CONTINGENT EDIS: A NEW CONTRACTUAL FRAMEWORK FOR MINIMIZING THE RISK OF INCENTIVES FAILURES
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Contingent EDIs: A new contractual framework for minimizing the risk of incentives failures

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Abstract

Granting economic development incentives (or “EDIs”) has become commonplace throughout the United States, but the efficiency of these mechanisms is generally unwarranted. Both the politicians granting, and the companies seeking, EDIs have incentives to overestimate the EDIs benefits. For politicians, ribbon–cutting ceremonies can be the highly desirable opportunity to please political allies and financiers, and the same time that they demonstrate to the population that they are successful in promoting economic growth – even when the population would be better off otherwise. In turn, businesses are naturally prone to seek governmental aid. This explains in part why EDIs often “fail” (i.e. don’t pay–off). To increase transparency and mitigate the risk of EDI failure, local and state governments across the country have created a number of accountability mechanisms. The general trait of these accountability mechanisms is that they apply controls to some of the sub–risks that underlie the risk of EDI failure. These sub–risks include the companies receiving EDIs not generating the expected number of
jobs, not investing enough in their local facilities, not attracting the expected additional
businesses investments to the jurisdiction, etc. The problem with such schemes is that
they tackle the problem of EDI failure very loosely. They are too narrow and leave
multiplier effects uncontrolled. I propose novel contractual framework for implementing
accountability mechanisms. My suggestion is to establish controls on the risk of EDI
failure itself, leaving its underlying sub-risks uncontrolled. I call this mechanism
“Contingent EDIs”, because the EDIs are made contingent on the government achieving
a preset target that benchmarks the risk of EDI failure. If the target is met, the EDIs will
ex post kick in; if not, then the EDIs never kick in.
I. Introduction

Granting economic development incentives (or “EDIs”) to foster local and state development is now commonplace in the United States. Tax breaks are the most common form of EDIs, but cities and states often grant other sorts of handouts such as direct subsidies in cash, land grants, real-estate rental rebates, infrastructure improvements, low interest financing, worker training incentives, preferential purchasing practices, and so on. EDIs can play a justifiable role in securing public goods (for example, in building infrastructure, in fostering basic research, and in improving education or public health) that would otherwise remain undersupplied,¹ but they can also be easily subverted by the interests of lobbyists, campaign financiers, and ambitious politicians.

Government lawyers frequently face the challenge of having to draft legislation and contracts that can minimize such risks. The solution most commonly adopted is to attach “strings” to the handouts being granted to the businesses. These “strings” typically comprise a blend conditions for the granting of EDIs such as a minimum number of jobs to be created, non-relocation provisions and even requirements for minimum wage levels, among others.

This paper is written in the spirit of providing an additional tool that can be considered in such situations. It describes an alternative contractual framework called “Contingent EDI” that in some cases will improve EDIs more than the usual strings.

¹ See Kenneth J. Arrow, Uncertainty and the Welfare Economics of Medical Care, 53 Am. Econ. Rev. 941, 1963; and Rice & Ulen, Rent-Seeking and Welfare Loss, 3 Research L. Econ. 53, 1981.
The jurisdictions that grant EDIs bear the risk\(^2\) that the companies receiving them will not benefit the city and/or the state inasmuch as the cost of the EDIs.\(^3\) Like any other public investment, EDIs sometimes pay off, and sometimes don’t. Urban political economy literature employs the expression “subsidy failure” to designate the risk that a broad range of publicly-sponsored mechanisms designed to foster business activities do not pay-off.\(^4\) I use “EDI failure” instead of “subsidy failure” in order to avoid the terminological disputes amongst legal scholars about the differences between subsidies and economic incentives.

The risk of EDI failure is a complex risk. By “complex” I mean that it is a risk that in reality is comprised by a number of underlying sub-risks. Whether a certain EDIs package pays-off depends upon the outcome of these underlying sub-risks. To illustrate, the risk of EDI failure resembles the risk of losing in a craps game. In craps, each player rolls two dice, so each die represents a different sub-risk that determines whether the player will win or lose. The government granting EDIs may “win” (when the EDIs pay-off) or “lose” (when they don’t). In the EDIs “game”, the underlying risks typically have to do with whether new jobs will be created, what kinds of jobs will be created, whether the businesses that relocate to the jurisdiction granting the EDIs will thrive or decline, and (perhaps most importantly) whether the businesses relocating will attract more businesses and help creating “multiplier effects” in the economy. When entering a craps


\(^3\) The federal government frequently grants EDIs as well, but this paper focuses on local and state EDIs.


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game the player cares more for the combined outcome of the dice than for the result of each die individually taken. Similarly, when granting EDIs the government cares more for the aggregate outcome of the EDIs than for the outcome of each underlying variable individually taken.

Just like a craps player bears the risk of having bad dice, so does the government when granting handouts to private businesses. To illustrate, suppose a small city commits a large part of its tax revenues to subsidize the relocation of an automaker. Even if the automaker relocates to that city, the plan will fail if, for instance, few additional businesses arise or if the automaker soon goes bankrupt leaving a mass of unemployed workers living in the city.

In reality, the subsidies granted to the automaker will pay–off insofar as the relocation of the automaker to that jurisdiction generates a certain number of jobs prompting a multiplier effect in the economy. Cities do not – and should not – grant tax breaks and other sorts of EDIs in order to help specific businesses individually taken; they do it in order to try to spring a virtuous cycle in the local (or state) economy. Thus, the tax breaks will not pay–off if the automaker relocates to the city without bringing along car part suppliers, or if the automaker relocates and soon after goes bankrupt, or if the relocation of the automakers brings a huge number of individuals that pay very low taxes and strain the city’s schooling system. In these cases, the taxpayers of that city would have been better off with a reduction in the general taxation levels or with a different allocation of the tax break.
To mitigate the risk of EDIs failure, many cities and states have passed legislation creating accountability mechanisms. A common trait of these mechanisms is that they establish narrow targets for the EDIs. For example, a city granting a piece of land to attract a company to its jurisdiction may require that the company remains in that city for a minimum period, or hires a minimum number of local residents, or pays a minimum wage-level.\(^5\)

These narrow targets reflect activities that lie within the immediate powers of the companies receiving the EDIs. For instance, the decision to hire labor, to invest, to relocate, etc. is taken by each company individually and independently of the government. In attaching these requirements to the EDIs being granted, the government minimizes the chances that the land grant turns out to be a waste of public resources. The problem is that these kinds of requirements are too narrow and leave multiplier effects uncontrolled, and that the risk of EDI failure is still retained by the government.

This paper suggests privatizing the risk of EDI failure. The hypothesis here is that in some cases large corporations may be the superior risk bearers for the risk of EDI failure.\(^6\) The corollary of this hypothesis is that, insofar as these large corporations are the superior risk bearers, they should bear the risk of EDI failure or value will be destroyed.\(^7\)

Suppose again that a city is offering tax breaks to the auto industry. I propose that the city should make the tax breaks contingent on them actually “working”; if the tax

breaks fail, they never kick in. The tax breaks will be deemed to have worked insofar as the city meets a preset target that benchmarks the risk of EDI failure. This broad target could be the creation of an aggregate number of new jobs in the whole city or region, or a revival of the local economy measured by land prices or by tax revenues. This target does not relate exclusively to the specific actions of the automaker but encompasses additional elements that are expected to be brought about as a multiplier effect of the investments made by the automaker.

For example: an automaker makes certain investments and would keep on paying taxes at the usual rates. However, the portions of these taxes that correspond to the tax break are kept in escrow by the government. If after the maturation of the investment (say, after five years) a certain aggregate number of new job positions are created in the city, then the government will return to the company the taxes that were being held in escrow. But if this target is not met, then the government retains these taxes.

Standard economics poses that governments should provide public goods and bear the ensuing risks, while private agents should provide private goods and bear the ensuing risks. The risk of EDI failure is in its nature a public risk because it has to do with the overall situation of the jurisdiction, not with the companies’ bottom line. This suggests that the risk of EDI failure should be borne by the government. Therefore, the proposition that some large corporations may be superior risk bearers for the risk of EDI failure is counterintuitive.

How come would private corporations be in a better position to manage the risk of EDI failure? I envisage two plausible reasons. First, CEOs are more accountable than
politicians. Because of well known agency problems, shareholders’ scrutiny is generally more effective to tame CEOs, than voters’ scrutiny to tame politicians, so corruption and other sorts of value-destroying behavior are more likely to come about within governments than within private companies. Second, large corporations may be in a position to reduce uncertainty more cheaply than the government. Large corporations often have more experience, bureaucratic capacity, and resources to predict the aggregate effects of the investments. Indeed, making predictions costs a lot of money and requires expertise, and governments (especially local governments) often have neither. Moreover, large corporations will often be in a better position to estimate if other companies developing ancillary activities will actually relocate to the region offering the EDIs (for example, an automaker can estimate better than the government if car part suppliers will actually relocate).

Under existing EDIs programs, both the politicians granting the EDIs, and the companies receiving them, have incentives to overestimate the EDIs potential benefits and the ensuing multiplier effects. Businesses are naturally prone to seeking public aid, and will present overoptimistic scenarios to persuade governments and the general public that EDIs are badly needed to spring growth and development. Politicians tend to be eager to endorse such unrealistic forecasts because the granting of EDIs gives them the highly desirable opportunity to reward political allies and campaign financiers, and also to voters that they are successful in promoting economic growth – even when the population would be better off with a different allocation of public resources or with tax
cuts. The upshot is that government and private businesses will often collude in presenting the EDIs to voters as magic formulas that will spread massive growth.

Contingent EDIs change the political dynamics for the government’s practice of aiding businesses. Because governmental handouts only kick in if the preset target is met, politicians and companies will be forced to be realistic about what can really be achieved, so unrealistic forecasts will not be appealing to the companies.

Section II outlines key issues in the political economy of EDIs. Section III examines the risk of EDI failure and some of the existing accountability mechanisms that try to minimize it. Section IV contrasts these kinds of accountability mechanisms with Contingent EDIs. Section V discusses the factors determining the scope of Contingent EDIs, and Section VI concludes.

II. The political economy of EDIs

A. EDIs defined

Over the past 30 years, state and local governments have increasingly undertaken responsibility for promoting economic development. Aside from relying on (and marketing) natural locational advantages such as climate, availability of raw materials, land area, and proximity to supplying or consuming markets, states and cities frequently devise specific development policies designed to enhance economic development.

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Development policies often try to foster investment, job creation, research, and economic activity by reducing business costs.

Reducing business costs entails either one, or both, of these strategies. The first strategy is to improve the overall quality of the business climate. Specific measures include improving the educational system to increase available human capital, keeping a sound fiscal situation, providing an adequate regulatory environment, and lowering labor or environmental standards.

The other alternative is to reduce business costs by granting targeted Economic Development Incentives, or “EDIs”. Generally speaking, EDIs are publicly sponsored or publicly funded business incentives that aim at enhancing private investments, job creation, job retention and research. Tax breaks, such as income or property tax abatements, discretionary sales tax incentives, and single-factor sales formulary apportionment, are the most common forms of EDIs. Other instruments include tax increment financing, tax-exempt bonds, low-interest financing or similar forms of cash subsidies, low-cost or free land grants, real-estate rental rebates, infrastructure improvements, training funds and other worker training incentives and preferential purchasing practices.9

While in past decades only large cities aggressively engaged in promoting development, nowadays, virtually every American city and state offers some kind of

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Currently, the average American state provides more than 30 different kinds of EDIs,¹¹ and the overall state and local expenditures in EDIs has been estimated in approximately $50 billion a year.¹²

B. What prompts governments to grant EDIs?

There are three forces driving governments to offer ever larger EDI packages to businesses. The first is interjurisdictional competition. In an environment of ever growing capital mobility, businesses can auction governments against one another and decide to invest in the jurisdiction that offers the largest aid package. A popular interpretation of this dynamics is that governments are trapped into a sort of Prisoners–Dilemma game, a “race to the bottom” whereby governments are forced to grant increasingly larger EDI packages to outbid competing jurisdictions, and at the end every jurisdiction is worse off. In the United States, some have claimed that the country is now facing a “second civil war” (this time a “war on taxes”), where governments compete for ever lower levels of taxation straining their budgets and financial situation. However, this view is controversial because the granting EDIs restrains the ability of “Leviathanic” governments to grow beyond efficient levels.¹³

The second force is politics. For politicians, ribbon-cutting ceremonies that arise with the inauguration of new plants and businesses can be highly desirable opportunities to show to voters that they are successful in promoting economic growth – even when the population would be better off with a different allocation of the public resources. Most importantly, granting EDIs is also an opportunity to please political allies and campaign financiers, and this explain why the granting EDIs walks hand-in-hand with cronyism and corruption.

