story, "As Companies Seek Tax Deals, Governments Pay High Price."

> than our peer states for every job created or retained, yet attracted five times less capital investment per incentive dollar. . . . Under our current programs, New Jersey continued to lag at No. 42 in job growth and No. 49 in wage growth in the nation. Forty-second and forty-ninth—out of 50.[38]

However, even with that evidence in hand, Murphy made it clear that New Jersey would continue to offer targeted economic development incentives regardless, saying, "I will not unilaterally disarm our economic development while our competitor states are luring businesses, in part, through incentives."[39]

After years of negotiation and an estimated $335 million in subsidies (payments that in some cases motivated businesses to move only across the street), Kansas and Missouri recently called a truce in their Kansas City border war.[40] The challenge of getting just two states to end a wasteful competition described as "the poster child for how not to create jobs" demonstrates the difficulties facing state-led solutions.[41] Yet, as Missouri Governor Mike Parson noted at the truce-signing ceremony, "Sometimes common sense does prevail."[42] It hasn't prevailed enough, however—the agreement is limited to the Kansas City area and does not apply to local governments.[43] Meanwhile, Missouri and Kansas continue to offer subsidies to lure businesses from the other 48 states. As Kansas Governor Laura Kelly said, "I think both of us would

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[38] Anjalee Khemlani, "Pushing for Deal: Murphy, Touting Own Proposals, Says He Won't Let N.J. Go without Incentives," *ROI-NJ*, June 5, 2019.
[39] Khemlani, "Pushing for Deal."
[40] NPR, "Episode 699: Why Did The Job Cross The Road?," *Planet Money*, May 4, 2016, https://www.npr.org/sections/money/2016/05/04/476799218/episode-699-why-did-the-job-cross-the-road; Jonathan Shorman and Allison Kite, "Kelly Plans Action to End Kansas-Missouri Border War, after Parson Signed Truce Bill," *Kansas City Star*, June 18, 2019.
[41] Amy Liu, "The End of Kansas-Missouri's Border War Should Mark a New Chapter for Both States' Economies," *The Avenue*, Brookings Institution, August 14, 2019.
[42] Kevin Hardy, "'Sometimes Common Sense Does Prevail.' Missouri, Kansas Celebrate End of Border War," *Kansas City Star*, August 13, 2019.
[43] Kansas City Star Editorial Board, "Kansas Gov. Laura Kelly vs. KC Mayor Quinton Lucas: Is the Border War Already Back?," *Kansas City Star*, December 6, 2019.

prefer that we wouldn't have to do that, but I don't think either one of us is really ready to unilaterally disarm."[44]

David Lehman, commissioner of the Connecticut Department of Economic and Community Development and senior economic adviser to Connecticut Governor Ned Lamont, proposed a way out of this mess. He suggested that the federal government adopt the European Union's strict rules on the granting of subsidies:

> Here's what we agree on: incentives don't drive the economy. That's not the key to a successful economy. . . . If the United States on the federal level adopted it [a restriction on subsidies], I think that would be best."[45]

A Federal Bailout for States Offers a Solution

State and local government leaders unfortunately face substantial political costs for shunning the subsidy arms race, even if economic analysis and empirical research both suggest that unilateral exit would lead to improved local economic development.[46] A multilateral solution, using an interstate compact for states to credibly commit to prohibiting subsidies, has recently built momentum; 14 states introduced relevant legislation in 2020.[47]

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[44] Hardy, "'Sometimes Common Sense Does Prevail.'"
[45] Mark Pazniokas, "An Effort in Connecticut to End the Economic Border Wars," *Connecticut Mirror*, January 29, 2020.
[46] Mitchell et al., *The Economics of a Targeted Economic Development Subsidy*; Brainerd, "Tax Break Tug-of-War."
[47] Michael D. Farren, "An Interstate Compact to Phase Out Corporate Giveaways" (Testimony before the Illinois General Assembly, House Revenue and Finance Committee, February 27, 2020); "Coalition to Phase Out Corporate Tax Giveaways," Coalition to Phase Out Corporate Tax Giveaways, accessed February 5, 2020, https://endtaxgiveaways.org/.

A Federal Antisubsidy Rule for States Accepting Bailouts

However, the possibility of a federal bailout for states offers another, faster, solution: Congress could condition its bailout on states' contractual promise to permanently forswear the use of targeted economic development subsidies.

In creating this mechanism for simultaneous and multilateral disarmament, Congress would be neither penalizing state and local governments for previous policy decisions nor rescuing them from the consequences of having made bad deals. The antisubsidy rule would be entirely forward looking, prohibiting only the creation of new subsidies rather than interfering with existing contracts or liabilities. It would place every state on a level and fair playing field, liberating policymakers from the never-ending race to the bottom just when they most need to free up funding and pursue policies that assist genuine recovery.

