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The political economy of state-provided targeted benefits

Christopher J. Coyne · Lotta Moberg

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Abstract The governments of American states often attempt to incentivize businesses to locate within their borders by offering targeted benefits to particular industries and companies. These benefits come in many forms, including business tax credits for investments, property tax abatements, and reductions in the sales tax. Despite good intentions, policymakers often overlook the unseen and unintended negative consequences of targeted-benefit policies. This paper analyzes two major downsides of these policies: (1) they lead to a misallocation of resources, and (2) they encourage rent-seeking and thus cronyism. We argue that these costs, which are often longer-term and not readily observable at the time the targeted benefits are granted, may very well outweigh any possible short-term economic benefits.

Keywords H1 · H2 · H3 · P16

JEL classification Target benefits · Economic calculation · Cronyism

1 Introduction

Competing for businesses by offering companies targeted benefits is a popular policy among the governments of American states. Targeted benefits come in many forms, including business tax credits for investments, property tax abatements, and reductions in the sales tax paid by the recipient businesses. Policymakers sometimes establish "enterprise zones" to facilitate these benefits, granting them to companies that hire people and invest in the zones. State governments can extend targeted benefits through special state programs or simply give them out directlyto individual companies. The purpose of targeted benefits, as stated by their proponents, is to promote employment, innovation, economic growth, and revitalization.

C. J. Coyne · L. Moberg (✉)
Department of Economics, George Mason University, MS 3G4, Fairfax, VA 22030, USA
e-mail: Lmoberg2@GMU.edu

C. J. Coyne
e-mail: CCoyne3@GMU.edu

Despite their good intentions, policymakers often overlook the unseen and unintended negative consequences of targeted benefits. This paper analyzes two major, neglected downsides of these policies, which are not readily observable when the policies are designed and implemented: (1) they lead to a misallocation of resources, and (2) they encourage rent-seeking and thus cronyism. An argument can be made that these negative consequences of targeted benefits are likely to outweigh any benefits.

Targeted benefits are by no means a new policy in the United States. During the "railroad era" in the 1800s, many American cities provided subsidies to railway companies to attract their business (Taylor 1993, 671). As railroad expansion slowed in the early 1900s, local governments' role in luring particular companies to their locales diminished, although some conflicts later arose when Southern states lured companies from the North with property tax abatements in the 1950s (LeRoy 2005, 72). As the federal government ended the Urban Renewal Program and pulled back some intergovernmental transfers in the 1980s, there was a revival of targeted benefits by state and local governments (Taylor 1993, 674).

In recent decades, the trend has been a steady increase in the number of state governments offering various tax benefits to businesses (Kenyon et al. 2012, 5; Burnett 2011, 3). The 1980s has been called the "decade of industrial recruitment and state incentive packages" (Milward and Newman 1989, 203). Enrich (1996, 378) describes state competition for business as "the second Civil War." According to a recent report by the Pew Centre on the States (2012), 6), tax incentives are the "leading tool" for state policymakers trying to grow their economies. An estimated $65 billion was given out in state and local subsidies in 2005, out of which $45 billion as incentives (Thomas 2011, 96).

Surprisingly many states do not evaluate their benefits programs consistently (Pew Centre on the States 2012, 6), and most empirical studies on tax incentives find that they have little or no effect on employment or the economy as a whole (Calcagno and Hefner 2009, 135). Studies on targeted benefits rely on several assumptions about firm behavior that bias their conclusions. For example, a study of the Michigan Economic Growth Authority Tax Credit Program estimated the program's cost per job at $1,653. However, this cost rose to $45,000 when the researchers no longer assumed that all new jobs by subsidized firms resulted from the tax-credit program (Bartik and Erickcek 2012, 19). The Department of Employment and Economic Development in Minnesota estimated the cost per job in its Opportunity Building Zones (JOBZ) program to be around $5,000. A later, more rigorous evaluation by the legislative auditor's office put the same figure at $26,900 to $30,800 (Pew Centre on the States 2012, 7). Because such studies must make qualified assumptions about the ability of targeted benefits to attract companies, results tend to vary greatly.

Some studies on enterprise zones find that they have little to no effect on employment (see GAO 1988, 39; Bondonio and Engberg 2000; Lynch and Zax 2011; Boarnet and Bogart 1996; Hanson 2009). Several studies on enterprise zones in the United States and France find that they do not increase the likelihood of people finding jobs (Elvery 2009; Busso et al. 2013; Gobillon et al. 2012). Some studies find positive effects on employment compared to neighboring areas (O'Keefe 2004; Ham et al. 2011). It is however, unclear to what extent growth in enterprise zones comes at the expense of adjacent neighborhoods. There is also a lack of consensus as to whether

enterprise zones attract companies, as their supporters suggest (Peters and Fisher 2004; Billings 2009; Papke 1994, 38; Wilder and Rubin 1996).

One thing missing from most studies on the effects of targeted benefits is a consideration of the unintended and unseen economic and institutional effects of these policies. The focus is typically on measuring the effects that show up in aggregate measures, such as changes in employment and economic growth. Such studies thus tend to ignore the longer-run—and often unseen—negative effects on both resource allocation and political institutions. The purpose of this paper is to provide a better understanding of targeted benefits by addressing these issues.