The third force driving governments to grant EDIs has to do with the political pressure for governments to create jobs. The practice of granting EDIs is often inspired by counter-cyclical policies which suggest that, in times of economic downturns, the government can play an important role in revamping the economy by spending more. Put simply, the theory is that when the aggregate demand in a certain region is declining, the companies will hold back production and lay off employees. By laying employees off, the income of potential consumers as a whole decreases and therefore the aggregate demand in the economy goes down even lower. Accordingly, companies will not invest and rehire unless they foresee that the demand will rise again. In such a situation, the economy is caught in a vicious circle of low demand and high unemployment. Arguably, this is where an exogenous actor, such as the government, can intervene and increase its spending and subsidies. As the theory goes, the increased government outlays can stimulate demand, which in turn can stimulate companies to invest to meet the demand. That would then cause higher demand, and then higher investments, and so the vicious cycle can be transformed into a virtuous cycle.
But what do we really know about EDIs, and how sure are we about these findings? There are two core questions on the policy debate about EDIs. The first is whether EDIs are efficient on the intrajurisdictional level, that is, whether they promote the welfare of the state or city granting the incentives. The second has to do with whether EDIs are efficient when the interjurisdictional effects are also considered, and particularly whether EDIs cause severe externalities on other states and cities damaging their economy and ultimately engendering a “war” and a “race to the bottom” amongst states and municipalities. These highly controversial issues will be discussed in the next paragraphs.

C. Intrajurisdictional effects of EDIs: Theoretical debate and empirical evidence

The massive use of EDIs has brought new attention to the longstanding controversy about the role of government in the quest for economic development. Should the government help certain strategic business activities, or should it invest in improving the general business environment and hope that development will flourish? Are EDIs a cost-effective strategy for attaining economic growth?

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14 See e.g. Peter D. Enrich, Saving the States From Themselves: Commerce Clause Constraints on State Tax Incentives For Business, 110 Harv. L. Rev. (1996) (“In recent years, the states have enacted a vast array of tax provisions that are designed to lure businesses to locate their facilities in the state, and interstate ‘bidding wars’ offering tax breaks for major new facilities have become commonplace”); Robert Guskind, The New Civil War, 25 Nat’l J. 817, 821 [1993] (describing incentive offers in excess of $1 billion to attract a McDonnell Douglas aircraft assembly plant).

Governments have generally used two rationales to justify the granting of EDIs. The first is that EDIs will generate minimum efficient scales that can prompt strategic business investments and the creation of new jobs, which will in turn generate an increase in the local demand for goods and services and eventually induces new rounds of economic growth. The second rationale (which in reality is only an implication of the first one) postulates that EDIs can be used as a means of improving the government’s budgetary situation, because growth will ultimately generate more revenues. A unifying theme between these two rationales is that EDIs enhance growth, or improve the government’s budget, insofar as multiplier effects ensue from the original investments that are made possible because of the EDIs being granted.

Critics of EDIs have pointed out that the efficiency of these mechanisms is in most cases unwarranted, if not completely unlikely. The spirit of the most influential set of critiques has recently been articulated by Robert Cooter in a paper that links the reliance on governmental subsidies to the lack of innovation and ultimately to underdevelopment. The paper recaptures the Schumpeterian notion that growth springs from the conjunction of capital and innovation to sustain that asymmetrical information prevents governmental officials from being able to efficiently direct EDIs to the right businesses. As the theory goes, innovation resembles a biological mutation because it is unpredictable before it occurs and understandable afterwards. Innovation

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\begin{itemize}
\item Peters & Fisher 2004.
\item Peters & Fisher 2004. Other justifications such as industrial diversification and promotion of high-tech industries can be considered derivatives of the first two. Under the argument that poverty alleviation requires proper “targeting” of incentives, some people consider this to be a third autonomous justification for granting of EDIs which is different from simply creating jobs.
\end{itemize}
begins with an innovator who learns how to do something new or something better – thus it is unpredictable; but only after the innovation is implemented, will it become public – by then, it becomes understandable. After the innovation is implemented, the venture will undergo a process of transition toward equilibrium which in many cases can take a long time. It is only after the project has achieved equilibrium that it becomes possible to estimate whether it was successful or not.

From this perspective, designing a EDIs packages and choosing the sectors that deserve them poses an insurmountable challenge for the government officials. In deciding which industries deserve EDIs, government officials must rely on public information; relying on private information would open a window for corruption and bribery. But public information cannot signal which sectors will actually innovate and thrive and as so government officials are not in a position to tell the industries that will indeed be strategic in fostering growth from those that will simply use up taxpayers’ money and eventually go down. In short, information asymmetries impair the ability of the government of picking the “winning horses” and the granting EDIs bears similarities to a sheer gamble.

Another problem is that state officials don’t have the right incentives to pick the winning horses, even if they could do that. In Cooter’s words, “the motivation of public officials to make wealth for the nation is weak, because they cannot keep it. Public officials, however, can keep the wealth that they receive in salaries or bribes. By steering industrial development, officials increase their responsibilities and justify higher salaries, and they also increase their opportunities for bribes. Industrial policy is rife
with political favoritism, chicanery, cronyism, and corruption”, and that is part of the explanation of why “public officials have performed dismally in channeling investments to enhance growth”. “Even so”, Cooter continues, “some people convince themselves that politicians and officials will make more wealth using other people’s money than private investors can make using their own money”.

There is now a considerable amount of literature trying to assess empirically the effects of EDIs. These studies typically select a dependent variable that can give some measure of economic development such as aggregate levels of employment or income. It is then necessary to eliminate possible confounding variables such as regulatory changes, costs of raw materials, etc. that could otherwise explain the fluctuation of the dependent variable chosen. Identifying whether an EDI pays-off is difficult because it requires not only measuring the actual effects of the chosen EDI (typically, some kind of tax break) but also the counterfactual exercise of comparing the actual effects with what would have happened if the EDIs had not been granted. This analysis is further complicated by the need to draw a distinction between welfare effects in equilibrium versus welfare effects during the transition process toward equilibrium.20

Reviewing this literature, Peters & Fisher note that the late 1980s marks a shift in academics’ perception of the impact of EDIs on growth.21 Until then, it was widely believed that EDIs normally had a very discrete impact (if any) on the companies’

20 Stark & Wilson, 2006 (“Given the rapid rise in the availability and generosity of state tax incentives in recent decades, it seems clear that the current state of affairs represents a disequilibrium, as state tax competition evolves toward a long-run equilibrium distribution of state tax incentives”).
location decisions, and thus in the inducement of new investment and job creation. Two pioneer reviews of the impact of taxes on economic growth – one by Newman & Sullivan in 1988, the other by Bartik in 1991 – prompted a change in this perception. Equipped with more sophisticated econometric methods, these studies presented fairly robust conclusions that taxes – and by extension, EDIs in general – impact intrametropolitan location, and therefore have an impact on regional and local growth. Throughout the 1990s, a number of other studies followed, including a series of additional reviews commissioned by the Federal Reserve Bank of Boston. This new wave of research made the pendulum shift back toward the idea that EDIs granted by state or local government were likely to result in greater local or regional economic growth.

The idea that EDIs may have a statistically significant impact on economic growth gained prominence in the academic and political settings. In their overview of the effects of state and local public policies on economic development, Bradbury, Kodrzycki & Tannenwald notice that “policies pursued by subnational governments do affect the pace of economic development within their borders”, although these effects are “generally

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22 Citing J. Due, Studies of state–local tax influences on location of industry, National Tax Journal, 14, 1961, P. Eisinger, The rise of the entrepreneurial state, Madison: University of Wisconsin Press, 1988, W. H. Oakland, Local taxes and intraurban industrial location: A survey. In G. F. Break (Ed.), Metropolitan financing and growth management policies, Madison: University of Wisconsin Press, 1978. EDIs were thought not to significantly matter for growth because tax breaks – the most common form of EDI – were thought not to significantly reduce total operating costs because “even quite large spatial variation in taxes and incentives could easily be neutralized by quite small spatial variation in factor prices or transportation costs”. Moreover, fiscal differences across states were thought to be flattened by higher federal taxes. In addition, companies were found to chary of making a location decision based only on incentive offers because such massive aid packages could also be a sign of wasteful – and in the long term, expensive – government or of low quality public services.


25 See Alan Peters & Peter Fisher, State enterprise zone programs: Have they worked? Kalamazoo, MI: W. E. Upjohn Institute for Employment Research Press, 2002 [In addition to better econometric tools, another factor that may explain this shift in the perception of the effects of EDIs on growth may be the fact that intensified incentive competition may have led to an increase in the size of the tax and other EDIs differentials amongst states and cities].

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modest”.

While some authors view this positive impact of local and state policies on growth as a “new consensus”, others have pointed to the fact that most (if not all) of the studies that ground such “consensus” are still open to criticism because “even those who are fairly optimistic about the relationship between taxes and growth offer important cautions”.

For example, Peters and Fisher observe that the literature on EDIs other than tax incentives, including the literature on the so called “enterprise zones”, offers “almost no support to the new ‘consensus’ position”.

The bulk of the studies on the welfare impact of EDIs tries to capture the businesses activity response to tax incentives. These studies usually apply the concept of “tax elasticity”, which is “the percentage effect on state and local business activity caused by a 1% change in state and local taxes.”

For instance, high tax elasticity means a high level of responsiveness to tax cuts resulting in economic growth in a certain area (e.g. new business activity, more jobs, higher wages, etc.). Relying on Bartik’s aforementioned research of 1991, it has been suggested that the new “consensus” elasticity is around –0.3, but this is a highly contentious point. For instance, in his study about state taxation and economic development, Wasylenko notes that the elasticities to

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27 Peters & Fisher 2004 (also pointing out that “many of the studies are still open to important criticism”, and that “even those who are fairly optimistic about the relationship between taxes and growth offer important cautions in their reviews”).

28 Peters & Fisher 2004 (noting that “even Newman & Sullivan [1988] concluded by saying that ‘... the evaluation of tax impacts on industrial location should be treated as an open rather than settled question’”).

29 Peters & Fisher 2004 (also noting that the literature on the impact of tax increment financing is possibly the only exception).

tax policy “are not very reliable and change depending on which variables are included in the estimation equation or which time period is analyzed.”³¹

Even more problematic than the debate over the extent of the tax elasticity is the jump from statistical significance to political significance (and action). Even if one accepts the tax elasticity of –0.3 reflected in the new “consensus”, an unlimited endorsement of EDIs should not follow. Peters & Fisher note that the –0.3 tax elasticity is still “far below what many public officials and incentive advocates appear to believe”, as “it is not unusual for public officials to attribute all new employment to incentive programs.” Moreover, “given a typical incentive package that represents about a 30% cut in state and local taxes, the new ‘consensus’ elasticity implies that only about 1 in 10 new jobs in the average community will actually be attributable to the incentives, even if incentives are provided for all new jobs. Thus the best case is that incentives work about 10% of the time, and are simply a waste of money the other 90%”.³²

A subtler shortcoming of these empirical studies has to do with the apportionment of the benefits, if any, generated by EDIs. Do local and state governments target EDIs at more needy places or populations? This question is relevant especially from a fairness perspective because poorer populations need more economic help than others. In his support for the enhanced use of EDIs, Bartik contends that focusing EDIs on poorer populations is an efficient policy. Accordingly, moving jobs from low to high unemployment areas is likely to create a net benefit because the reservation wage (the lowest wage at which a worker would accept employment) for those in high

unemployment areas is lower than for those in low unemployment areas. However, the “skimpy” empirical literature on this topic surveyed by Peters & Fisher shows that the “theoretical prerequisites that incentives be substantially more generous in poorer places is shaky at best”.