An antisubsidy rule would be in Congress's best interest as well: the fungibility of federal grants means that the federal government could end up funding both sides of future interstate subsidy competitions, like the one brewing over Tesla's "Cybertruck Gigafactory."[48]

Vast amounts of previous research have found clear evidence of a "flypaper effect"—that a dollar of federal aid increases state spending more than an extra dollar of state taxpayer income. The term came from the research observation that federal aid seems to "stick where it hits" and that state governments do not reduce spending as much as would be expected.[49] Federal grants tend to increase total state and local government spending by 30–100 percent of the value of the

[48] In fact, Joplin, Missouri, has already reportedly offered subsidies in excess of $1 billion for the facility. Dana Hull, "Tesla on the Hunt for Cybertruck Plant Location in Central U.S.," *Los Angeles Times*, March 11, 2020; Kif Leswing, "Missouri City Offers $1 Billion in Incentives for Tesla Cybertruck Factory," *CNBC*, April 14, 2020.

[49] This appears to be a long-run effect, with state taxes increasing after federal grants end. Matt Mitchell, "Stimulating $19,000,000,000 in New State Taxes," *Neighborhood Effects*, September 9, 2010; Russell S. Sobel and George R. Crowley, "Do Intergovernmental Grants Create Ratchets in Staten and Local Taxes?" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, August 2010).

federal grant.[50] The upper end of this range suggests that federal aid only expands aggregate public spending, rather than replacing some of the local portion. To the extent that local policymakers have discretion over where they redeploy locally funded spending, federal grants—which were estimated to total $750 billion last year—may be underwriting a substantial portion of the estimated $95 billion that state and local governments spend on subsidies every year.[51]

Mark Funkhouser, former mayor of Kansas City, had a front-row seat to the "border war" between Kansas and Missouri.[52] Along with University of Minnesota economist Art Rolnick and former Minnesota Representative David Minge, Funkhouser has made the argument that Congress needs to step in to end this wasteful spending:[53]

> We need a national law that prohibits corporations from extracting bribes from state and local governments and bans governments from donating tax dollars to private entities—a sort of domestic equivalent of the Foreign Corrupt Practices Act, which prohibits American companies from bribing foreign governments.[54]

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[50] It should be noted that for increases in local taxpayer income (obviously the main source of state and local government spending), the largest estimated increase in their desired government spending is about 15 percent. Furthermore, there seems to be good evidence that at least some public officials are "budget maximizers," especially those representing larger jurisdictions. Robert P. Inman, "The Flypaper Effect" (NBER Working Paper No. 14579, National Bureau of Economic Research, Cambridge, MA, December 2008); James R. Hines and Richard H. Thaler, "Anomalies: The Flypaper Effect," *Journal of Economic Perspectives* 9, no. 4 (1995): 217–26.

[51] Congress provided an estimated $750 billion in federal grants to state and local governments in fiscal year (FY) 2019. Federal grants amounted to 23 percent of state and local budgets in FY 2017. The "flypaper effect" suggests that federal grants do not completely displace local spending, and sometimes they even motivate overspending in the federally funded area. However, to the extent that federal grants displace local funds that would have been spent on these initiatives, local funding is then available for secondary uses, such as targeted economic development subsidies. Robert Jay Dilger and Michael H. Cecire, "Federal Grants to State and Local Governments: A Historical Perspective on Contemporary Issues," *Economic Research Service*, May 22, 2019; Center on Budget and Policy Priorities, "Federal Aid to State and Local Governments," April 19, 2018, https://www.cbpp.org/research/state-budget-and-tax/federal-aid-to-state-and-local-governments; Thomas to Farren, "Estimates of Total State and Local Subsidies," May 4, 2020.

[52] NPR, "Episode 699: Why Did The Job Cross The Road?"

[53] Arthur J. Rolnick and Melvin L. Burstein, *Congress Should End the Economic War among the States* (Minneapolis: Federal Reserve Bank of Minneapolis, January 1, 1995); Arthur J. Rolnick, "Congress Should End the Economic War among the States" (Testimony before the Domestic Policy Subcommittee, Washington, DC, October 10, 2007), https://www.minneapolisfed.org/publications/special-studies/economic-bidding-wars/rolnick-testimony; Distorting Subsidies Limitation Act of 1997, H.R. 3044, 105th Cong. (1997); Distorting Subsidies Limitation Act of 1999, H.R. 1060, 106th Cong. (1999).

[54] Mark Funkhouser, "How to Stop the Economic Development Wars," *Governing*, November 25, 2013.

Sean O'Byrne, vice president of the Downtown Council of Kansas City, agrees with Funkhouser:

> 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.[55]

Indeed, there is evidence that state and local governments intend to continue offering economic development subsidies, even as their tax revenue drops precipitously because of the coronavirus-related economic downturn.[56] Offering subsidies will allow state and local politicians to signal to their constituents that they are indeed working hard to improve the economy after the downturn, even as the subsidies do more harm than good.[57]

The Effect of Economic Development Subsidies on State and Local Government Fiscal Health

The effect of targeted economic development subsidies on state fiscal health should be of paramount concern. Coronavirus-related state revenue shortfalls are occurring while the total state debt as a share of national GDP is at its highest level since the 1840s, when many states defaulted on their debt.[58] Recent Mercatus research on that episode confirmed the link between those subsidies and poor state and local government fiscal health.[59] Bruce McDonald, J. W.