Our analysis contributes to the aforementioned literature by exploring the feasibility of target benefits to achieve the ends stated by their proponents.[1] We ground our analysis in the literature on "robust political economy" (see Levy 2002; Boettke and Leeson 2004; Leeson and Subrick 2006; Pennington 2013). Robustness refers to the ability of a system to handle the stress of human imperfections (Pennington 2013). A system is robust if it generates desirable outcomes in the face of human imperfections. We focus on two human imperfections in the context state-provided targeted benefits: limited knowledge and limited benevolence. Our analysis shows that the policy of awarding targeted benefits as a means to promote economic growth is not robust in the face of limited economic knowledge and perverse political incentives.

The focus on the epistemic constraints facing policymakers is important because proponents of state-provided targeted benefits contend that such tax incentives can contribute to economic growth. We argue, however, that they instead contribute to the misallocation of resources, as they divert resources from the uses that market actors value the most. As many scholars in the Austrian tradition have noted, the knowledge necessary to allocate scarce resources among an array of feasible competing ends emerges through the market process as entrepreneurs, guided by economic calculation, continually reallocate resources to new, and more highly valued, uses (see Mises 1920, 1949; Hayek 1945; Sowell 1980; Hoff 1981; Lavoie 1985a, b; Thomsen 1992; Boettke 1998; Horwitz 1996, 1998). For policymakers to improve on the resource allocation that the market process generates, they would need to possess superior knowledge as compared to market actors. The existing literature on economic calculation and the feasibility of economic planning cast doubt on this assumption.

Limited benevolence implies that policies that favor some people or companies over others tend to distort incentives. Those who can benefit from state-provided targeted benefits will engage in rent-seeking in order to shape policies to benefit their own narrow interests. When such rent-seeking becomes prevalent, a system of cronyism develops (see Aligica and Tarko 2014). When firms can succeed by winning favorable status from the public sector, they are incentivized to serve political interests instead of satisfying private consumers. Political competition thus replaces market competition. People redirect their efforts from productive, positive-sum activities to unproductive and even negative-sum activities.

In what follows we examine the systemic effects of targeted benefits on market competition and the incentives facing both companies and politicians. The next section

[1] Our analysis also contributes to the Austrian literature exploring "urban interventionism" (see Ikeda and Staley 2004; Pennington 2004; Desrochers and Sautet 2004; Ikeda 2004; Staley 2004; Holcombe 2004) and on attempts to create export zones to foster economic development (Seshadri, and Storr 2010).

focuses on how targeted benefits cause a misallocation of resources as governments use them to change the composition of economic activity and to increase overall economic activity. Section 3 details how the use of targeted benefits leads to cronyism as individuals and firms seek to secure benefits from the government. Section 4 concludes with the implications of our analysis.

2 Targeted benefits and the misallocation of resources

To understand how targeted benefits affect the allocation of resources, one must consider the ways in which state-provided targeted benefits are supposed to boost a state's economy. For one, they are intended to promote economic modernization by attracting specific types of companies. This implies that state governments should target "strategic" industries and companies. Second, by attracting companies from other states, targeted benefits are supposed to increase overall economic activity within the subsidizing state. This implies that states should thus target firms that are more "flighty" or "location elastic." There are however, reasons to believe that the knowledge of policymakersis insufficient to determine which industries are strategic and which industries are likely to move.

2.1 Attracting the "right" firms

Targeted benefits are a way to attract particular kinds of firms to improve the composition of a state's economic activity. In this regard, targeted benefits resemble the industrial policies pursued by many governments at the national level. Industrial policy generally means that governments give advantages to specific industries and companies in order to achieve particular social or economic goals (Di Tommaso and Schweitzer 2013, 4). While the "big push" theory of industrialization indicates that, in principle, subsidies for investments in many sectors can "jump-start" the economy (Rosenstein-Rodan 1943),governments also use industrial policy to support particular industries and companies (Wade 1990). Governments in South Asian economies for instance, used subsidies to incentivize companies to become exporters (Studwell 2013). In the United States, the federal government has pursued industrial policies from the time of Alexander Hamilton's 1791 plan for the development of manufacturing industries. The US government has supported railways, iron, steel, cars, defense, and R & D, and it remains highly engaged in industrial policy today (Di Tommaso and Schweitzer 2013, 43–94).

Industrial policies rest on the notion that governments can know how to best allocate resources. The implicit assumption is that left to their own devices, private entrepreneurs fail to fully promote the well-being of citizens because they invest at a socially suboptimal level. They do not take into account the significant positive external effects that they have on the economy as a whole, and should therefore be persuaded by tax breaks to invest more and hire more people.

However, because policymakers operate outside of the market context, they have no way of knowing the opportunity costs of the resources redirected by their policies. Even where subsidies contribute to the growth of what policymakers consider to be a desired industry, that does not mean that they have allocated resources to their highest-valued

use. This is important, because market-failure justifications inherently assume that markets generate suboptimal outcomes that policymakers can correct. This in turn requires the assumption that policymakers have superior knowledge about the optimal outcome.