These set of findings complicates the analysis of EDIs. Even if one accepts that the granting of EDIs boosts local and regional growth, it still does not follow that EDIs pay–off. The first problem is that EDIs redirect to businesses scarce funds that perhaps could be better employed to fund public goods such as health, infrastructure and education. EDIs can, and often do, strain the planning capacity of local governments. Furthermore, they are often subject to cronyism, abuse, and fraud, they distort the markets and the companies receiving EDIs often fail to create the jobs and other public benefits expected by the government. To make matters worse, EDIs often favor large businesses over small, and frequently contribute to sprawling development on the suburban/ rural edges of major metropolitan areas. The issue, as Bartik puts it in an influential paper, “isn’t whether economic development incentives can work; empirical evidence suggests they can. The issues are whether benefits of incentives outweigh costs, and how benefits and costs are affected by local conditions and incentive design”.33

The budgetary impact of EDIs is another kind of variable that can be used to evaluate EDIs impacts. A common justification for the granting of EDIs is that they can

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33 Timothy J. Bartik, Eight issues for policy toward economic development incentives, The Region, Federal Reserve Bank of Minneapolis, Jun of 1996 (“The issue isn’t whether economic development incentives can work; empirical evidence suggests they can. The issues are whether benefits of incentives outweigh costs, and how benefits and costs are affected by local conditions and incentive design ... But do the earnings benefits justify the costs of incentives? Incentives are costly per job created”) (“Bartik 1996”).
boost the government’s tax revenues in the mid-term. The dearth of empirical research on this topic leaves a question mark on this issue. A research from 1990 suggests that EDIs have more leverage on investment decisions amongst closely matched local areas (such as neighboring cities) than among states, and thus EDIs may produce fiscal gains for the localities that adopt them (or that make use of targeted incentives provided by the state). The problem is that the budgetary gains obtained by the local governments are likely to be offset by the losses of the states. In the end, the (fairly scant) existing evidence suggests that the net budgetary effects are generally negative.

D. Interjurisdictional effects of EDIs: Theoretical debate and empirical evidence

The interjurisdictional effects of EDIs have to do with the problem of spillovers (or externalities). Suppose we accept the argument that EDIs granted by local governments generally enhance local welfare, or that EDIs granted by state governments generally enhance state welfare. Will this cause an increase in the country’s welfare? The answer is: not necessarily. It may well be possible that EDIs merely cause a relocation of economic activity from regions offering incentives to those that do not offer them, and the net welfare impact might be positive, neutral, or negative.

The political and legal environment in which economic development takes place is one in which the companies promise to create jobs, bring income and pay taxes, and the government promises to facilitate all of that through the granting of EDIs. This

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negotiation often takes place in a competitive environment where local governments compete against each other bidding for the higher offer to attract the companies. This dynamics occurs within the parameters set forth by state and municipal statutory and case law, which outline the boundaries of how far government officials can go in their quest for investment, development and growth.

The downside of this interjurisdictional competition is that it can empower businesses to a position where they can squash governments to obtain the sweetest possible deal, causing the governments’ budgetary situations and public services available to the population to deteriorate. The upside is that this competition can also work to constrain governments not to overregulate or overtax businesses and to strive to maintain good public services and fiscal soundness so as to attract more businesses. Whether the upsides offset the downsides is a contentious matter.

Formal economic analysis of interjurisdictional competition can be traced back to Charles Tiebout’s 1956 seminal model based on a theory of consumer choice. Accordingly, under certain conditions, competition among jurisdictions for households leads to an efficient provision of local public goods. Tiebout challenged Paul Samuelson and Richard Musgrave’s proposition that the absence of effective preference–revelation mechanisms prevents the state from providing efficient levels of public goods. Tiebout contended that local public goods could be efficiently provided because in the local setting individuals can “shop” amongst multiple jurisdictions selecting the one that matches their preferences for the appropriate combination of

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taxes and services. Jurisdictions will respond to consumer–taxpayers mobility by competing to offer distinct tax–service packages, resulting in a quasi market for public goods. Consumer–taxpayers have an incentive to reveal their preferences for the desirable combination of taxes and services, and jurisdiction have an incentive to offer the appropriate mix that will attract the such consumer–taxpayers. The original Tiebout model, which dealt with the question of fiscal competition amongst local governments for mobile residents, has since been applied to numerous other mobile factors of productions.

Three stringent assumptions of the Tiebout model are (i) non–distortionary / efficient taxation, (ii) costless mobility among jurisdictions, and (iii) governments acting in the best interest of their residents. Relaxing these assumptions, scholars have formulated alternative theories for inefficient and wasteful tax competition.

Assuming away the notion of non–distortionary taxation, Oates used a per–unit (or per–dollar) tax, which means that a region's total tax revenues (and also the provision of public services) depend on the amount of capital that the region is able to attract. In this case, the reduction in the region's tax rate inflicts a negative externality on the welfare of other regions because it reduces their quantity of capital and consequently their tax base. In a system where every region will autonomously select its tax rate, each region will not take this negative externality into account and thus will choose a tax rate that is inefficiently low from the perspective of the nation as a whole. This will prompt inefficiently low levels of public services across the nation. The strategic dynamics of the

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situation would be captured by a “prisoner’s dilemma” game in which lack of coordination makes every jurisdiction worse off.\footnote{See for example LeRoy 1994 [claiming that interjurisdictional competition in the US results in a “ruinous economic development civil war”].}

Equilibrium inefficiency tends to decrease as the aggregate capital supply becomes more elastic. If the overall capital supply is inelastic (that is, if the aggregate quantity of capital available for investment does not vary as a function of the taxation level), lower levels of taxation will (by definition) have no effect on the overall supply of capital available for investment. Thus, a decrease in taxation does not increase the overall level of investment in the economy. As the overall supply of capital becomes more elastic (that is, as the overall supply of capital increases as a function of lower taxation), lower levels of taxations may conceivably engender welfare enhancing investment levels. A similar rational applies when relaxing Tiebout’s assumption of costless mobility among jurisdictions because costlier capital movement impairs the response to EDIs and interjurisdictional competition in general.\footnote{Stark & Wilson, 2006 [remarking that the “extensions of these basic theories of tax competition find that equilibrium inefficiency (1) decreases with the elasticity of aggregate capital supply, and (2) increases with the degree of mobility of capital and with the number of regions ... In addition, inefficiency may be exacerbated by differences across regions in capital productivity or heterogeneity in residents’ preferences for public goods”].}

Brennan & Buchanan’s “Leviathan” models relax Tiebout’s assumption that governments maximize the well-being of their residents and propose that taxation levels are determined by government officials who are, to a large extent, motivated by an aspiration to increase the governments’ revenues.\footnote{Brennan & Buchanan 1980.} It follows that in the absence of interjurisdictional competition the total size of government would be excessive. This self-serving nature of government can end up offsetting, at least partially, the trend.
toward pushing tax rates too low.\textsuperscript{40} I can also recast the aforementioned “race to the bottom” theories because under the [seemingly realistic] assumption that government officials strive to artificially enlarge the governments’ budgets, competition among regions for mobile capital can contain overtaxation and overregulation, and so its ultimate effect is to place a set of highly desirable checks on the government’s ability to become inefficiently wasteful and large. In short, interjurisdictional competition gives individuals and businesses leverage against the “Leviathan’s” desire of expropriating their wealth.

Most empirical studies on the welfare effects of EDIs try to measure the influence of EDIs (especially tax incentives) on state and local economic growth, but say nothing about the spill overs that on neighboring states and cities. Interjurisdictional competition means that states and cities are competing for private investments that have alternative possible allocations, so dollars invested in a certain place are also dollars not invested elsewhere. If, as it has been suggested, the internal additional investments arise altogether from external reduced investments, then the granting of EDIs entails a “zero-sum” game, thus an undesirable instrument as a matter of public policy. There are but a few studies that have tried to empirically work out this hypothesis.\textsuperscript{41}

In a recent study, Chirinko and Wilson used a panel for all 50 American states with over 20 years of data to try to measure the intrastate and interstate effects of state investments tax credits, and specifically to try to answer two questions: [i] are these tax

\textsuperscript{40} Stark & Wilson, 2006 (noting that “perversely, tax competition may actually be less inefficient if government agents are assumed to maximize government spending”).

incentives effective in increasing investment within the state?; and (ii) to the extent that these incentives raise investment within the state, how much of this increase is due to investment drawn away from other states? Their assessments revealed that own–state economic activity is positively affected by own–state tax incentives and is negatively affected by competitive–state tax incentives. Interstate capital flows, which are a necessary element for meaningful tax competition, appear to be “quantitatively important.”42 However, “whether state investment incentives are a zero–sum game among the states is less certain and depends on the definition of the set of competitive states.”

In another study about the effects of R&D state tax incentives, Wilson constructed a comprehensive state–level panel data set on after–tax R&D prices. His conclusion is that, while the state R&D tax incentives are effective in achieving their stated objective of increasing R&D spending within the state, nearly the entire increased R&D within the state is due to drawing R&D away from other states.43 That result indicates that the net national effect of R&D tax incentives on R&D spending is “near zero” because the positive in–state effects of state R&D tax incentives are basically completely offset by the negative out–of–state effects.

E. Targeting

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When a local or state government decides to grant EDIs to attract businesses, targeting becomes a crucial problem. Which firms deserve EDIs, and which don’t? EDIs should be channeled to those firms and businesses that provide greater social benefits (such as more jobs, higher wages, and more assistance to the needy) at lower incentive costs. This goal entails at least four underlying notions.

First, EDIs should be channeled to those firms and industries with a higher “tax elasticity”, that is, to those firms and industries which investment decisions are more sensitive to changes in taxation. One of the major critiques that has been directed at EDIs has been that the investments that EDIs are believed to have prompted would have been made anyway. Studies have suggested that in the course of their negotiations with the government companies generally overstate the role of incentives, and sometimes simply decide on the project sites before governments make subsidy offers. The problem is that research has not provided clear evidence about the kinds of firms or industries that respond better to incentives, so government officials simply lack information about the extent to which EDIs will be decisive in the location and investment decisions.

Second, EDIs should be directed to strategic companies and industries that will actually engender multiplier effects in the economy. In particular, development economics has a long story of defending industrial policy based on scale of production. Given increasing returns to the scale of production, the argument goes, a minimum size is necessary for a company or industry to be profitable, and in certain cases private capital markets cannot provide sufficient funds to reach the minimum size needed for

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44 Bartik 1996.
45 Bartik 1996.
profitability. Thus, in these cases the government has to provide the supplementary capital that is needed. Appealing as this theory sounds, the United States presently has highly developed capital markets, so except for extremely large projects or for projects that generate public goods (e.g. air and space) there seems to be no reason why funding from the government is necessary.

Third, EDIs should be destined to firms willing to make long-term commitments (in terms of jobs and investments) with the jurisdiction granting EDIs. Urban planning literature contains many examples of situations where businesses took advantage of EDIs for a while and quickly thereafter left the jurisdiction without leaving benefits.

Four, targeting should be based on a cost-benefit analysis of the EDIs, not on media attention or political pressure. Cost-benefit analysis entails a comparison between the present value of anticipated public costs (such as cash or in-kind expenditures, foregone tax revenues, and supplementary infrastructure investments such as public hospitals or schools) with the present value of the anticipated benefits (such as new job positions for local residents, higher wage and skill levels, better labor conditions, higher job security, an expansion of the local tax base, and multipliers effects). But pressure from the public opinion and the threat (whether real or merely perceived) that businesses may relocate to other jurisdictions also hampers the officials ability to negotiate adequate deals. Indeed, due to a perceived lack of technical precision

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47 Weber & Santacroce 2007.
and to pressure to approve deals quickly, many officials do not carefully evaluate the costs and benefits of their subsidy programs.\footnote{Weber & Santacroce 2007.}

All of the above suggests that the choice of the beneficiaries of EDIs should ideally be strictly technical, not political. However, it should come as no surprise that exactly the opposite tends to happen. For instance, most local and state efforts billed as economic development projects take the form of subsidies to a fairly small number of private companies\footnote{Joseph Persky, Daniel Felsenstein and Virginia Carlson, What are Jobs Worth?, Employment Research, Upjohn Institute, 2004.} and that suggests that the granting of EDIs is largely dependant on lobbying and is rife with corruption. For politicians, granting EDIs can be a rather expedient means for rewarding campaign donors, receiving kickbacks, and protecting various forms of vested interests. An even more fundamental problem is the fact that even highly qualified, ethical and well-intentioned government officials, have a hard time deciding which firms or industries will eventually spurt development (just twenty or thirty years ago, who would have predicted that software company could turn Bill Gates into one of the richest man in the planet?).