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[55] Story, "As Companies Seek Tax Deals, Governments Pay High Price."

[56] Allison Kite, "Amid COVID-19 Budget Uncertainty, Kansas City Proceeds with $43M Soccer Park—Warily," *Kansas City Star*, April 22, 2020; Associated Press, "Incentive Deal to Move Carolina Panthers to S.C. Approved," April 23, 2020, https://kmph.com/sports/content/incentive-deal-to-move-carolina-panthers-to-sc-approved-04-23-2020; Jay Hanselman, "Cincinnati's Budget Deficit for the New Fiscal Year Continues to Grow," *Cincinnati Public Radio*, April 29, 2020; Pat Garofalo, "The Post-Pandemic Lobbying Blitz Is Underway," *Boondoggle*, April 21, 2020; Sam Karlin and Mark Ballard, "Cut Taxes, Enact Tort Reform, Expand Tax Breaks to Start Coronavirus Recovery, Business Execs Say," *The Advocate*, May 11, 2020.

[57] Nathan M. Jensen and Edmund Malesky, *Incentives to Pander: How Politicians Use Corporate Welfare for Political Gain* (Cambridge: Cambridge University Press, 2018); Richard Florida, "Why Mayors Keep Trying to Woo Business with Tax Breaks," *CityLab*, February 7, 2019.

[58] Jeremy Horpedahl, "US State Debt Defaults and Constitutional Reform in Historical Perspective" (working paper, 2020).

[59] Mitchell et al., "Outlawing Favoritism."

Decker, and Brad Johnson, using contemporary data covering most of the US economy, found even broader evidence (covering many states over a period of time) to support this conclusion:

> After controlling for the governmental, political, economic, and demographic characteristics of a state, we find that incentives draw resources away from the state. Ultimately, the results show that financial incentives negatively affect the overall fiscal health of a state.[60]

Targeted economic development subsidies harm state fiscal health in part because most subsidies are provided via tax credits that reduce future revenue, while at the same time the demand for public services increases because of the subsidized economic activity.[61] Because most subsidies do not actually motivate new projects, governments are needlessly reducing their tax revenue. Perhaps unsurprisingly, higher levels of economic development subsidies are correlated with increased state dependency on federal grants.[62]

Targeted economic development subsidies also indirectly decrease tax revenue. To fund the subsidy, the taxes paid by other businesses and residents must be higher or the public services provided must be reduced (or both). Holding public services constant, higher taxes lead to slower GDP growth over the long run, with the best estimate being that future state GDP will be 0.5 percent lower for each additional percentage point increase of total tax revenue currently collected.[63] Furthermore, the higher tax rate on a narrower tax base amplifies the economic harm because deadweight loss—the lost economic exchange caused by taxation—increases exponentially as the tax rate rises.[64] This reduced economic activity then causes a reduction in future tax revenue compared with what would otherwise be collected.

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[60] Bruce D. McDonald, J. W. Decker, and Brad A. M. Johnson, "You Don't Always Get What You Want: The Effect of Financial Incentives on State Fiscal Health," *Public Administration Review*, February 27, 2020.
[61] Please note, just because the economic activity is subsidized does not mean that the subsidy was material to the project being initiated. Bartik, "'But For' Percentages for Economic Development Incentives."
[62] McDonald, Decker, and Johnson, "You Don't Always Get What You Want."
[63] Bartik, *Who Benefits from Economic Development Incentives?*, 10.
[64] Mitchell et al., *The Economics of a Targeted Economic Development Subsidy*, 24.

Economic development subsidies can also harm the credit rating of state and local governments. In December 2015, Moody's Investors Service cut the credit rating of Pearl, Mississippi, four notches to junk status because of the city's difficulty in repaying the debt it had taken on to build a minor league baseball stadium.[65]

At the state level, New Jersey may join Illinois to share the title of the state with the worst credit rating in the nation after Moody's revised its credit rating outlook to "negative." New Jersey's underfunded public worker retirement and healthcare programs receive most of the blame for the *11 credit downgrades* it received from 2010 through 2018.[66] However, the state continued spending profligately on economic development subsidies during the same period, with little to show for it. Last year, New Jersey's comptroller released a scathing audit of the state's economic development programs, finding that the Economic Development Authority "improperly awarded, miscalculated, overstated, and overpaid" the tax credits it was responsible for and that there was no way to determine whether the $11 billion in subsidies promised to businesses generated any economic benefits for the state.[67]

To better understand the national scale of the estimated $95 billion annually spent by states and local governments on targeted economic development subsidies, it helps to compare the value with more relatable concepts. That amount could easily pay the entire annual state budget for any but three states; in fact, it could cover the annual budgets for 11 states

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65 Ira Boudway and Kate Smith, "The Braves Play Taxpayers Better Than They Play Baseball," *Bloomberg Businessweek*, April 27, 2016.