We consider three assumptions about how targeted benefits can serve a state economy by attracting the "right" firms. First, targeted benefits are assumed to increase overall economic activity in a sector. Second, they are assumed to attract companies that are strategic and more wealth enhancing than others. Third, they are assumed to help form efficiency-enhancing industrial clusters. We provide reasons to doubt each one of these assumptions.

2.1.1 Crowding out: the futility of creating a dominant industry

State governments aim to increase investment and employment in the industries that they are targeting. However, government expenditures tend to make companies in the same sectors reduce their own spending and investment. One reason for this "crowding out" is that overall demand for the goods they produce often does not change. Companies in the industry are also competing for the same kind of capital and labor inputs for their production. Targeted benefits give targeted companies more purchasing power for labor and capital, which allows them to expand, which pushes up input prices. Unsubsidized companies therefore find it more difficult to remain profitable, and some shrink or go out of business. The result is that government expenditures can fail to increase the overall economic activity of a targeted sector.

Crowding out is well-established in the existing empirical research. From charitable giving (Abrams and Schitz 1978) to health-care expenditure (Kronick and Gilmer 2002) and investment generally (Bairam and Ward 1993), government spending has been found to result in the crowding out of private investment. Subsidies to particular firms and industries may well have the same effect. Research and development is a popular target of state benefits, as indicated by the fact that as of 2005, 41 states had programs granting tax benefits to R&D (Stark and Wilson 2006,139). In a meta study on the effects of government R & D expenditures, García-Quevedo (2004)) finds that in most cases they substitute for rather than complement private investment. This suggests that more government-funded R&D leads to less privately funded R&D.

Targeted benefits tend to cause similar crowding out. Wal-Mart, for instance, is a popular target for fiscal benefits. By 2013 it had received at least 260 special benefits in the United States, worth over $1.2 billion in total (ii). While these benefits increase the amount of Wal-Mart-related economic activity, they also crowd out competitors that do not receive those same benefits. Basker (2005), for example, finds that while a Wal-Mart store generates an average of 100 jobs, 50 jobs also disappear as other retailers are outcompeted. Jia (2008) concludes that "Wal-Mart's expansion from the late 1980s to the late 1990s explains about 40–50 % of the net change in the number of small discount stores and 30–40 % for all other discount stores." Tax expenditures in the form of tax breaks or company subsidies thus have the same effect as direct government expenditures. They lower the costs of targeted companies, who can thus increase their production, while other companies have a harder time competing. The net effect of targeted benefits varies, but even if targeted benefits increase the overall level of

activity of an industry, the problem of crowding out means that the magnitude of the increase will be smaller than the size of the targeted benefit.

2.1.2 Why there are no "right" firms or industries

Even when targeted benefits generate an increase in economic activity, the question remains as to whether governments are able to target the "right" companies. There are numerous examples of governments wasting money while trying to promote new industries. Consider, for example, the California Alternative Energy and Advanced Transport Financing Authority (CAEATFA), which makes investments in alternative-energy projects on behalf of California's taxpayers. Between November 2010 and August 2012, the largest award among 45 projects went to Solyndra, a solar-cell manufacturer, which also received $528 million in loan guarantees from the federal government. After spending $25 million in state tax exemptions on equipment the company filed for chapter 11 bankruptcy and ceased all business activities (Summers and Chawla 2013, 1, 24). The failure of Solyndra also exemplifies how the targeting of "right" industries is often guided by information from the interested party according to one estimate, the company spent $1.9 million on lobbying efforts between 2008 and the bankruptcy (McArdle 2011).

Governments often subsidize industries that they see as "strategic," but what exactly constitutes this category is unclear and constantly shifting. Once, textiles were considered strategic, along with coal, steel, cars, defense, and construction (Di Tommaso and Schweitzer 2013, 7). The catalog of strategic industries today is often considered to include telecommunications, software, energy, and green industries (Id., 23). In the era of cloud computing, data-storage companies can attract substantial government subsidies. North Carolina is building its "Data Center Corridor" with subsidies to companies like Apple and Google. In 2007, Apple received local and state subsidies for building a large facility in the city of Maiden, North Carolina. Generous tax breaks make the deal worth $370 million, assuming that Apple stays there for 30 years. Also in 2007, the state awarded Google benefits worth $255 million over 30 years for setting up its data center in the city of Lenoir (News & Observer 2007; Fehrenbacher 2012).

These policies rely on the assumption that a government can choose the best companies for its state's future over a period of decades. Further, these decisions are often based on the implicit assumption that "modern" industries are always better for the state. Such decisions, however, can often yield very small benefits for a state's residents. High-tech firms often create very few jobs. The Apple facility in Maiden was estimated to hire 50 people; that is one job for every $7.4 million in subsidies (Catawba County Board of Commissioners and Maiden Town Council and 2009. Resolution No 2009).

If a state really is a good location for a particular firm, there should not be a need for the government to lure it with targeted benefits. Established companies like Google and Apple surely do not need help in covering the start-up costs. More generally, nobody knows what the dominant industries in the future will be. Neither can anyone foresee which companies will deliver large positive external effects on other companies in the same state. However, market participants, relying on market knowledge, have the incentive to be alert to potential profit opportunities. Because they invest their own resources, market participants need to be careful and astute when making investment

decisions. In contrast, political actors have an incentive to invest taxpayer money in large-scale, observable investments that appear to contribute to economic activity and wellbeing—even if they do not. Lacking market knowledge, political actors have few means of gauging the economic efficacy of these investments.