III. The risk of EDI failure

A. Uncertainty and the risk of EDI failure

Local and state governments granting EDIs face high levels of uncertainty and risk. The uncertainty lies in that the government does not know ex ante the extent to
which the firms receiving EDIs will actually benefit the jurisdiction, its citizens and its government. It is difficult to estimate the multiplier effects that new investments can generate. The upshot is that governments do not know for sure how much and what kinds (if any) of EDIs they should offer to businesses.

The notion of EDI failure has to do with whether the EDIs attain their stated objective (typically, to generate some sort of improvement within the jurisdiction granting them). Hence, it does not capture interjurisdictional externalities, meaning that the effects of EDIs outside the sponsoring jurisdictions are left aside. But for present purposes, there will be no “EDI failure” if the interjurisdictional costs outweigh the intrajurisdictional benefits. Here, an EDI may be welfare decreasing at a country or global level and still not be deemed to have failed. This paper focuses on the risk that the businesses receiving EDIs end up not benefiting the sponsoring jurisdiction (city or state) inasmuch as cost prompted by the granting of such EDIs.

The definition of EDI failure suggests a comparison between the intrajurisdictional costs and benefits of the EDIs. The potential benefits are basically the increased level of jobs and investment that may be prompted by the EDIs, and also the potential increase in government’s revenues due to higher levels of property taxes, paybacks and profit sharing. Measuring these benefits entails the same difficulties that I have examined in discussing the “tax elasticity” of tax incentives. To recapitulate, the central problem is that it is very difficult to measure and isolate from confounding factors the benefits that specifically result from the EDIs being analyzed. Timing is also a

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50 Note that many locally sponsored EDI programs (such as those making use of Tax Increment Financing) shift costs to the state or federal governments and these transfers are not captured by cost–benefit analysis conducted only at the local scale.
problem because benefits should be evaluated in equilibrium, not in the process of transition toward equilibrium.

The government’s cash outlays or other in–kind expenditure are fairly easy to measure, but the real costs of EDIs also encompass a broad range of indirect costs and opportunity costs tied to below–market interest rates, deferred paybacks, deferred tax collection, tax exemptions, loan guaranties, etc. EDIs can also distort the price system and stimulate economic agents to inefficiently choose their levels of production and consumption of a large number of activities and products, and ideally these costs should also be accounted for. Therefore, measuring the costs of EDIs can be quite complex.51

The same can be said about measuring expected benefits of the EDIs. Even if we leave aside the problem of confounding factors that create “noise” in the calculation of tax and other EDIs elasticities, many prospective public benefits such as environmental cleanup or physical improvements have no market price.

What prompts the materialization of the risk of EDI failure? In reality, the risk of EDI failure is comprised a variety of case–specific, underlying sub–risks. Some of these sub–risks are a function of the conduct of the companies receiving the EDIs, but others are not. The former group of sub–risks includes companies not generating the expected number of jobs, not investing enough in their local facilities, and not attracting the expected additional businesses investments to the jurisdiction. The latter group includes

51 Rachel Weber, Do better contracts make better economic development incentives? Journal of the American Planning Association, January, 2002 (“Even if incentives can change the locational choices of firms, many economists would assert that the deadweight costs stemming from the distortion of economic decisions are significant and cumulatively reduce social welfare. In other words, incentives induce firms to choose locations that otherwise might not be perceived of as optimal and are therefore inefficient. In addition to these two kinds of inefficiencies, a third type exists when, regardless of the intention of the firm, a subsidy changes hands and the expected level of jobs and investment never materializes. When firm opportunism or chance intervene, the tax incentive can be a very wasteful use of public money and effort”) (“Weber 2002”).
downturn business cycles, the offer of more generous EDIs from competing jurisdictions causing rapid relocation, or the general decline in the industry receiving EDIs, just to name a few.

Now we have to consider again the following factors: (i) EDIs are often granted in a competitive context where governments bid against each other offering the biggest EDIs package possible; (ii) the granting of EDIs is (often decisively) influenced by political pressures and vested interests; (iii) companies, especially large companies, may have a lot of leverage in negotiating with governments; (vi) most municipalities and many states do not have the expertise or resources necessary to adequately carry out cost–benefit analyses; and (v) even well–intentioned governments cannot predict wherefrom innovation (and development) will arise. All of that explains why the risk of EDI failure is generally very high.

B. Minimizing the risk of EDI failure: EDIs Accountability Laws

The granting of ever larger EDIs packages has drawn a lot of media attention over the past two decades. For instance, in 1998 journalists Donald L. Bartlett and James B. Steele conducted an 18–month investigation about America’s “corporate welfare” in which they documented a myriad of highly questionable handouts given to corporations

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52 Political pressure against the alleged American “corporate welfare” resonates with academic studies on the topic. See e.g. Edward B. Shils & George W. Taylor, Measuring the economic and sociological impact of the mega–retail discount chains on small enterprise in urban, suburban and rural communities, Philadelphia: Wharton Entrepreneurial Center, The Wharton School, University of Pennsylvania, 1997.
by local, state and federal government. The report was published in a four-part series in *Time* magazine and concluded that the system of corporate welfare “costs every working American the equivalent of two weeks pay every year” and helps the rich and powerful instead of the more needy ones. It also concluded that government assistance to corporations have “turned politicians into bribery specialists, and smart business people into con artists.” While this language conveys sensationalist undertones, it captured quite well the problem of lack of accountability of the politicians sponsoring EDIs programs. These kinds of report, together with a number of grassroots movements against “corporate welfare”, brought a lot of political pressure against the use EDIs.

Under drumfire, many governments across the country passed legislation creating mechanisms to increase the likelihood that their respective jurisdictions would really benefit from providing EDIs (the so-called Economic Development Incentives Accountability Laws or “EDI Accountability Laws”). EDI Accountability Laws generally encompass a blend of five broad, often overlapping, approaches, setting forth qualifying conditions for receiving EDIs, disclosure requirements, enforcement provisions, impact analyses parameters, and authorization for the execution of performance agreements between the governments granting and the companies receiving the EDIs. Their overall goal is to specify performance standards and threaten penalties that are expected to induce the subsidized company to operate in a way that enhances the public’s welfare.

(1) Qualifying conditions

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Qualifying conditions are specific targets that must be attained by each company receiving EDIs. These targets typically include the requirement to create a certain minimum number of new jobs, meet a minimum level of fresh investment, remain in the same location for a minimum period, offer a minimum level of wages or health care coverage for newly created job positions, or ensure environmental and labor protection.

Job creation requirements are the most common of the targets. Typically, EDIs are made conditional on the creation (or maintenance) of a minimum number of jobs, but they may also be calculated on a per–new job basis. EDIs for investments are typically granted by means of nonrefundable state income tax credits which are valid for purchase of machinery or equipment located or used within the state. They allow taxpayers to reduce their state income tax liability on a dollar–for–dollar basis by an amount equal to the credit percentage multiplied by the taxpayers’ qualified investments.

Anti–relocation targets typically require that the company receiving the EDIs continues to be located and to do business within the boarders of the sponsoring city or state. Foreseeing the losses at the local level, some states such as Iowa and Pennsylvania, try to restrict intrastate relocation. Others, such as Connecticut, don not. In recent times, EDI Accountability Laws have increasingly incorporated quality
standards such as minimum wage rates\textsuperscript{55} and environmental requirements as qualifying conditions.\textsuperscript{56}

The chart below exemplifies some qualifying conditions used across the country.

<table>
<thead>
<tr>
<th>Target</th>
<th>Jurisdiction</th>
<th>Law</th>
<th>Condition</th>
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</thead>
<tbody>
<tr>
<td>Job creation</td>
<td>Alabama</td>
<td>Business Investment Tax Credit (Act No. 95:187)</td>
<td>20 new jobs; 15 if small business\textsuperscript{*}</td>
</tr>
<tr>
<td></td>
<td>Georgia</td>
<td>Job Tax Credit Program (Georgia Code 48:7:40:40.1)</td>
<td>5 to 50 new jobs depending on local unemployment, poverty and income levels\textsuperscript{*}</td>
</tr>
<tr>
<td></td>
<td>Iowa</td>
<td>New Jobs and Income Agreement, Iowa Statute 15.330</td>
<td>50 new full-time jobs and maintain that level for five years\textsuperscript{**}</td>
</tr>
<tr>
<td></td>
<td>Michigan</td>
<td>Michigan Economic Growth Act Tax Credit Agreement, Public Act 24, 1995</td>
<td>75 new jobs if it is expanding its facility within Michigan, 150 jobs if it is relocating to the</td>
</tr>
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</table>

\textsuperscript{55} The effectiveness of minimum wage rates is highly questionable. One of the problems is that it makes hiring unskilled individuals more expensive.

\textsuperscript{56} Anna Purinton, The Policy Shift to Good Jobs, Washington, DC: Good Jobs First, 2003 (noting that "there are now at least 116 state programs with standards and 49 standards that apply to local subsidies, often covering multiple programs. Altogether, that amounts to 165 job quality precedents." Moreover, "at least 43 states, 41 cities, and 5 counties – a total of 89 jurisdictions – now attach job quality standards to at least one development subsidy", up from just two in 1989).
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<tr>
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<tr>
<td></td>
<td>Pennsylvania</td>
<td>Job Enhancement Act (House Bill 2668, PN 3934, June 1996)</td>
<td>state; and 25 jobs if the facility is relocating to a state enterprise zone**</td>
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<td></td>
<td>Vermont</td>
<td>Vermont Act Relating to Education, Taxation and Education Financing, Public Act 71, Sec. 5930g, 1998</td>
<td>25 new jobs or increase of workforce by 25 percent* Up to 149 full-time jobs (10% investment tax credit); 150–249 full-time jobs (6–9% investment tax credit); above 250 (5% investment tax credit)**</td>
</tr>
<tr>
<td>New investment</td>
<td>Maine</td>
<td>Jobs and Investment Tax Credit (MRS Title 36, Part 8, Chp 822 sec. 5215)</td>
<td>Invest at least $5 million and create 100 new jobs over following two years*</td>
</tr>
<tr>
<td></td>
<td>Nebraska</td>
<td>Employment and Investment Act (LB 775,1987)</td>
<td>Invest $3 to $20 million and create 0 to 100 new jobs (various tax exemptions for different...</td>
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<tr>
<td>Target</td>
<td>Jurisdiction</td>
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<td></td>
<td>Washington</td>
<td>High Technology Sales Tax Deferral for Research and Development Investment (RCW 82.63)</td>
<td>Sales taxes deferred on qualified R&amp;D or pilot manufacturing investments; no repayment required if investment use requirements are met for eight years*</td>
</tr>
<tr>
<td>Anti-relocation</td>
<td>Connecticut</td>
<td>All Business Incentives (Public Act No. 93:218)</td>
<td>Business cannot relocate out of state for ten years or term of subsidized loan; cannot relocate within state unless employees are offered jobs at the new site*</td>
</tr>
<tr>
<td></td>
<td>Iowa</td>
<td>Community Economic Betterment Program (Iowa Code 261:22.13)</td>
<td>Business may not change structure of business, sell business, shut down, or</td>
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* Indicates that the conditions are specific to certain circumstances or requirements.
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<tr>
<td></td>
<td>Ohio</td>
<td>Corporate Franchise and State Income Tax Credits (sec. 122.17)</td>
<td>relocate without permission of department*</td>
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<td></td>
<td>Mississippi</td>
<td>Mississippi Business Investment Act Program (Miss. Code Ann. § 57:6:1)</td>
<td>Business must maintain operations at project location for twice the duration of credits*</td>
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<td></td>
<td>Nevada</td>
<td>Sales and Use Tax Abatement [NRS 374, Sec. 1]</td>
<td>Wages: Interest rates on subsidized loans reduced 1/2 percent for each dollar the company’s hourly wage is above the state average manufacturing wage*</td>
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<tr>
<td></td>
<td>Ohio</td>
<td>Job Creation Tax Credit (Ohio Revised Code § 122.17 and 718.15)</td>
<td>Wages: The average wage of all new employees must be at least 150 percent of the current</td>
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<td>Target</td>
<td>Jurisdiction</td>
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<tr>
<td></td>
<td>Washington</td>
<td>Business and Occupation Tax Credit for New Jobs (RCW 82.62.030)</td>
<td>Wages and Benefits: Tax credits of $4,000 for each qualified job with wages and benefits of $40,000 or more per year; tax credits of $2,000 for other qualified jobs*</td>
</tr>
<tr>
<td></td>
<td>California</td>
<td>Chapter 938 of CA Statutes of 2001</td>
<td>Companies must pay prevailing wages for construction on public works paid for in whole or part by public funds***</td>
</tr>
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<td></td>
<td>New York</td>
<td>Article 18–B of the General Municipal Law</td>
<td>Companies must pay ≥ 135% of the minimum wage (equal to $6.95) to receive the $3,000 credit (full-time employees receiving lower wages qualify the company for a $1,500 credit)***</td>
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<tr>
<td>Target</td>
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<td></td>
<td>North Carolina</td>
<td>North Carolina Session Law 1999–360 Senate Bill 1115 § 105–129.4 b(3)</td>
<td>Certain EDIs are forbidden where the company receiving them incurred any significant violations of any program implemented by an agency of the Department of Environment and Natural Resources in the 5 preceding years**</td>
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The so called “disclosure” laws require businesses to reveal certain information to the government. The most common examples are requirements to disclose the amount of the tax breaks received and the number of new job positions created. Some laws also request that applicants for public financial assistance provide the names of all programs to which they are applying and the total public cost of the assistance. Another interesting kind of disclosure provision – the so called “but for” provisions – requires companies receiving EDIs to attest to the fact that they would not have considered locating in the specific municipality or state, or would have eliminated a certain number of jobs, but for the specific incentive. The problem with but for provisions is that they are disgracefully difficult to disprove, so in fact they provide governments with a false sense of security.