66 Daniel J. Munoz, "Moody's Warns of Potential Downgrade for NJ amid Global Pandemic," *NJBIZ*, April 14, 2020; Kristen M. DeJong, "New Jersey: The Garden State Remains under Scrutiny," *Nuveen*, April 3, 2019.

67 Samantha Marcus, "N.J.'s $11B Corporate Tax Break Program Blasted as Audit Finds It Overpaid and Improperly Awarded Millions under Christie," *NJ.Com*, January 9, 2019; Philip James Degnan, *New Jersey Economic Development Authority: A Performance Audit of Selected State Tax Incentive Programs* (Newark, NJ: Office of the State Comptroller, January 9, 2019).

combined.[68] It could easily pay for the $40.8 billion that states spent on bonds last year—twice.[69] And at the federal level, if Congress reduced federal grants commensurately with state expenditure savings from not offering subsidies, it could pay for the entire cost of all federal food assistance programs and purchase two new aircraft carriers *every year*.[70]

A critic might note that the estimated $95 billion that state and local governments spend each year on subsidies corresponds to "only" 4.5 percent of total state expenditures.[71] But every little bit will help over the coming years as states and cities are desperately searching for low-hanging fruit to cut out of their budgets. Even better, cutting subsidies would be a long-term benefit, whereas the limited ability to defer other expenses, such as highway maintenance, can only temporarily fill a budget hole.

States and cities facing fiscal problems because of the subsidies they have granted is not a recent problem. Mercatus research illustrates how eight states and a territory (Florida at the time) defaulted on their debt during the Panic of 1837 after underwriting ill-conceived private infrastructure projects. A similar wave of local government defaults occurred after the Panic of 1873.[72] Those difficult lessons led to state constitutional provisions that were intended to prohibit most targeted economic development subsidies, but the legal interpretation of the provisions has been watered down over time, meaning they are mostly ineffective today. Congress has the

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[68] Brian Sigritz, *2019 State Expenditure Report* (Washington, DC: National Association of State Budget Officers, 2019).

[69] Sigritz, *2019 State Expenditure Report*, 8.

[70] The federal government spent $68 billion on federal food assistance programs in FY 2018. The cost of a Ford-class aircraft carrier is around $12.5 billion. For reference, the United States has commissioned only 11 new fleet carriers since 1975, and the next will not be delivered to the Navy until 2024. Center for Budget and Policy Priorities, "Policy Basics: The Supplemental Nutrition Assistance Program (SNAP)," June 25, 2019, https://www.cbpp.org/research/food-assistance/policy-basics-the-supplemental-nutrition-assistance-program-snap; Ronald O'Rourke, *Navy Ford (CVN-78) Class Aircraft Carrier Program: Background and Issues for Congress* (Washington, DC: Congressional Research Service, May 7, 2020).

[71] Sigritz, *2019 State Expenditure Report*, 8.

[72] Mitchell et al., "Outlawing Favoritism."

authority to help states restore policies put in place after hard lessons were learned, and in the process it can help state leaders achieve a subsidy-free future that so many want but cannot achieve on their own.

Local Government Subsidies

The National League of Cities has requested $500 billion in COVID-19 federal relief for municipal governments, in addition to the $500 billion in aid to states requested by the National Governor's Association.[73] Whether Congress decides to directly subsidize municipal budgets in this manner, any prohibition on subsidies should be applied to states' local government subdivisions (municipalities and counties) to the greatest extent possible. Specifically, a state or local government agency of any size or scope should be held accountable to ensure its actions do not provide a targeted subsidy to any corporation that engages in interstate commerce.

A few businesses may not be subject to congressional oversight through the commerce clause.[74] However, in an increasingly interconnected economy, the vast majority of businesses are likely to engage with out-of-state customers or suppliers, either currently or at some point in the future.

A primary reason why a targeted economic development subsidy prohibition should also apply to subdivisions of state government is because local subsidies often are the most wasteful. Although economic research has found that subsidies are unlikely to sway a company's *regional* location or expansion decisions, it has found that subsidy offers can indeed make a difference

[73] National League of Cities, "Cities Are Essential."
[74] In fact, the US Supreme Court has repeatedly found that congressional authority over economic exchange has little limit, up to and including self-production for self-consumption. Regardless, regulating state and local governments' attempts to privilege certain companies, ostensibly to benefit their local economy, certainly satisfies even the limited definition of interstate commerce that the US founders likely intended. Wickard v. Filburn, 317 U.S. 111 (1942); Douglas W. Kmiec, "Gonzales v. Raich: Wickard v. Filburn Displaced," *Cato Supreme Court Review*, 2005, 30.

within a region or metropolitan area. This is because the business is able to access the same local resources, worker talent pool, and supplier and customer connections regardless of which suburb around a major city or small town in a rural region that it chooses; therefore, any local subsidies are just (extra) icing on the cake.[75]