2.1.3 The case against government-built industrial clusters

Industrial clusters refer to the geographic concentration of specific businesses—producers, suppliers, related providers, etc.—associated with a specific industry. In technology sectors in particular, geographical clusters are often deemed good investments for three main reasons: (1) they promote economies of scale, which increase the productivity of individual members of the cluster, (2) they generate network effects, which spur innovation in the industry, and (3) they encourage new businesses to enter the industry (Krugman 1993; Porter 2000).

The US manufacturing belt is one of the most powerful examples of a geographical cluster. Natural resources first laid the foundation of the metal industry. Significant economies of scale prompted high concentration, and a huge aluminum plant was located at Niagara Falls in the 1880s, to take advantage of the electrolytic process for power (Chandler 1990, 70). As Krugman (1991, 22) notes, access to markets through new transportation technologies attracted large investments to what is now called the rust belt. Although its heyday was between the time of the Civil War and the 1920s, the prominence of the manufacturing belt endured in the age of the automobile. Because it was profitable for car manufacturers to stay in the cluster, the belt persisted for decades (Krugman 1993, 174). Successful industrial agglomerations are often used as evidence that governments should actively create more clusters by incentivizing certain companies to invest in the same location (Krugman 1993,176; Desrochers and Sautet 2004). However, the American manufacturing belt shows that clusters can form without government intervention.

Government planning of clusters relies on the notion that governments are better than private entrepreneurs at detecting industries that are not exploiting their potential network effects and economies of scale. Yet, if that were so, companies would seek the advice of policymakers about where to form a cluster, even without receiving any subsidies.

Policymakers are in fact less apt than entrepreneurs at judging what clusters will be profitable in the future. They may observe what clusters worked in the past and attempt to mimic those past successes. However, successful clusters in one time and place do not imply that identical clusters will be as successful in the future. What was a successful strategy last year, or last decade might not be so tomorrow. In addition, if an industry is already endowed with a cluster, this makes it harder for new clusters to compete. Another uncertainty is whether agglomeration really will be a superior form of industrial organization in the future. With production stages increasingly spread out geographically, there are indications that technologically advanced industries are moving toward less agglomeration (Baldwin 2012).

Agglomerations can also make economies more prone to sudden downturns (Desrochers and Sautet 2004). In this regard, diversifying economic activity to avoid having to rely on a few industries has its merits as well (Wagner and Deller 1998). Detroit relied on its automotive industry throughout the 20th century. It now seems that

the decades of decline leading up to the city's 2013 bankruptcy revealed the instability of the cluster over the longer term. Investing in a cluster in the present, even if it is successful in the medium term, may create lock-in effects that will contribute to economic stagnation in the future.

2.2 Attracting more companies

While the previous sections focused on government efforts to shape the composition of economic activity, this section deals with another argument for targeted benefits: that governments can utilize these benefits to increase overall economic activity in their states. The underlying idea is that each state is involved in a zero-sum game with other states, meaning that states attract companies at each other's expense. The winner is the state that obtains the largest number of firms by offering the most attractive deals.

A key part of the argument for increasing overall activity is that one company leads to the formation of additional companies and other economic activities through so-called economic multiplier effects. For example, the Illinois Department of Commerce and Community Affairs estimated in 1989 that losing the Sears headquarters would cost not only 5,400 jobs at Sears, but also 2,200 indirect jobs. This 40% multiplier effect was used to justify granting the company $242 million in state and local incentives to stay (LeRoy 2005, 31; Goozner 1989). The logic is that when people are on the payroll, they spend their income locally. This encourages more investment, which further increases employment. The main concern for a state government is therefore to attract as many companies as possible to spur this beneficial process. Governments should bet on the companies most likely to respond by moving into the state—or staying if they are already there. In what follows we critically analyze the feasibility of efforts to attract more companies.

2.2.1 The futility of estimating company elasticities

To attract as many companies as possible, targeted benefits should aim at businesses with the highest propensity to respond to the incentives being offered. Frank Ramsey (1927) suggested that sales taxes should be set on each good individually, depending on the price elasticity of the demand for that good. He argued that the size of the tax should be inverse to the price elasticity of demand—i.e., the more elastic the demand for the good or service, the smaller the tax. From this idea grew the theory of optimal taxation, where tax rates could, conceptually, be calculated for each good individually, depending on the expected effects on consumer, worker, and business behavior. The logic is that a tax can be raised if it does not change the behavior of people and businesses. Following similar logic, targeted benefits can allow for different business taxes between industries, or between companies for even higher precision, according to their elasticity of production and job creation.

Pursuing such a policy in practice, however, would be extremely complicated. Governments would need to determine individual companies' elasticities and to update their elasticity assessments as conditions change. The individualized tax rates would thus inflict considerable administrative costs, which would waste whatever efficiency was gained from differentiating the benefits (Buchanan and Congleton 1998, 9).