Disclosure laws serve four purposes. First, they leverage the governments’ position in negotiating EDIs packages with businesses, ultimately protecting taxpayers. The finances of governments are typically more transparent than those of companies, and this imbalance of information can give a lot of leverage to the companies. In a competitive setting, where governments bid against each other to attract businesses, the government with the highest bid will probably be the one with the most optimistic (overoptimistic?) views about the value of economic development, or the one with the most lax budget and statutory constraints. Disclosure laws permit that the governments gain more knowledge about a firm’s actual cost structure and financing gaps.

57 Weber 2002 [“If the firm decides to relocate and the price of the incentives outweighs the value of the public benefits generated by the firm’s operation, the host government will find itself stuck with a ‘winner’s curse.’ The difference between the actual value of the benefits created and the price paid for them is a public cost”).
Second, disclosures serve as monitoring tools because they facilitate the
government’s task of supervising business compliance with the qualifying conditions.
Third, they help public agencies to collect information to assess the effectiveness of their
programs ex post facto. And fourth, they make the whole process more transparent
because they enable citizens and government officials to visualize how well the local and
state economic development funds are actually being spent.

Disclosure requirements however tend to have rather weak practical effects. The
main problem is that it is easy to inflate or overstate a company’s cost structure\textsuperscript{58} and
proving this sort of fraud in courts is difficult and costly. The chart below describes some
of the disclosure requirements existing in the country.

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Program</th>
<th>Law</th>
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<tbody>
<tr>
<td>Connecticut</td>
<td>Economic development assistance to a business with 25+ full–time employees in the state. For $250,000 or more, annual reporting includes company–specific data on actual jobs created, projected jobs created, number of jobs at initial application, and amount of assistance.</td>
<td>94 PA 231 – §32– 450 through 32 457 [2000 statutes]*</td>
</tr>
<tr>
<td>Illinois</td>
<td>Tax credits and tax exemptions: company–specific information of the type and amount of development assistance, the projected and actual number of jobs</td>
<td>Public Act 93–0552*</td>
</tr>
</tbody>
</table>

\textsuperscript{58} Weber & Santacroce 2007 (noting that “development consultants regularly admit that firms draft separate pro forma for separate purposes (e.g., understating revenues for incentive and income tax purposes while overstating them for lenders”).}
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<td>created or retained, and the average wages paid by job classification.</td>
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<tr>
<td>Louisiana</td>
<td>Industrial property tax exemptions: company–specific information including jobs created (both permanent and construction), 10–year value of exemption, company’s investment amount, and taxes paid</td>
<td>Records of the state’s tax exemption board*</td>
</tr>
<tr>
<td>Maine</td>
<td>Company–specific information for all deals over $10,000; includes number of jobs by occupational type, wage and benefit levels of jobs created or retained, any changes in employment levels, total amount of assistance and details about type and purpose of each form of assistance. Also includes disclosure on whether the deal was a relocation within the state.</td>
<td>§13070–L and K*</td>
</tr>
<tr>
<td>Minnesota</td>
<td>Company–specific information for all deals over $25,000: includes number of jobs, amount of subsidy, hourly wage of each job created (listed in dollar ranges), sum of hourly wages and cost of health insurance broken down by wage level, statement of goals identified in subsidy agreement, date by which job and wage goals will be met, reason for relocating from within in Minnesota if applicable, and list</td>
<td>§116J.994*</td>
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<tr>
<td>Jurisdiction</td>
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<tr>
<td>Nebraska</td>
<td>Detailed disclosure of incentives under the Employment and Investment Growth Act (various property, sales, and income tax breaks). The State Tax Commissioner must make an annual report to Legislature listing agreements signed that year, agreements still in effect, identity of each taxpayer, and location of each project; and report by industry group with incentives applied for under Employment and Investment Growth Act, refunds allowed, credits earned, credits used for individual and corporate income tax, credits used to obtain sales and use tax refunds, number of jobs created, total employees at reporting dates, capital investment, wage levels of new jobs, tax credits outstanding, and value of personal property exempted in each county.</td>
<td>Employment and Investment Growth Act: §§77–4110</td>
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</table>

Aggregated disclosure: For incentives under the Employment Expansion and Investment Incentive Act, the State Tax Commissioner must prepare a report identifying the amount of investment, number of equivalent jobs created, including amount of credits claimed in aggregate. | Employment Expansion and Investment Incentive Act: §§77–27,187.77–27,196. Reporting requirement: |
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<td></td>
<td>If companies claiming credits under this act are in an enterprise zone, the Commissioner must report the amount of such companies, investment, number of jobs created, and average hourly wage or average salary of new jobs created in each zone.</td>
<td>§77–27,195*</td>
</tr>
<tr>
<td>North Carolina</td>
<td>Starting March 31 2002, the Department of Revenue must publish annual, company-specific disclosure of tax credits for training, research and development, and machinery and equipment. The Department’s data must also show the number of new jobs created in development zones (enterprise zones), and how many of those new jobs went to zone residents.</td>
<td>§105–129.6.(b)*</td>
</tr>
<tr>
<td>Ohio</td>
<td>Company-specific disclosure: Cities and counties must submit all enterprise zone agreements to the Department of Development, including number of employees at site before agreement, number of employees at end of reporting year, property value, relocation information, new payroll, property taxes paid, property taxes exempted, and total employment. State tax commissioner must submit an annual enterprise zone report with this information to the</td>
<td>§5709.68 §5709.88.2*</td>
</tr>
<tr>
<td>Jurisdiction</td>
<td>Program</td>
<td>Law</td>
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<td>governor and legislature. Property tax abatement agreements must be submitted to state development and local school districts, reporting number of employees, number of agreements in effect, compliance reviews, compliance status, and change in employment. Department of Revenue maintains data on property tax abatements and tax increment financing by county.</td>
<td></td>
</tr>
<tr>
<td>Texas</td>
<td>Comptroller must maintain centralized registry for reinvestment zones and tax abatement agreements, with description of zone and copy of tax abatement agreements.</td>
<td>Tax Code §312.005*</td>
</tr>
<tr>
<td>West Virginia</td>
<td>Tax credits must be reported in State Register. Reports include company, address, type of credit, and dollar value of credit, though only in quarter-million and half-million dollar ranges</td>
<td>§11–10–5s(b)(1)*</td>
</tr>
<tr>
<td>City of Minneapolis (MN)</td>
<td>Applicants for public contracts or financial assistance to provide the names of all programs to which they are applying and the total public cost of the assistance</td>
<td>1998 Minneapolis living wage ordinance**</td>
</tr>
</tbody>
</table>

Enforcement provisions are designed to enable the governments to punish the companies that breach the qualifying or disclosure requirements. Their purpose is to give “teeth” to the conditions established for the granting of EDIs. The most common forms of enforcement provision are those canceling the EDIs upon the breach of a qualifying or disclosure condition. “Clawback” provisions enabling the government to recoup or retrieve some or all of the granted EDIs are now increasingly common. Other enforcement provisions may include the readjustment of the subsidy to reflect new business conditions, penalties and fines (for example, interest accrued on the government’s investment), and suspensions preventing the company from receiving EDIs in the future. The table below contains some examples.

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Penalty</th>
<th>Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Colorado</td>
<td>Partial repayment (typically 15 percent) of benefits if business fails to meet job</td>
<td>Office of Business Development FIRST training</td>
</tr>
</tbody>
</table>

LeRoy 1994 (noting that clawback provisions raise the “cost of failing to deliver on job promises with specific, legally-enforceable regulations and contract language. The most powerful way to raise the corporate cost of non-performance is by a clawback provision: if the recipient company fails to deliver, the incentive must be refunded, back to day one, preferably with an interest penalty”).
<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Penalty</th>
<th>Law</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>creation and wage projections</td>
<td>program policies*</td>
</tr>
<tr>
<td>Connecticut</td>
<td>Full repayment of benefits plus 5 percent interest if business leaves state</td>
<td>All Business Incentives (Public Act No. 93:218)*</td>
</tr>
<tr>
<td>New Jersey</td>
<td>Companies committing detrimental relocations barred from state contracts, state subsidies, and pension fund investments</td>
<td>Multistate Industrial Retention Commission (State Assembly, No. A:1339)*</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>Penalties: Increase subsidized interest rate as much as 3 percent if employment goals not met; increase subsidized interest rates as much as 4 percent if wage levels not met</td>
<td>Pennsylvania Industrial Development Authority, Statement of Policy (Sections 303.61 to 303.65)*</td>
</tr>
<tr>
<td>Washington</td>
<td>Full repayment of tax credits plus interest if research and development spending goals not met</td>
<td>High Technology Tax Credit for Research and Development (RCW 82.04.4452)*</td>
</tr>
</tbody>
</table>


(4) Impact analyses
Impact analyses aim at reducing the uncertainty faced by governments when deciding on the extent of EDI packages. Estimating the benefits that companies will bring to the jurisdictions helps government officials to establish the maximum size of EDIs that they can offer and still benefit the jurisdiction. Because typically the governments do not have access to companies’ actual cost structure, they are not in a position to accurately estimate the financial gaps that will have to be covered in order to make feasible a certain project. A competitive setting can easily drive governments to bid against each other and to grant EDIs that do not pay-off. Moreover, politicians often try to claim political credit for big, highly visible projects, like bringing new businesses to the city or state. This explains at least in part why politicians are so eager to attract businesses, even when it is in the best interest of their communities to invest in less politically appealing activities such as education, healthcare, or even business retention or small business development. Impact analyses can therefore restrain politicians’ impulse to overbid.