But the effectiveness of local subsidies is not an argument in their favor. They are likely to carry even less weight than state subsidies in a company's decision of which region to locate in. In addition, much of the economic impact from the relocation or expansion likely spills over to nearby municipalities because of local governments' smaller jurisdictions, meaning that local governments gain even less than states from their subsidy spending. And most importantly, economic research suggests that raising taxes to pay for local subsidies to sway business location decisions between communities in the same region reduces long-run local GDP growth by as much as 10 times more than in the interstate and intermetropolitan cases.[76]

Enforcement of the Antisubsidy Rule

The quantity of state and local economic development subsidies will make enforcement of an antisubsidy rule difficult. For example, $5 billion to $10 billion in property tax subsidies are handed out annually by thousands of small communities.[77] Because of the sheer scale of monitoring required—in addition to the 50 state governments, there are nearly 39,000 general-purpose governments (municipalities and counties) and 51,000 special districts across the United

[75] Michael D. Farren and Anne Philpot, "With Amazon HQ2, the Losers Are the Winners: Why Economic Development Subsidies Hurt More Than They Help" (Arlington, VA: Mercatus Center at George Mason University, November 2018), 5.
[76] Timothy J. Bartik, *Who Benefits from State and Local Economic Development Policies?* (Kalamazoo, MI: W. E. Upjohn Institute for Employment Research, 1991), 43.
[77] Daphne A Kenyon et al., *Rethinking Property Tax Incentives for Business* (Cambridge, MA: Lincoln Institute of Land Policy, 2012); Benjamin Schneider, "The Lowdown on TIF, the Developer's Friend," *CityLab*, October 24, 2019; Bill Osmulski, "Tax Increment Financing in Wisconsin" (MacIver Analysis, MacIver Institute, Madison, WI, March 29, 2019).

States—the most efficient mechanism to encourage compliance will be to create markets for monitoring and enforcement.[78]

Such a market can be implemented by motivating peer monitoring by other states, competitors, and taxpayers. In effect, peer monitoring deputizes the members of the community to be on the lookout for economically harmful behavior, rather than having a central regulator. This can be done in several ways, but the most straightforward way is to impose a legal penalty on states and local governments that provide targeted economic development subsidies and on those corporations that receive the subsidies, and then allow the state, business, or taxpayer that brings the violation to light to collect the value of that legal penalty.[79] An objective definition of what qualifies as a targeted economic development subsidy (discussed earlier in this paper) is critically important, and the mechanism should allow states and subsidy recipients the ability to defend their supposed infraction before an impartial court.

A financial penalty should have the following eight characteristics:

1) Be large enough to inhibit the interstate subsidy competitions observed in recent years.
2) Be large enough to motivate effective monitoring and enforcement by other states, businesses, and taxpayers.
3) Be large enough to motivate states to monitor their political subdivisions effectively to avoid lawsuits from other states.
4) Be applied immediately so that the policymakers responsible for the infraction are the ones to suffer the consequences.
5) Be proportional to the relative size of state revenues or the subsidy received.

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[78] Mike Maciag, "Number of Local Governments by State," *Governing*, May 31, 2019; Farren and Mitchell, "An Interstate Compact to End the Economic Development Subsidy Arms Race."
[79] Peter D. Enrich, "Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business," *Harvard Law Review* 110, no. 2 (1996): 377.

6) Scale proportionally over time so that the legislation maintains its effectiveness despite inflation.
7) Satisfy the average person's sense of proportional punishment.
8) Employ a straightforward process of collecting and redistributing the penalty.

There are likely many mechanisms that would satisfy these conditions, but our suggestion is a twofold system holding both the state and the subsidy recipient individually and separately responsible for the transgression (because the act of offering and of acceptance are separate and individually culpable, after all).

First, the penalty for state or local government-granted subsidies could be a reduction in a state's future federal grants, the value of which would be redistributed to the state that engaged in the monitoring and enforcement costs. For example, the financial penalty could be

- equal to 5 percent of a state's five-year average of total federal grants,
- applied proportionally to each type of federal grant in the offending state in the next fiscal year,
- redistributed as a lump-sum, no-strings-attached grant to the state that initiated the enforcement action, and
- adjudicated by federal courts.

On the basis of federal grants and state spending in FY 2017, this particular penalty would correspond to a 1 to 2 percent reduction in the state's revenue for the following fiscal year.[80] The effect would be spread proportionally across all programs receiving federal grants, mitigating the impact on any one program. Furthermore, the proportional application ensures that

[80] Center on Budget and Policy Priorities, "Federal Aid to State and Local Governments."

the penalty is not improperly applied to any particular federally funded endeavor.[81] The "spreading of the pain" of the penalty also helps to create many distinct interest groups to provide intrastate monitoring to head off potential subsidy violations. This approach would also cultivate additional cultural pressure against subsidies.