A more fundamental problem is that it is impossible for governments to obtain realistic data regarding company elasticities. Before a company has received a certain benefit, there is no reliable data on how the company will react to it. Even if a company increases its workforce after receiving a benefit, this does not imply that it will do so again in the future. Policymakers cannot target companies with certain elasticities, precisely because knowledge about elasticities is not readily available. Even if policymakers know that a targeted company came to their state and hired a certain number of people, they cannot disentangle behavior that was a result of the targeted benefit and behavior that would have happened in its absence.

Counting the people a targeted company employs to measure the effectiveness of targeted benefits assumes that the company would never have moved to, or stayed in, the state absent the benefits. These assessments assume that all companies that received targeted benefits by virtue of moving to or staying in a state were completely location elastic. Such assumptions about companies' propensity to move underlie much of the common perception about the positive effects of targeted benefits.

Targeted benefits are frequently evaluated by comparing the value of tax benefits to the performance of a subsidized company in order to approximate a "price" for job creation and investments. For example, North Carolina paid FedEx $77,000 per new job in a new hub (LeRoy 2005, 35). South Carolina paid an estimated $68,000 per job per year in incentives to a BMW auto plant (Tomsho 1995). Finally, consider the 2010 deal between the state of Louisiana and Cheniere Energy. In return for benefits worth $1.7 billion, the company was expected to hire 148 new people and retain 77 existing jobs. Counted optimistically as a gain of 225 jobs, those jobs thus had a price tag of $7.5 million each (Mattera et al. 2013; Office of the Governor and Louisiana 2011).

Setting price tags on jobs like this presents an obvious paradox. If targeted benefits always lure a company to the state, the taxes that it does not pay are not a cost to the state. This is an often-made assumption. The implication is that a state should always grant tax benefits to new arrivals. In short, since companies do not pay taxes when they are outside the state, the government has nothing to lose by allowing them to operate without paying taxes.

If, on the other hand, jobs would have been created in the absence of the benefit, these jobs cannot be considered gains for the state. Because it is impossible to know whether companies agree to move to or stay in a state because of a particular benefit, it is impossible to make a benefit-cost calculation for targeted benefits. In the absence of a counterfactual, one can only guess about the net results of targeted benefits. Even very sophisticated statistical methods fall short when trying to assess whether a firm invested, hired people, or relocated on the basis of a certain benefit. Statistical studies can measure what is seen, but they cannot compare it to the chain of events that would have played out in the unseen counterfactual.

It should also be noted that policymakers cannot find companies' location elasticities simply by asking them. Companies will always want to declare that they are very sensitive to fiscal incentives if the government may respond by awarding them benefits. And they do not have an incentive to reveal afterward that the benefits did not affect their location decision (Fisher and Peters 1998, 14). Company executives who have already decided to move to another state have an incentive to generate a bidding war between states by declaring that they are considering the move. In many cases,

companies use the bids from their home State's government as a negotiating tool when bargaining over taxes in their new location (LeRoy 2005, 14).

Whether company executives determine the location first and start negotiating its benefits later is usually impossible to know. Occasionally though, companies declare ex post that the subsidies did not determine their location decision. American Express received a $25 million grant for returning to lower Manhattan after the September 11 attacks. Having received the money, its spokesman declared that the company had had every intention to return without the subsidy, while hinting that American Express does not turn free money down when it is offered (LeRoy 2005,61). Honda was one of several Japanese manufacturers that US states attempted to lure with targeted benefits. Yet the vice-president of Honda explicitly declared that the incentives that Ohio offered the company "were never part" of Honda's choice to locate there (Kenney and Florida 1991).

From the perspective of policymakers, companies can enter the high-elasticity category simply by announcing that they are considering relocating. When companies are paid merely to stay, the efficacy of the subsidy seems very dubious. New York State allegedly dissuaded both Morgan Stanley and Kidder, Peabody &Co. from moving when they threatened to do so in 1995, offering them $30 million each in benefits. By hinting that it might move to New Jersey, the New York Stock Exchange earned the largest government subsidy in the state's history in 1998 (Los Angeles 1998). The benefits from New York State, allegedly worth more than $1 billion, included a new trading floor and subsidized energy (Nader 2001; Parrott 2001). The stock exchange subsequently showed its gratitude by announcing that it would remain in New York.

The list of targeted benefits offered to prevent companies from leaving is long. When the Walt Disney Company threatened to relocate its Disneyland Park, the company received $800 million in benefits from the state of California and the city of Anaheim (Myerson 1996). Illinois has twice paid Sears not to move, once back in 1989 and then again in 2011 (Goozner 1989; McCourt and LeRoy 2003, 36; O'Connor 2011). Perhaps Sears really would have moved absent the subsidy, but we will never know. There is no reason to believe that governments are actually targeting the most mobile companies, as opposed to those that have best cultivated the art of appearing flighty.

Misdiagnosing location elasticities can be costly. When a company would stays in a given place without a targeted benefit, but receives the benefit nonetheless, the loss of tax revenues implies a need to raise the tax burden on others in the state. Also, even if companies actually do decide to move to where they will obtain the best benefits package, that only means that the "winning" state is probably the biggest loser. If any state overestimates the company's value, it is likely to be the state offering to pay the most for it (Thaler 1992; Cowen 2007, 6).