Conducting impact analyses is obviously difficult, but some commercially-available software programs (such as Regional Economic Models Incorporated (REMI) and IMPLAN\(^\text{61}\)) allow government officials to evaluate both the employment and revenue

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\(^{61}\) The IMPLAN model (Impact planning model) was originally developed by the University of Minnesota for the United States Forest Service. This model puts together a huge quantity of information (mostly based on federal census data), and uses it to calculate each industry’s effect on other industries. By taking census data, it looks for the correlation among the industries (for example, if an automaker moves into an area, will it bring suppliers? How many new residents will be attracted to the area? How much money will the new residents spend in the local economy versus somewhere else?). IMPLAN website explains that the software is designed to “examine the effects of a company moving into your area or the contributions of an existing company, to estimate industrial targeting opportunities, to examine resources regulated by the government, to analyze the benefits of commercial development and use the information to attract new companies and the effects of the tourism industry, to examine the region’s strengths and market opportunities and to analyze a wide variety of other economic/marketing issues” (source: [www.implan.com](http://www.implan.com)).
impacts of potential incentive deals. The University of Illinois at Chicago has also developed a similar software.\textsuperscript{62}

A number of jurisdictions have created policies imposing limits on EDIs. For example, the U.S. Small Business Administration and the U.S. Department of Housing and Urban Development have capped subsidy at $35,000 per created or retained job.\textsuperscript{63} Illinois’ Department of Commerce and Economic Opportunity limits incentives at $10,000 per job created or retained through its Community Development Assistance Program. Minnesota, Pennsylvania, New Jersey and West Virginia also cap subsidies at $15,000 to $35,000 per job created. Similar measures were also reported to have been imposed at the municipal level. In Indianapolis [IN], for example, a project is not eligible for incentives if the fiscal impact analysis shows that it will take more than four years for the project to cause a “positive revenue return” to the city. All these impact analyses are of course subject to the same measurement difficulties aforementioned.

[5] Performance agreements

The early 1980s decade witnessed severe downsizing and deindustrialization of a number of sectors of the American economy. When many large companies reneged on their vague promises to create jobs, not to relocate, and provide other public benefits, governments from a number of cities sued on a theory of contract breach. Courts tended

\textsuperscript{62} Weber & Santacroce 2007.
\textsuperscript{63} Weber & Santacroce 2007.
to view the EDIs packages as gifts (and not as reciprocal arrangements expressed in contracts) and generally ruled against the governments.

In that context, cities and states increasingly set themselves to execute performance agreements with the businesses receiving EDIs to formalize their exchanges. Performance agreements typically lay down the EDIs package granted by the government and also specific targets that are to be met by the companies receiving the EDIs, such as new investment, relocation, number of direct jobs, etc.

The existence of a *quid pro quo* is the touchstone to distinguish gifts from sales because only the latter is based on a reciprocal obligation, and this is a relevant distinction in the context of EDIs. The granting of EDIs is (or at least, should be) a *quid pro quo* for a specific set of contributions (new investment, relocation, more jobs, etc.) by private businesses.

C. Extent and effectiveness of EDI Accountability Laws

By increasing accountability and establishing objective parameters for EDIs packages, governments can generally enhance transparency and rationality in the use of public funds and also discourage abuse and corruption. But the extent of the use of EDI Accountability Laws across the country varies a lot. Why?

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There are three possible sets of answers. Public choice theories highlight interregional competition for capital to suggest that cities and states with budgetary problems will not be in a position to adopt controls. In their “desperate attempt” to counter economic decline, fiscally stressed jurisdictions would have less leverage in imposing controls and would be more prone to accepting investment with few or no “strings”.

Urban political economy theories focus on the interface between economic and political forces, suggesting that citizen involvement in politics and policy making increases the probability of adoption of controls, while business influence reduces it. While the aforementioned public choice theories envision unitary intraregional interests in attracting capital, urban political economy theories stress the existence of different groups with competing sets of interest within each jurisdiction. This diversity leads to distributional imbalances of growth within the jurisdiction.

A third group of explanations contends that the extent of EDI Accountability Laws will be a function of the local and state governments’ internal organization. This perspective encompasses a fairly broad range of theories ranging from a society–centered view in which the government serves the interest of dominant societal actors (such as big businesses), to a society–plus–state–centered view in which the governments’ own interests are coordinated with local businesses (especially businesses elites). These theories do not assume aprioristically societal influences on

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65 The source is Daniel M. Sullivan & Gary P. Green, Business subsidies and municipal controls, Journal of Urban Affairs, 21, 1999 (“Sullivan & Green 1999”). It must be noted that Sullivan and Green focus exclusively on subsidy controls at the municipal level, but the theoretical framework they use [but not their empirical study] can be expanded to the controls at the state level.
policy decisions and focus on the government’s structure and capacity to implement policies more than on its interaction with the business community.

Whatever explains regional differences in the adoption of EDI Accountability Laws, the fact is that the mere existence of strings in legislation or contracts does not guarantee that the government will have the will or the resources to enforce them. Not only is enforcement costly in itself, but it also depends on effective monitoring that can detect breaches and violations by the companies, and that can be very costly too. Moreover, political whims may prompt governments to be lax on enforcement.

Empirically testing the correlation between EDI Accountability Laws and precise outcomes (such as investment levels, job positions or land value) is easily frustrated by a number of confounding factors, especially those that ensue from the general up or downswing of the economy. This explains the dearth of relevant empirical studies on this topic.

IV. EDIs controls X Contingent EDIs

In insurance literature, it is common to divide risks into two broad categories: risks that lie within the control or management of the primary risk bearer, and risks that lie outside the control or management of the primary risk bearer. To illustrate, someone who owns a car can generally manage the risk of car theft by locking the doors, parking in safe places, and avoiding dangerous areas, so the risk of theft is said to be within the

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control of the primary risk bearer. However, once the car owner buys insurance, that risk of theft is shifted to the insurance company, so it is outside the risk of the primary risk bearer.

The risk of EDI failure does not fall squarely within any one of these two categories because whether EDIs fail depends on the outcome of a number of underlying risks. Some of these underlying risks, such as whether enough jobs will be created or whether the company will stay in the sponsoring jurisdiction after the tax breaks have expired, are within the control of the company receiving the EDIs. Other risks pertaining to levels of taxation and quality of regulation are basically within the control of the government (in fact, of the federal, state and local government). Moreover, a number of very relevant risks, such as the risk of business cycles downturns, are mostly outside the control of both the sponsoring jurisdiction and the company receiving the EDIs.

It follows that the existing schemes of placing strings on the public handouts tackle the problem of EDI failure very loosely. The strings typically used focus on the underlying risks that lie within the control of the company, but they are very narrow and leave multiplier effects uncontrolled. When the government requires, for instance, that companies receiving EDIs maintain minimum levels of employment or refrain from leaving the jurisdiction for a certain period after a tax has elapsed, that government is in reality trying to mitigate the risk of EDI failure by controlling some of its underlying risks. The problem is that such controls are expensive to monitor and (most importantly) are not necessarily effective in preventing the risk of EDI failure, which is retained by the government.
I now wish to propose an alternative contractual framework that will place controls on the risk of EDI failure itself and will leave the underlying sub-risks uncontrolled. I call this mechanism “Contingent EDIs”, because the EDIs are made contingent on the government achieving a preset target that benchmarks the risk of EDI failure. This target may be, for example, generating a certain number of direct and indirect job positions in the whole city, or increasing aggregate land value or aggregate levels of investments or taxation to a new baseline.

The economics of contracts contains two general principles that can shed new light upon the debate about the efficient framework for reducing the risk of EDI failure. The first principle is related to the “risk-shifting” (or insurance) function of contracts, suggesting that contracts create value insofar as risks are shifted to the superior risk bearers. The second principle suggests that contractual promises can be controlled directly or indirectly, and the parties to a contract should choose the alternative that is relatively more economic. I will review these principles and explain how they can provide theoretical grounding for Contingent EDIs.

A. First principle: Risks should be shifted to superior-risk bearers

Insurance companies underwrite insurance policies because by aggregating various independent risks of the same value they can create a single “pool” or risks. The outcome of the whole pool is much more certain than the outcome of every single risk individually taken and that explains the comparative advantage of the insurance
company over each insured individual. This is proved by the “Law of Large Numbers”, a mathematical theorem [in fact, corresponding to an empirical statistical phenomenon too] demonstrating that if an event of probability $p$ is observed repeatedly during independent repetitions, the proportion of the observed frequency of that event to the number of repetitions converges towards $p$ as the number of repetitions becomes large. The insurers’ losses are more predictable than those of the insureds, and thus insurers are said to have a comparative advantage in risk bearing. This is why the offer of insurance makes economic sense, and why it can create value.

The economics of contracts suggests that all enforceable contractual promises create an “implicit” or “disguised” form of insurance. Insurance is provided in implicit form whenever the actions of an individual affect the risks of gains or losses borne by another individual. Just like an ordinary automobile, marine or fire insurance policy creates an “explicit” insurance arrangement, there will be an “implicit” insurance arrangement in most ordinary contractual relationships. Some form of insurance is

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67 For example, if the probability of throwing a double–6 with two dice is 1/36, then the more times we throw the dice, the closer, in proportion, will be the number of double–6s thrown to of the total number of throws. In more technical insurance terminology, the probability density function of average loss tends to become concentrated around the mean as the sample number increases. In practice, this means that the greater the number of equal risks pooled together, the lower the variance of expected outcomes, and the higher the capacity of the insurer to scientifically predict the amount of indemnifications that it will have to pay to its insureds. For example, if the insurance company covers, for instance, 1,000 automobiles representing independent 5% chances of losses of yearly losses of $1,000, its predictions will be more accurate than if it covers only 100 automobiles; and with 100 automobiles, the accuracy in its predictions will be higher than if it covers only 10 automobiles, and so on.


69 Joseph E. Stiglitz, Risk, Incentives and Insurance: The Pure Theory of Moral Hazard, 8 Geneva Papers on Risk & Ins. 4, 1983. Obviously, for legal purposes insurance arises where the law finds an insurance coverage. The idea of implicit insurance means that the economics of insurance applies to a number of other situations that legally are not defined as insurance.

70 The risk–shifting function of contracts should be traced back to Nobel laureate Kenneth Arrow’s 1963 article discussing the purpose of institutional arrangements for risk–shifting in the context of insurance, stock markets, cost–plus markets, future markets, implicit contracts, and insurance. The main argument was that all these institutions serve to transfer risks to individuals that can bear risks more cheaply. See Arrow 1965.
present in basically any economic relation that encompasses a promise to do or pay something. Insurance is almost everywhere, either in explicit or in implicit form.\footnote{Joseph E. Stiglitz, Risk, Incentives and Insurance: The Pure Theory of Moral Hazard, 8 Geneva Papers on Risk & Ins. 4, 1983. Obviously, for legal purposes insurance arises where the law finds an insurance coverage. The idea of implicit insurance means that the economics of insurance applies to a number of other situations that legally are not defined as insurance.}

For example: when a department store promises that it will return the money to consumers who acquired defective products, this store is providing its consumers with an implicit form of insurance. The implicit insurance exists because the promise to return money is actually shifting the potential losses that arise if the defects actually materialize to the store. The consumers pay a premium for this insurance coverage, which is a slight increase in the nominal price of the goods being sold. Just like any “explicit” insurance arrangement, this “implicit” insurance will cause ex ante a loss to all consumers [which is the insurance premium] and ex post an indemnification payable only to those consumers who had been unlucky enough to buy a defective product.

This notion of implicit insurance can be traced back to Kenneth Arrow’s definition of insurance as any institutional arrangement designed to shift risks from one party to another. According to Arrow, “if I dislike an uncertainty and if I can find someone else or some organization to whom the cost of bearing the uncertainty is less than it is to me, then there will be a fixed premium, and both of us are better off.”\footnote{See also Kenneth J. Arrow, Insurance, Risk and Resource Allocation, in Foundations of Insurance Economics. Readings in Economics and Finance, edited by George Dionne and Scott E. Harrington, Kluwer Academic Publishers, Boston / Dordrecht / London, 1991.} Articulating on Arrow’s seminal insight, Richard Posner suggested that “the risk-shifting or insurance function of contracts is related to the fact that a contract […] by its nature commits the
parties to a future course of action; and the future is uncertain.”73 In a contractual setting, the future is uncertain mostly because parties may act opportunistically and also because there may be contingencies that are unforeseen for the parties at the time they enter into the contract.

To create value, risks should be allocated to the party that is in a better position to manage it, that is, the “superior risk bearer”. The superior risk bearer is the party that can maximize gains and minimize losses at a lower cost. Posner & Rosenfield suggest that the superior risk–bearer (or “lower–cost avoider”) in contracts is the party who [i] may be in a better position to prevent the risk from materializing or [ii] is the least cost insurance provider.74 For example, if performance is stymied because one party fails to order the proper supplies, then that party should bear the risk because they are in the better position to avoid that risk. In turn, determining which party is the least cost insurance provider involves two factors: [i] which party is in a better position to estimate the probability of the risk occurring and the magnitude of the loss resulting from the risk if it happens, and [ii] which party could self–insure, i.e., the party who could better spread the risk of loss.75

The superior risk bearer is more easily identified ex post than ex ante so any market arrangement is likely to be efficient (in a Pareto sense).76 The problem is that governments are too often motivated by the interests of self–serving bureaucrats,

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74 Posner & Rosenfield 1977.