Interstate monitoring would be motivated by the $50 million to $4.8 billion in potential rewards for the state that initiated the enforcement action (values based on FY 2017 state receipts of federal grants), and by the flexibility of the reward to be used for whatever need was most important for that particular state.[82] The imperative for the case to be heard in federal courts avoids potential bias in state courts. Lastly, the fact that the penalty is preestablished means that federal judges only need to rule on whether the subsidy in question meets the predetermined definition, which simplifies the judicial proceedings.

Second, the penalty for corporations that accept subsidies could be equal to the value of the subsidy, so that there is little incentive to pursue the subsidy in the first place. The legislation would have to create legal standing for businesses that have been harmed by the subsidy's anticompetitive effects and for the state's taxpayers who have been harmed by the misspent funds so that these groups could bring suit to claim the penalty.

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[81] It is worth mentioning that a proportional approach may be subject to legal challenge on the argument that a proportional distribution of the penalty will affect programs that are unrelated to the limitations of use prescribed for the federal funds. Absent the proportional option, however, the penalty could instead be a total forfeiture of economic development–related grants the state would have received for a sufficient period of time, such that the total value of forfeited grants would be enough to dissuade states or their subdivisions from granting subsidies. "The Supreme Court has also suggested that grant conditions may be improper if they are unrelated 'to the particular national projects or programs' to which the federal funds are being directed. The Court has not provided further elaboration on the nature of this 'relationship' requirement, other than by noting that grant conditions must 'bear some relationship' to the underlying purposes of the funds 'otherwise . . . the spending power could render academic the Constitution's other grants and limits of federal authority.' The Court does not appear to have invalidated a federal spending condition on the basis that it fails this 'relatedness' standard, nor has any lower court seemingly done so." Brian T. Yeh, *The Federal Government's Authority to Impose Conditions on Grant Funds* (Washington, DC: Congressional Research Service, March 23, 2017).

[82] Center on Budget and Policy Priorities, "Federal Aid to State and Local Governments."

Either of these mechanisms could inhibit, and perhaps even end, the subsidy war between the states, but combining both provides a "belt and suspenders" degree of confidence. The combination is also more robust to future policy changes and legal challenges, especially because a mechanism that relies on federal grants to states is effective only while those grants remain large.[83]

Discussion

States May Not Take the Deal

It is entirely possible that some states may desire to continue offering targeted economic development subsidies, reasoning that they need the benefits of the subsidies more than they need federal relief from the current economic downturn. If that occurs, then it is reasonable to conclude that they did not need the relief funding as much as they claimed.

Regardless, the removal of even a few states from the subsidy arms race is worthwhile, for the same economic and fiscal reasons that a unilateral exit makes sense. In fact, an obvious follow-on argument is that a requirement to end economic development subsidies should be applied to all federal grants, not just coronavirus relief. And as we explain later, Congress has the authority to impose an antisubsidy rule regardless of whether it is attached to federal grants. The fact that the federal government provides funding to the states simply offers a useful launching pad for the discussion.

[83] There have been effective arguments that the current paradigm of outsized federal grants to states undermines the dual-federalism system that motivates greater government accountability and should therefore be ended. Michael S. Greve, "Big Government Federalism," *Federalist Outlook* 5 (March 2001); Michael S. Greve, *The Upside-Down Constitution* (Cambridge, MA: Harvard University Press, 2012); Michael S. Greve, *Federalism and the Constitution: Competition versus Cartels* (Arlington, VA: Mercatus Center at George Mason University, 2015); Chris Edwards, "Restoring Responsible Government by Cutting Federal Aid to the States" (Policy Analysis, Cato Institute, Washington, DC, May 20, 2019); Chris Edwards, "Federal Aid to the States: Historical Cause of Government Growth and Bureaucracy" (Policy Analysis, Cato Institute, Washington, DC, May 22, 2007).

Federal Targeted Economic Development Subsidies

Those wishing to make a counterargument to our proposal might suggest that the federal government engages in targeted economic development subsidies as well and question why we are not similarly concerned with federal subsidies. In fact, we are. There is no reason to believe that federal subsidies are any less wasteful than state subsidies, and they often are redirected to benefit the politically influential rather than to improve the general welfare.[84] However, that topic is much larger and beyond the scope of this current paper. We will likely return to it in a future paper.

In addition, there is a worst-case scenario that deserves mentioning: the prohibition of state and local subsidies could motivate state and local policymakers to call for expanded federal grants to support economic development. In that situation, states would replace the current unhealthy competition for economic development with an identical problem, this time carried out using federally funded programs and subsidies. The result would be the exact expansion of government spending combined with reduced accountability that federalism scholars warn about, especially because it would then be funded by the deeper pockets of the federal government.[85]

It might seem impossible that the federal government would consciously fully fund both sides of an interstate subsidy arms race, but the possibility should not be taken lightly, given previous failures to contain the granting of subsidies.[86] Therefore, any legislation should clearly articulate the desire to end the interstate subsidy arms race and build mechanisms to forestall this unintended consequence.