2.2.2 The alternative uses of resources

Regardless of whether the benefits had any impact on its investment decisions, when a targeted company comes to a state, it gives the appearance that it is increasing economic activity. The company hires people and makes investments that it might otherwise have made elsewhere. Yet this apparent contribution also has an unseen side.

In the absence of a counterfactual story, it is unknown where and how the people and capital that the company employs would otherwise have been allocated. Labor and

capital are scarce resources and they are rarely left idle. New investments may increase demand for goods from local providers. Yet subsidies also help certain companies bid for workers and capital from other firms. When new companies receive extra money to invest, they raise the price of capital and drive up wages, which imposes an additional cost on unsubsidized companies in the state. Since there is no direct way of tracing the loss of one company to the targeted benefit of another, this side of targeted benefits is rarely recognized. We can see how much labor and capital a subsidized firm employs. We cannot see which firms are adversely affected by the policy.

We have already discussed crowding out within an industry. Because many different industries share the same costs in terms of capital and labor, there is also a crowding out in the broader economy. This means that a benefit scheme can potentially succeed in both attracting companies and increasing an industry's share in the economy, yet still not increase overall economic activity. Because so many firms are to some extent competitors for production inputs, policymakers cannot avoid adversely affecting local investors when luring more companies to the state.

2.2.3 The obsession with size

State-provided benefits tend to be biased toward larger companies. According to a 1995 survey by KPMG, 79% of 203 companies with gross revenues over $300 million were receiving some kind of tax break (McNamee 1995). Large companies including Alcoa, Boeing, Nike, and Intel have received benefit packages worth over $2 billion each. In 2007, Alcoa obtained what was then the largest deal between a firm and a state government ever. The state of New York granted it electricity for over 30 years at an estimated value of $5.6 billion. In return, Alcoa was to make a $600 million investment, and it promised not to fire more than 165 people (Mattera et al., 2013, 6). Boeing beat this record in 2013, when the state of Washington offered it tax and other benefits worth $8.7 billion to build the wings of its new 777× aircraft in the state. In February 2014, Boeing announced that it was taking up the state's offer (Wilson 2013; Gates 2014).

The logic behind this large-company bias is that politicians measure success by observable outputs. A larger company has more employees and spends more, relative to smaller companies. It therefore creates the appearance of contributing more to the local economy. Contrary to this appearance, there is evidence that larger firms are not generally better for economic growth than smaller firms are (Fox and Murray 2004). Further, smaller firms are more likely to file "high-impact" patents, and newer firms, which are generally smaller, are more likely to license new technology (Mitchell 2012, 21). Finally, by focusing on larger companies, state governments are potentially crowding out smaller firms that may be both more efficient and more innovative. Such crowding out usually goes unnoticed when policymakers consider the net benefits of discriminatory fiscal policies.

3 The emergence and persistence of cronyism

The misallocation of resources that targeted benefits cause is the direct effect of the reliance on political mechanisms for designing and implementing these policies. In addition to this direct effect they have perverse indirect effects as well. When

policymakers use incentives to steer private investments, businesses have an incentive to influence and shape these decisions for their own, narrow benefit (see Buchanan 1986).

Ultimately, this political manipulation sows the seed of cronyism, the established practice of exchanging favors between powerful people in politics and business. Cronyism is an institution that arises from and facilitates rent-seeking. It emerges when people invest in long-term, repeated relationships to secure future gains from rent-seeking. It is not a simple, one-off lobbying effort. Instead, cronyism describes long-term, repeated dealings between powerful parties, where one side can create rents through its access to public resources (Aligica and Tarko 2014).

In contrast to nepotism, cronyism does not necessarily entail people in power giving favors to their family and friends. It can also involve parties without any initial personal connections who learn to rely on each other because of their exchange of favors through the political system. Crony relationships take time to establish, but once there is an expectation of repeated political favoritism between public and private actors, cronyism becomes institutionalized. For example, Mazumdar (2008) describes how crony relationships developed in India under high political dominance and ownership in business. Even after the government liberalized many companies in the 1990s, the incumbent leading firms remained dominant. Once patronage was built into the Indian system, the same businesses largely kept benefiting from government policy.

3.1 Why targeted benefits encourage rent-seeking

Targeted benefits incentivize firms to seek and secure those benefits by devoting resources that could otherwise have been used for wealth creation. Targeted benefits are valuable to firms because of their discriminatory nature they give the recipient favorable advantages over competitors that do not receive the same benefits. A state government that regularly targets companies with benefits worth millions of dollars cannot expect companies to sit idly by and hope to be the lucky recipients. Instead, companies will actively work to signal to policymakers that they fulfill the criteria of a good target. This includes creating the impression that they are strategic firm sand that they have a high propensity to relocate. Multinational corporations are for this reason happy to proclaim their status as “stateless” companies (Barnet 1994). Companies based in America similarly do not want to pledge a strong loyalty to any particular location.