75 For an introductory summary of the theory, see Eric D. Beal, Posner and Moral Hazard, 7 Conn. Ins. L.J. 81, 2000/01.

76 Presumably, if the government were not the superior risk bearer for the risk of EDI failure, it would not grant EDIs in the first place.
politicians and campaign financiers, and so the assumption that government’s actions always aim at maximizing social welfare is dreadfully feeble.

Standard economic theory poses that governments should generally provide public goods and bear the ensuing risks, while private players should provide private goods and bear the ensuing risks. In most cases, governments are in a better position to prevent the risk of EDI failure to materialize because they can, for instance, work to improve the business environment, increase or decrease taxes, create other EDIs, enact regulations, supervise businesses, seek aid from the federal government, etc., while private businesses generally have a limited ability to do any of these things. This suggests that the risk of EDIs failure should be borne by the government, as generally happens in reality.

I propose that in certain situations large corporations receiving EDIs may bear the risk of EDI failure more cheaply than the government. My suggestion is that sometimes governments are not the lower cost avoiders for the risk of EDI failure; large corporations are. Insofar as large corporations are the superior risk bearers, they should bear the risk of EDI failure, or value will be destroyed.

Two reasons ground this rather counterintuitive suggestion: (1) CEOs are more accountable than public officers, and (2) large corporations may be in a position reduce uncertainty more cheaply than the government.

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77 Economists have long argued that government intervention makes most sense in the presence of externalities. Externalities are costs or benefits that spill over onto third parties. When individuals bear the full costs and receive the full benefits of their own actions (that is, when they perfectly internalize costs and benefits) the justification for government involvement is much weaker. In the context of EDIs, the additional jobs, growth etc. that may ensue from investments made by private entities can be considered a form of externality. This is true at least in the sense that the jurisdiction offering the EDIs derives costs and benefits (however they may be calculated) from private economic activities.
Companies are driven by profits; governments, by politics. Thus, CEOs and politicians face a different set of incentives for performance. While CEOs need the approval of controlling shareholders to retain their jobs, politicians need the votes of the majority of voters. Shareholders' generally do a better job in evaluating the performance of CEOs' than voters in evaluating that of politicians. The main reason is that shareholders tend to have better incentives to carefully appoint and monitor the CEOs. A competent CEO can cause the shareholders to obtain direct, sometimes immediate, benefits (i.e. dividends or stock appreciation), yet the benefits that a competent politician can give to its voters are much less palpable and unevenly distributed. Rational choice theory refers to that situation as a problem of “rational ignorance” because the marginal benefits that a voter can derive out of investing his time and energy to educate himself about a politician are so low that it is rational for him not to do it. All of that suggests that shareholders will generally choose CEOs that are relatively more competent (in generating profits for their companies) than the politicians (in promoting the voters' well being).

Another problem is that shareholders have a very palpable benchmark to assess the CEOs performance: the amount of profits or share value created. In turn, voters have to rely on a bundle of blurry indicators ranging from the quality of public services to the ideology of the politician in question. To that extent, CEOs tend to be more accountable
to their shareholders than politicians to their constituents. A “property principle” also suggests that CEOs may have better incentives to do a good job (for their companies) than politicians (for the state and the society at large) because CEOs can retain a much larger share of the wealth that they create. After all, CEOs remuneration is often linked to the companies’ performance, while the politicians’ remuneration is fixed and independent from the quality of their performance.

The upshot of all of this is that companies have incentives to make decisions to create jobs, invest, etc. only insofar as the expected marginal gains outweigh marginal costs; that is, only insofar as these decisions enhance the companies’ welfare. But politicians seek votes, not profits, and so it may well pay-off for a politician to give EDIs even when the expected marginal gains for the jurisdiction and the voters are lower (or even much lower) than the marginal costs.

[2] Impact analyses and uncertainty

Impact analyses reduce uncertainty by outlining the probable direct and indirect costs and benefits that EDIs can create. Conducting an impact analysis typically entails an estimation of the overall number of additional jobs, investments, tax revenues, etc. that shall arise after the projects financed with EDIs have matured. By making probable outcomes more transparent, impact analyses can reduce public bias in favor of highly visible development projects and shift public investment to where it is really needed.79

The indirect benefits of the EDIs can also be referred to as the “multiplier effects” of the EDIs. The multiplier effects are often misunderstood, recurrently overstated, and hardly ever mentioned by the news media. Calculating the multiplier effects requires an evaluation of how many companies involved in the production chain will work with the company in question (such as suppliers, customers, etc.), how much additional revenue – and taxes – the company will generate, how many indirect jobs will be created, what the environmental impact will be, etc. Media typically focuses only on the very narrow conditions established by the government, particularly on the costs of subsidies per direct jobs created, but it almost always ignores the governments’ actual targets.

To illustrate with a case that became famous in the legal milieu, in the late 1990s the city of Toledo, Ohio entered into a development agreement with DaimlerChrysler for the construction a new Jeep assembly plant.80 The auto manufacturer received a $280 million package of tax incentives and other handouts as *quid pro quo* for a promised investment of $1.2 billion in the new plant.81 Resounding with the commotion that this large package created in Toledo, the local press went quickly to question whether the city was paying too much to keep Jeep.82 Press articles focused on the comparison of the ratio of governmental grants per job created in each city. While in Kenosha, Wisconsin, DaimlerChrysler had built a plant a few years earlier where the government kicked in roughly $3,000 per job created, in Toledo the government kicked in $57,000 for each new

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80 Cuno v. DaimlerChrysler, Inc., 386 F.3d 738 (6th Cir. 2004).
81 The central components of the package were an investment tax credit of 13.5% against the state corporate franchise tax for certain qualifying investments and a 10-year property tax exemption. DaimlerChrysler also received other corporate welfare handouts such as the transfer of free land (including site preparation) and the transfer of environmental liability from DaimlerChrysler to the city.
job position (a mild figure when compared to the state of Indiana\textsuperscript{83} where a few years earlier the government had kicked in $1.2 million for each new job position created).\textsuperscript{84}

Considering only the direct benefits, EDIs are almost certain to make absolutely no economic sense at all. How come can a job position in the same automaker cost $3,000 to the government in one place, and $1.2 mi in another? It is only when multiplier effects are taken into account that EDIs might start to make economic sense.

Which party is in a better position to calculate the multiplier effects? The government or certain large corporations receiving the EDIs? Conducting impact analysis can be fairly expensive and time consuming. A recent study suggested that the most important factor in predicting whether local governments will conduct impact analyses is their "bureaucratic capacity", which is the technical ability to accurately process the necessary data.\textsuperscript{85} This means that conducting impact analyses is a costly activity that cannot be afforded by many governments. But large corporations are often more resourceful, and often have more expertise, than governments, particularly when EDIs are being granted by local governments.

The corporations also tend to be better informed about the extent to which other companies developing ancillary activities (part suppliers of an automaker, for instance) will do business and generate wealth within the jurisdiction offering the EDIs. Moreover,

\textsuperscript{83} Kitchen 2005 ("DaimlerChrysler agreed to make a $624 million investment in equipment for its Kenosha, Wisconsin engine plant for just $7 million in government grants. The incentive cost per job of the Kenosha deal was roughly $3,000, compared to a price tag of more than $57,000 per job in Toledo").
\textsuperscript{84} Kitchen 2005 ("In 1998, Chrysler opened a transmission plant in Indiana, for which the state kicked in $872 million in tax incentives—an amazing $1.2 million for each of the 758 jobs promised by the company"). See also New jobs targeted at Jeep suppliers, Toledo Business Journal, Jun 1, 2004 (noting that the development agreement signed between the government and the company contained no express target for the multiplier effect).
\textsuperscript{85} Sullivan 2002 (the "bureaucratic capacity" of a local government was measured based on the number of [full-time equivalent] professional developers who work for the government, the number of [full-time equivalent] development support workers, and the dollar amount of the government’s economic development budget.)
these large corporations are generally better informed about their actual (as opposed to the publicly disclosed) investment prospects, and they have easy access to information about the effects of their presence in other localities, so lack experience is also a factor that impairs governments.

Timing is another factor that may favor large corporations. Studies have shown that EDIs are almost irrelevant when a company is choosing the region of the country where to locate. Accordingly, they only matter (if at all) at a later stage when the companies are narrowing their choice to a specific city within the chosen region.\(^{86}\) At the first stage (when companies are looking for a desirable region), proximity to supply or consumer markets, costs of qualified labor, transportation and utility costs and even the "whims" of corporate executives tend to be much more relevant than the availability of any kinds of EDIs packages. Once a certain region has been picked, then the local tax burden and other sorts of available EDIs may become more relevant, and it is at this points that corporations open negotiations with governments. While the decision of which region to invest is lengthy and can take years, the second stage is much faster. The pace of the negotiations with local governments typically does not allow much time for the governments to make careful calculations of the overall impacts of EDIs. A recent study noticed that "some corporations take as long as five years to narrow their selection of possible sites for investments. But development agencies have often no more than a month to assemble incentive packages. There is little time for sound

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\(^{86}\) Weber & Santacroce 2007.
economic and fiscal impact analysis.\textsuperscript{87} In this scenario, it should come as no surprise that the governments’ projections often fail so miserably.

B. Second principle: Contractual promises can be controlled directly or indirectly and the parties should choose the most economic alternative

Contracts create obligations to pay or do something. Sometimes, these obligations are performed in tandem with the entering into of the contract (the purchase of a piece fruit in a street market, for example), but in many cases the performance of the contractual obligations is to be made at a later stage (a residential lease agreement, for example). In these cases, the parties to the contract face two dangers: opportunism and unforeseen contingencies.\textsuperscript{88}

To deal with these problems, the parties will typically decide to establish “controls” for some of the possible risks that can materialize during the life of the contract. A risk is said to be contractually “controlled” if its materialization will trigger a contractual sanction.\textsuperscript{89} For example, to control for the risk of delays in payment of the monthly rent, a lease contract may establish a fine for payments made in arrears. Other forms of controls commonly used in contracts regulate breach of contract, misrepresentations, force majeure, etc.

There are two ways in which controls can operate: direct controls regulate conducts and indirect controls regulate outcomes. To illustrate, employment contracts

\textsuperscript{87} Ledebur & Woodward, 1990.
\textsuperscript{88} Posner 1997, at 101.
rely more heavily on direct controls, and sales representation contracts rely more heavily on indirect controls. Employers typically try to obtain higher productivity levels from their employees by regulating conduct (working hours, vacations, detailed description of how to perform each task, hierarchy, etc.), so employees are generally paid a fixed salary that is not directly related to their actual productivity. Conversely, the bulk of the remuneration of sales representatives typically consists of commissions that depend mostly on overall sales. In many cases, the amount of hours that sales representatives have to work, the days of the week when they should work, their vacation time, etc. remain uncontrolled. Remunerating a representative based on his sales levels is a form of indirectly controlling his productivity because the focus is on the output (sales levels) and not on her conduct (hours, submission to hierarchy, etc.).

Direct and indirect controls engender different sets of costs, benefits, and incentives. Direct controls require investments in monitoring and court verification of relevant conducts. In contrast, indirect controls require investments in monitoring and court verification of the relevant output. The specific circumstances of each case will determine which one will render greater levels of productivity and lower levels of opportunism. To choose between direct and indirect controls, the parties to an agreement should balance (i) the cost of observing and verifying the realization of the

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90 To be sure, the choice between direct and indirect controls is not a line but a continuum. For instance, employment contracts may incorporate some remuneration based on productivity and sales representative contracts also regulate the conduct of the salespersons in many ways (non-competition clause, territorial limitations for the representative to work, etc.).
risk, (ii) the cost of observing and verifying the acts that influence the risk, and (iii) the distortions created by direct controls due to uncontrollable acts.\footnote{Cooter & Porat 2002.}

What is the nature of the controls established under existing EDI Accountability Laws? The risk of "EDI failure" is in reality the net result of a number of underlying sub-risks. These sub-risks include some risks that lie within the control of the company receiving the EDIs (especially job creation, investments, and relocation) and some risks that lie outside its control (especially attraction of ancillary businesses, business cycles, and reaction from competing companies or industries). It is the combined outcome of all these underlying sub-risks that determines whether EDIs will fail or succeed.