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[84] Tad DeHaven and Michael D. Farren, "The Right Fix for Opportunity Zones," *The Hill*, January 8, 2020.

[85] Greve, "Big Government Federalism"; Greve, *The Upside-Down Constitution*; Greve, *Federalism and the Constitution*; Edwards, "Federal Aid to the States"; Edwards, "Restoring Responsible Government by Cutting Federal Aid to the States."

[86] Michael D. Farren and Anne Philpot, "Congress Fumbles Tax Fix to Stadium Subsidies," *InsideSources*, January 3, 2018.

Similarities to the European Union's Regulation of State Aid

The European Union (EU) offers a useful comparison for the policy proposed here. It has forbidden member country governments from providing "state aid" (its term for targeted economic development subsidies) to commercial enterprises since its formation at the Treaty of Rome in 1957. The European Union defines state aid as "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods."[87]

State aid is any policy that distorts competition by satisfying the following criteria:

1) The policy causes a transfer of state resources from a public authority to a commercial enterprise.
2) The resource transfer confers an advantage to the commercial enterprise.
3) The policy is selective, meaning that it is not equally available to every enterprise across the entire country, region, or industry.
4) The policy must be capable of affecting trade between member states by distorting competition.[88]

These rules have helped the European Union to be more successful than the United States at preventing wasteful subsidies.[89] The rules require that all subsidy programs or individual subsidy deals be approved by a powerful central commission before they take effect. The subsidized relocation of existing facilities is banned. The European Union allows subsidies to be offered only in regions of low productivity per

[87] Alberto Heimler and Frédéric Jenny, "The Limitations of European Union Control of State Aid," *Oxford Review of Economic Policy* 28, no. 2 (2012): 352.
[88] Phedon Nicolaides, "State Aid: What Is State Aid?," *Lexxion*, June 23, 2016, https://youtu.be/MoPita-vdIY.
[89] In 2005, US states and cities provided 5.4 times more subsides than EU member states. Greg LeRoy and Kenneth Thomas, "How the EU Controls Bidding Wars for Jobs, Investment," *Shelterforce*, June 17, 2019; Thomas, *Investment Incentives and the Global Competition for Capital*, 96.

capita (which would generally correspond to low-income areas), and it limits the size of the subsidy to a declining proportion of the total investment.

That said, a €1 billion project in a region with the greatest permissibility of subsidies would be allowed to receive €190 million in state aid.[90] A similar project in the United States likely would receive much larger subsidies, so the EU solution is a major step in the right direction toward curbing the size of the problem. However, even if the EU rules were applied to the United States, it seems likely that low-productivity-per-capita regions could remain mired in a wasteful subsidy arms race.

Furthermore, the need for a central bureaucracy to oversee and approve local subsidies adds substantial complications. It arguably runs counter to American principles of federalism and raises a strong risk of regulatory capture.[91] The current spending on subsidies could continue (or even increase) when given official sanction. It seems clear that a better policy would be to find ways to end all targeted economic development subsidies, especially considering the consistent findings by economic research that the billions of dollars spent on subsidies are ineffective at best and may actually harm the subsidies' stated goals of job creation and economic growth.

Is It Appropriate to Attach Conditions to Federal Grants?

In the past, the practice of withholding federal highway funding to pressure states to raise the legal drinking age (among other issues) proved quite contentious.[92] This was doubly true for the

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[90] LeRoy and Thomas, "How the EU Controls Bidding Wars for Jobs, Investment."
[91] Adam Thierer, "Regulatory Capture: What the Experts Have Found," *Technology Liberation Front*, December 20, 2010.
[92] Brian Resnick and Emma Roller, "Four Times the Government Held Highway Funding Hostage," *Atlantic*, July 16, 2014; Jake Curtis, "Thirty Years of Federal Coercion, on the Drinking Age and More," *National Review*, June 23, 2017; Steven R. Weisman, "Reagan Signs Law Linking Federal Aid to Drinking Age," *New York Times*, July 18,

federal government's attempt under the Affordable Care Act to force states to expand their Medicaid programs under threat of losing all Medicaid funding.[93] However, because cash is fungible, federal grants likely displace much of what would be high-priority spending by state and local governments. In other words, it is reasonable to expect that federal grants enable increased secondary uses of state and local taxes, such as granting corporate subsidies.

The proposal to attach subsidy restrictions to coronavirus relief funds is fundamentally different than previous high-profile controversies where federal grants were withheld to pressure states to enact particular regulations. Although those programs were contentious because of the way they distorted principles of federalism by imposing federal decision-making on matters reserved by the states, this proposal is squarely based on enumerated federal powers: Nearly all targeted economic development subsidies are, by their very design, intended to distort the marketplace of interstate commerce by influencing corporate site-selection decisions in favor of the subsidizing state or city. As a result, it is reasonable and proper for Congress to exercise its Article I power under the commerce clause to attach relevant restrictions on interference by states in interstate commerce as a condition for their acceptance of federal grants.