Companies also have an incentive to signal that policymakers face competition when offering them subsidies. In 1997, the hotel chain Marriott indicated that it was considering moving its headquarters from Maryland to Virginia. That spurred two Virginia counties to offer the company $12 and $17 million in subsidies, respectively. Policymakers in Maryland countered with a subsidy worth $49–$74 million, which persuaded Marriott to stay (LeRoy 2005, 15). When state governments seek to target mobile firms, this incentivizes more firms to signal that they can be persuaded by government benefits to relocate elsewhere.

Companies have different ways to advertise themselves as “strategic.” If they are large enough, they may have the resources and presence to try to convince policymakers to offer them direct benefits. For example, in 1993 IBM cut its workforce by 7,000 people in upstate New York. This resulted in a rapid increase in

unemployment in the area. In 2000, in order to convince IBM to remain in the area and expand, the government declared IBM's location an enterprise zone. The company received $659 million in subsidies, of which $475 million was by virtue of its enterprise-zone location (LeRoy 2005, 17).

It is often harder for smaller firms to claim that they are strategic for the state economy as a whole. They also lack the resources that larger firms have to invest in lobbying efforts. This logic further explains why large companies are frequent targets for state benefits. They are simply better at advocating for why they are important for the state. Smaller companies may potentially overcome these problems by joining their efforts with those of other companies to lobby for targeted benefits for their industry (see Becker 1983). That kind of rent-seeking may therefore predominate when the government targets industries rather than single firms.

3.2 Why targeted benefits encourage regulatory capture

Businesses have the incentive, not only to capture rents being offered by the government, but also to actively influence the policy agenda to encourage the government to offer more such rent opportunities. The term "regulatory capture" refers to situations where special interests control the content or implementation of government policies (Laffont and Tirole 1991). Good candidates for targeted benefits will actively lobby the government to introduce more of them and will attempt to influence the specific benefits for their own narrow interests. For example, in 2008, representatives for the film industry met with legislators in Louisiana to lobby for subsidies. Another representative of the industry met with the state governor and legislature of Michigan. Shortly thereafter, that state signed into law a benefit scheme for movie production (Luther 2010; Binder 2008). Rent-seeking thus plays out when businesses try to take advantage of policies, and it further proliferates as policymakers see more reasons to introduce policies that create rent-seeking opportunities (Wallis 2006).

Regulatory capture is a complex form of rent-seeking. It requires planning, preparation, and strategic thinking, as well as learning the skills of lobbying and the rhetoric of politics. Industry representatives must learn to frame their demands for targeted benefits on the basis that they promote public-policy goals such as revitalizing neighborhoods, bringing more jobs, and setting a trajectory of high economic growth. Influencing government policy thus demands a lot of a company's resources, which it may be willing to spend as long as it expects the effort to yield positive net returns. In general, regulatory capture and other forms of rent-seeking are ways by which individuals, firms, and industries obtain larger shares of the economic pie rather than working to make the overall pie larger. Targeted benefits therefore waste resources in other ways than misallocating resources directly. Ultimately, they lead to cronyism, which institutionalizes these practices. The following sections look at how crony relationships form as a result of such discriminatory targeted-benefit policies.

3.3 Building political connections

When determining what companies or industries to target, policymakers try to learn how the industry operates and how it responds to various incentives, to gauge the economic benefits to their constituents of providing specific targeted benefits. The best

sources of such information are often people from the targeted industries. The problem is that these are also the people with the biggest interest in offering biased policy advice.

Governments may hire their own industry experts rather than relying on information provided by biased companies. However, many government-employed experts have previous experience in the industry, including an array of existing connections to those currently working in it. Because these experts may plan to return in the future—either as employees or as consultants—they need to remain on good terms with their company connections (Leaver 2009). This pattern of a "revolving door" between business and politics means that even government-employed experts will often work in the interests of the private producers in the industry rather than for some notion of the "public interest" (Cohen 1986; Mitchell 2012, 26; i Vidal et al. 2012).

There are other ways for businesses to cultivate close ties with the political class. Long-term relationships with policymakers allow companies to maintain a privileged position so that they can influence, and receive, whatever targeted benefits may appear in the future (Aligica and Tarko 2014). Without the right political connections, a company may have to lobby repeatedly every time an opportunity appears for new targeted benefits. Stable relationships with policymakers also mean that a company can obtain benefits today in exchange for promises of future support for policymakers. Good political connections are therefore more important for corporate profits than short-term payments and lobbying efforts (Milyo 2013).

Benefits that are renewed every year may soon disappear, so companies cannot count on them in the future (McChesney 1987, 108). Company executives therefore need to make sure that these benefit packages are not cancelled for political reasons. Relying too much on the people currently in power creates uncertainty, as they will be of little use to the company once they are out of office. Companies therefore have an incentive to make sure that future politicians honor the loyalty to the company that their predecessors showed. For this, companies can take advantage of public pressure on politicians. If the companies can convince the voting public that the economy needs targeted benefits, politicians will be reluctant to discontinue the benefits for fear of losing public support.

The case of Raytheon, a defense contractor, illustrates this dynamic. In 1995, executives from Raytheon threatened to leave Massachusetts for Tennessee if the company did not receive certain benefits. The scheme misfired, and the company was portrayed in the media as engaging in black mail. In response, Raytheon hired a lobbying team for a public-relations campaign, which proclaimed that the state's "defense initiative" would save 117,000 jobs. The governor soon offered Raytheon $20 million in tax cuts, while labeling the policy a "jobs package"(LeRoy 2005, 11; Myerson 1996). Like Raytheon, companies hoping for government benefits may need to invest, not only in their political relationships, but also in their relationships with the broader public (Becker 1983, 392).