Again, it is important to highlight the difference between the risk of EDI failure and the underlying risks that make up for it. The government (and indirectly, taxpayers) bears the risk of EDI failure, while the individual market players (especially companies and workers) bear only underlying sub-risks.

EDI controls generally aim at mitigating the risk of EDI failure by establishing direct controls on some of these underlying sub-risks. For example, the requirement that the company receiving EDIs create a minimum number of new jobs tries to control the risk that companies will apply public subsidies in activities that do not generate jobs locally; the requirement that the companies refrain from relocating to another jurisdiction immediately after using a local subsidy controls for the risk that these companies use subsidies granted by one jurisdiction in activities carried out in a another; and so on.
Enforcing such direct controls on underlying risks is expensive. Monitoring is a key ingredient to ensuring compliance on the part of the companies receiving the EDIs. A recent study on the topic indicated that “many local governments are not vigilant once an investment–agreement has been made, often due to a lack of resources” because “without monitoring, the time and care that went into negotiating and drafting the agreement is worth little. With the decision to give an abatement must also come the commitment to monitor compliance once it has been made”. ⁹²

While some of the underlying sub–risks are controlled, many others remain uncontrolled. Business cycles downturns, aggressive EDIs from competing jurisdictions, general decline in the industries receiving EDIs are just some of the sub–risks contributing to the overall risk of EDI failure that will not trigger any contractual (or legal) sanction. This means that when – for whatever reason – EDIs do not pay off, the government and the taxpayers suffer the loss, with no consequences other than the general welfare decline and perhaps additional political pressure on politicians. ⁹³

I now propose that in certain situations it may be cheaper to implement Contingent EDIs that would control the risk of EDI failure itself and leave its sub–risks uncontrolled. The central idea of Contingent EDIs is to shift the risk of EDI failure to large corporations that may be the superior risk bearers. Mechanically, Contingent EDIs work by means of a contractual framework where the EDIs kick in if, and only if, the government achieves a preset target that benchmarks the risk of EDI failure.

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Suppose a hotel chain wishes to build new hotels and asks the municipality for a ten–year property tax abatement. The investor argues that the new hotels will spring development in that area and that the tax base for property tax from that region will increase by 30% within five years. The investor is in a better position than the city to calculate whether this target is feasible, so the city proposes to the hotel chain that the property tax abatement will be contingent on whether this broad target is met. During five years, the hotel pays all its property taxes, but leaves it in escrow. At the end of this term, if the target is met [for instance, if the city increases its tax revenues by 30%], the government returns the tax to the investor. If not, the taxes are retained by the municipality.

Similar schemes can be made with almost any kind of government handout. Suppose an automaker wishes to build a plant and seeks an investment tax credit. The state can propose that the tax credit is contingent on the whole region increasing its current number of job positions by, say, 5%. Note that whether the increase is actually caused by the specific investment tax credit is no longer relevant.

Aside from shifting the risk of EDI failure to potentially superior risk bearers, Contingent EDIs render the process of public aid more transparent. Currently, governments throw money in the hands of certain businesses [often, political allies and campaign financiers] and cross fingers hoping for the best. They frequently refrain from making serious impact analyses or simply collude with private businesses presenting unrealistic estimates of benefits that will be generated. Contingent EDIs change this
dynamics by forcing government and businesses to conduct careful impact analyses, and to be fair about them.

V. Scope for Contingent EDIs: Variables

I have explained the concept of Contingent EDIs and illustrated it with examples of possible applications. Now I will list and discuss factors influencing the scope and limits of Contingent EDIs.94

A. Moral hazard on the government

Contingent EDIs may cause a problem of “moral hazard” on the part of the government. Since companies only get to take advantage of the EDIs if the government achieves its preset target, the government will have an incentive to avoid achieving the target in order to retrieve the tax or subsidy held in escrow. Specifically, the government can use its taxation and regulating powers to make sure that the preset target agreed for the implementation of Contingent EDI scheme is never achieved. This instance of moral hazard is indeed difficult to control, and might be the reason why contingent EDIs don’t exist in reality. Indeed, a “best-efforts” or similar clause requiring the government to strive to achieve the preset target is very difficult, if not impossible, to monitor and verify.

94 The scope of application of contingent EDIs parallels the scope of the “anti-insurance” contracts proposed by Cooter & Porat. See Cooter & Porat 2002.
Still, there may be a certain zone where the investment agreement that formalizes the Contingent EDIs is self-enforceable. A self-enforcing agreement remains in force as long as each party deems to be better off by continuing the agreement than by ending it.\footnote{Lester G. Telser, A Theory of Self-Enforcing Agreements, Journal of Business, 1980, 53(1), pp. 27–44.} Let us assume that the actions of the government are uncontrollable. The government will break its promise of best-efforts only insofar as doing so exceed its costs. The benefits of breaching the best-efforts covenant in the investment agreement corresponds to the amount of taxes or subsidies held in escrow [because by obstructing the attainment of the target the government retains those chattels]. But in so acting, the government incurs costs too. First, the government does not receive tax incomes that generally are paid with increased business activity. Second, the citizens of that jurisdiction incur a welfare loss, and that can lead to lower levels of political approval for the incumbent politicians. Third, the existence of various companies continuously investing in the jurisdiction creates a repeated interaction between the government and the pool of investors, in which case the government will strive to develop a reputation of business-friendliness. Thus, and perhaps most importantly, the government suffers a reputational cost by failing to exercise best efforts.

The reputational cost will be higher when there are various companies investing in the jurisdiction in different moments. In these cases, breach becomes more costly because the government will be able to show to new investors that it fulfills a best-effort clause during the whole duration of the contract.
B. Interjurisdictional competition

Interjurisdictional competition decreases the ability of the government to attach strings to EDIs. Interjurisdictional competition tends to be more pronounced in industries where the capital mobility is high and regional specificities are relatively unimportant. Thus, lower levels of interjurisdictional competition favor Contingent EDIs.\textsuperscript{96}

Many American states and cities currently find themselves swamped in a competitive environment where large corporations leverage their positions as large employers, large taxpayers, and large campaign financers to press governments to give the sweetest possible deal. The fact that large corporations can also attract investment from other corporations (for example, suppliers, service providers, etc.) works to further enhance their bargaining powers.\textsuperscript{97}

In this context where the governments’ bargaining powers are ever more abridged, shifting the risk of EDI failure to private entities will often not be feasible, especially because there is empirical evidence suggesting that business executives heavily discount future cash flows.\textsuperscript{98}


\textsuperscript{97} Bartik 1996 ("Targeting some firms for greater incentives than others may be rational. Such targeting should not, however, be based on political pressure or media attention. Targeting should be based on which firms are likely to provide greater social benefits at lower incentive costs").

\textsuperscript{98} Bartik 1996 ("empirical evidence suggests that business executives heavily discount future cash flows, [and] incentive dollars provided 10 years or more in the future have little effect on business location decisions").
C. Size and wealth of company and government

Contingent EDIs only create value insofar as the companies to which the risk of EDI failure is shifted are the superior risk bearers for the risk of EDI failure. The larger and the wealthier the companies receiving EDIs may be in comparison to the jurisdiction granting them, the more likely it is that these companies will be superior risk bearers. Larger and wealthier companies may have more resources to foresee the impacts of EDIs and to calculate whether the government will attain its economic targets with them. Large companies may also have a more decisive individual impact on the materialization of the EDI failure. Furthermore, by diversifying investments large corporations can minimize risks more easily than governments.

Therefore, contingent EDIs make more sense when the sponsoring jurisdiction has smaller economic power in comparison to that of the companies receiving them.99

D. Monitoring and verification costs

Existing accountability mechanisms focus on controlling some of the risks underlying the risk of EDI failure (such as companies not creating a preset number of jobs, not attaining certain standards for new jobs created, etc.), so enforcing such accountability mechanisms requires monitoring and verifying those risks. In contrast,

99 It follows that EDIs granted to small companies should not be made contingent, because small corporations do not have the comparative advantages that large corporations may have.
the focus of Contingent EDIs is on the risk of EDI failure itself, so enforcing Contingent EDIs requires monitoring and verifying the outcome of this preset target.

Contingent EDIs are particularly attractive when the monitoring and verification costs of monitoring and verifying the sub–risks that are controlled under existing accountability mechanisms are relatively too high.\textsuperscript{100} This may occur, for example, when the body of government’s controllers and inspectors is too small, disorganized, inefficient or corrupt.

E. Pricing costs

The government and the companies receiving EDIs have to agree upon an economic target that will benchmark the risk of EDI failure. To do so, the government has to be able to provide reliable data and statistics to assess the target that benchmarks the risk of EDI failure. Good data calculated based on objective criteria decreases pricing costs and favors Contingent EDIs.

F. Attitudes toward risk

\textsuperscript{100} Williamon, Oliver E. 1981. “The Economics of Organization: The Transaction Cost Approach.” American Journal of Sociology 87 [The transactions cost approach considers the transaction as the critical element of investigation and holds that understanding of “transaction cost economizing” is central to the study of organizations through assessing how their governance structures serves to economize on these transaction costs].
Companies will tend to be more risk-averse when the risks at issue correspond to a large proportion of their wealth. Consequently, Contingent EDIs are more attractive when the companies will bear small risks relative to their wealth.

VI. Conclusion

The welfare consequences of EDIs remain unclear. The main justification employed by local and state governments for the granting of EDIs is that they spurt economic development, help the needier populations within their jurisdictions and/or help their fiscal situations on the long-run. It may well be true that EDIs induce significant new growth, that the beneficiaries of such growth are those who really need more assistance, and that the granting of EDIs ends up being fiscally advantageous for local and governments. It is possible, but after decades of policy experimentation and hundreds of studies, these claims remain highly questionable both from the theoretical and empirical standpoints.

On the policy debate about the extent to which governments should be allowed to make use of EDIs, the case for severely restricting EDIs is fairly solid. EDIs cost state and local governments about 50 billion a year and yet there is [at best] feeble evidence that all this public investment is generating the expected rewards. Anecdotal evidence suggests that the practice of granting of EDIs is rife with corruption, favoritism,
nepotism, and cronyism, and perhaps it serves no purpose other than to benefit self-serving governmental bureaucracies and unethical businessmen.

The case against EDIs is strong, but it is not as compelling as some seem to believe. “Leviathan” theories can offer good arguments justifying the usefulness of tax (and other forms of EDI) wars. The rationale is that by being forced to compete, local and state governments cannot grow beyond certain levels. This means that containing these “wars” could end up having the effect of inefficiently increasing the governments’ size.

Contingent EDIs may be a smarter form of containing political abuse of EDIs, because Contingent EDIs restrain politicians from selling “dreams” to their constituencies. Under the existing state of affairs, both politicians and businesses have incentives to tell the population that extraordinarily high multiplier effects may ensue from EDIs programs. Businesses do that as a means to secure public support for their quests for governmental aid, and politicians do that as a means to convey an image of being “hands on”.

Contingent EDIs alter the set of incentives applicable to politicians and businesses. Accordingly, businesses will bargain with government to agree upon low multiplier effects for EDIs. The reason is that lower multiplier effects increase the chances the EDIs will actually kick in. This places a check on the government’s attempt to deceive the population, enhancing accountability and transparency in the handling of public affairs. As so, Contingent EDIs also work to promote John Rawls’ ideal of public
reason described in Political Liberalism, according to which candor on the part of authorities promotes public debate and makes democratic deliberation meaningful.¹⁰²

Why is it that contingent EDIs don’t exist in practice? Public goods theory generally does not endorse shifting risks related to the general welfare of the population to private entities. However, the comparative advantage that larger corporation may have in foreseeing the actual results of EDIs packages and the higher levels of accountability of CEOs vis-à-vis politicians suggests that the general point of public goods theory may have exceptions. Future econometric research may try to ground this suggestion. In the meantime, government lawyers are well advised to try to implement Contingent EDIs as a means of protecting the jurisdiction against unethical practices.

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