Furthermore, the typical limits on Congress's ability to attach conditions to the provision of federal grants do not hold in this situation. Those limitations apply when the federal government is acting outside its constitutional authority and when it is potentially treading on the powers reserved by states in the Tenth Amendment. But in this case, Congress would be acting within its enumerated authority under the commerce clause. In fact, it makes sense for Congress to impose these restrictions on state and local subsidies without regard to conditions attached to

1984; Stuart Taylor Jr., "Justices Back Use of Aid to Get States to Raise Drinking Age," *New York Times*, June 24, 1987.

[93] David B. Rivkin Jr., Lee A. Casey, and Andrew M. Grossman, "NFIB v. Sebelius and the Triumph of Fig-Leaf Federalism," in *Cato Supreme Court Review 2011–2012* (Cato Institute, n.d.).

federal grants—the requests for coronavirus relief simply provide a useful vehicle to establish this regulation.

Federalism works both ways. When states accept broad and fungible budget bailouts from the federal government, it is both fiscally responsible and constitutionally appropriate for the federal government to make that funding contingent on promises by the states not to turn around and use federal funds to interfere in interstate commerce via targeted economic development subsidies.

Conclusion

It would not be surprising to see state and local policymakers expand their granting of targeted economic development subsidies to convince voters they are doing everything they can to get the economy back on track after the coronavirus public health crisis. Recognizing the opportunity, potential subsidy recipients are already presenting their proposals: one plan from the tourism, sports, and hotel industries of Washington, DC, comes with a price tag of more than $3 billion, despite the District's projected $600 million budget shortfall over the next two years.[94]

The provision of subsidies in good times and bad has led to an estimated tripling of the annual spending of these deals across the country as a share of GDP since 1990. Over the same time period, new transparency requirements and datasets have allowed us to understand the limited effectiveness, minimal benefits, and massive costs generated by these programs.

No evidence exists that targeted economic development subsidies assisted in the recovery from the Great Recession, and no evidence exists that they will be helpful in responding to the

[94] Claude E. Bailey, "DC2021 Presents Plan for the District of Columbia's Economic Recovery from COVID-19 Impacts; Offers to Assist the District with Coronavirus Testing and Federal Lobbying Efforts," Venable LLP, April 20, 2020, https://www.venable.com/insights/publications/2020/04/dc2021-presents-plan-for-the-district-of-columbia.

economic upheaval of the COVID-19 pandemic.[95] Ending them will not create a hardship for states or cities, nor will it prolong the recovery or harm job creation. We can say this with confidence backed by decades of high-quality academic economic research. Fundamentally, the academic research and real-world experience agree on a simple truth: cities and states that offer more subsidies are not more successful than places that offer less. The evidence for this has become so overwhelming that leading urban policy researcher Richard Florida calls incentives "useless" and a "long-standing waste of state and local resources" and says they "do not have any meaningful relationship with the economic performance of states."[96]

Ending targeted economic development subsidies would improve economic inclusiveness and eliminate artificial inequities in America's economy. Such subsidies go disproportionately to the largest and best politically connected corporations. Furthermore, the benefits enjoyed by subsidized corporations often come at the expense of marginalized communities, especially when these communities are uprooted to make way for a new real estate development or manufacturing facility.[97] Ending subsidies would help eliminate the privileges enjoyed by entrenched interests and reduce the barriers to entry faced by entrepreneurs.

Many state and local elected officials have said that they would happily end their participation in the economic-development "race to the bottom," but they are unwilling to be the first to disarm. This is why the federal government would not be harming the states with an antisubsidy rule. Rather, it would be lifting a burden from them, in a way and within a time frame

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[95] Joshua Drucker, Geon Kim, and Rachel Weber, "Did Incentives Help Municipalities Recover from the Great Recession? Evidence from Midwestern Cities," *Growth and Change* 50, no. 3 (2019): 894–925.
[96] Richard Florida, "The Uselessness of Economic Development Incentives," *CityLab*, December 7, 2012; Richard Florida, "Regardless How They're Counted, Incentives Do Nothing for Economic Development," *CityLab*, December 13, 2012.
[97] Michael D. Farren, "Ghost of Poletown Hangs Over GM's Closing Plant," *Detroit News*, December 28, 2018.

that they cannot accomplish on their own. An antisubsidy rule would be especially helpful now, when the public health, fiscal, and economic crisis demands all states' attention and resources.

The states have already started taking the first steps down this road: nearly one-third of them have already introduced interstate compact legislation this year to move toward multilateral disarmament. Conditioning federal relief on states agreeing to forgo offering targeted economic development subsidies provides another way to achieve the outcome that state and local policymakers already desire. In short, it is similar in concept to a fast-tracked interstate compact.

Congress and the president have the opportunity to free state and local policymakers from the subsidy arms race, allowing them to focus on policies that truly help to attract and grow good businesses that create good jobs in their communities. Doing so will unleash greater productivity and lead to stronger national economic development that will make America more prosperous, more resilient, and better prepared to meet whatever challenges the future may hold.