3.4 Institutionalizing cronyism

The interplay between state policies, company behavior, and policy responses is a process that can feed on itself and accelerate. Just as productive

entrepreneurship encourages further wealth-increasing activities (Holcombe 1998), so can rent-seeking activities multiply and cause economic stagnation (Baumol 1990). More rent-seeking encourages the development of more institutions to facilitate rent-seeking (Coyne et al. 2010). Because cronyism is an important institution for rent-seeking, it may become entrenched and incorporated into the social fabric.

As companies direct more of their resources to securing special benefits, they need more people who can lobby or who have other rent-seeking skills. There is already a whole industry of "location consultants," some of whom demand a commission of up to 30% on the subsidies that they can negotiate with local governments (LeRoy 2005, 57). Consultant G. Brint Ryan in Texas is a good representative of this industry. Texas allocates corporate benefits exceeding $19 billion per year, more than any other state (New York Times 2014). Ryan realized the profit opportunity in serving as a consultant to companies seeking to obtain these benefits. He has since secured benefits for ExxonMobil, Samsung and Wal-Mart, among others. Ryan also illustrates the importance of having political networks for securing targeted benefits. In 2012, the Texas legislature set up a commission to evaluate the impact of state investments in development projects. Ryan, who donated more than $150,000 to the campaign of the state's lieutenant governor, was appointed to the commission by the lieutenant governor. Among others, Samsung, one of Ryan's clients, was invited to testify before the commission about the benefits of the tax cuts (Story 2012).

Targeted benefits encourage the growth of rent-seeking entrepreneurships. Skilled lobbyists will be highly sought after as targeted benefits become larger and more frequent. There are already numerous consulting firms that offer companies help in negotiations with governments; there are also law firms that specialize in subsidies. Companies are sold advice on how to play "hard to get" and how to access the right policymakers to obtain benefits (LeRoy 2005, 84–87).

Amazon turned to this market after receiving a tax-benefits package for a distribution center in Dallas in 2005. The company threatened to shut the facility down if it was not also excluded from paying $269 million in sales taxes that the state was imposing on it and other Internet companies. Amazon finally turned to the lobbyist market, hiring three advocates with close ties to Governor Rick Perry. The governor soon stated that he supported exempting Amazon from the tax payments, and they were indeed eventually exempted (Story 2012).

As a similar dynamic emerges in other industries, lobbying and cronyism are replacing market innovations and competition. Over time, the private consumer is ceasing to be the most important customer for businesses to satisfy. Instead, businesses are shifting their attention to satisfying those in government with the power to introduce and distribute state-provided targeted benefits.

When cronyism becomes institutionalized, politics becomes a key factor for the economic sustainability of private businesses. Under institutionalized cronyism, the companies that succeed will be those that become increasingly efficient in rent-seeking and in influencing policy. As this process unfolds, social norms may change toward an acceptance of rent-seeking behavior and hence of the system of cronyism itself (Acemoglu 1995, 30).

4 Conclusion

Our analysis has three related implications. First, state governments cannot plan economic progress by relying on targeted benefits. Reallocating scarce recourses to their highest-valued uses requires market knowledge about the resources' alternative uses. Policy-makers therefore lack the ability to solve the core economic problem required for development (see Coyne 2013, 61–89). This is not an issue of obtaining more information or investing more resources in efforts to promote growth. Instead, it is an insurmountable epistemic constraint. There is no way for policymakers, who are outside of the market process, to access the knowledge generated by economic calculation.

Second, targeted benefits encourage wasteful rent-seeking and cronyism. Decisions regarding the recipients of targeted benefits are made through the political process. This encourages private market actors to attempt to shape and influence political decisions for their own narrow interests. This is problematic because when cronyism becomes institutionalized, it threatens the long-term dynamism of the market economy (see Zingales 2012, Mitchell 2012, Phelps 2013; Holcombe 2013). Private, productive entrepreneurship and voluntary exchange are increasingly replaced by unproductive entrepreneurship in the form of rent-seeking and political favoritism. To the extent that state-provided targeted benefits contribute to a system of cronyism, they are accomplishing the opposite of their original purpose. Instead of promoting economic growth, they are contributing to economic stagnation and decline.

In the face of epistemic constraints and perverse political incentives, the policy of awarding targeted benefits to promote economic growth is therefore not robust. This leads to a final implication. Rather than relying on narrowly targeted benefits to attract entrepreneurs, local governments are better off promoting a general environment conducive to productive entrepreneurship. This approach requires policymakers to adopt a generality norm, as compared to discriminatory policies, whereby no company or industry receives preferential treatment over others (see Hayek 1960; Buchanan and Congleton 1998). Because a generality norm means that rules are equally applicable to all, it discourages companies from engaging in destructive rent-seeking. By curtailing discriminatory policies, governments also avoid misallocating resources, since they are no longer selecting specific recipients of targeted benefits.

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