The Effects of State and Local Public Policies on Economic Development: An Overview

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The use of state and local public policy as an instrument of economic development is more controversial than ever. Profound technological and political changes have made capital more mobile and broadened the geographic areas over which firms may operate, intensifying competition among states and localities. At the same time, the demand for state and local public services continues to rise, while impending reductions in federal aid compound the states' fiscal dilemma.

Caught between conflicting fiscal pressures, state and local policymakers have sought advice on which policies are most cost-effective in stimulating their jurisdictions' economies. In November 1996, the Federal Reserve Bank of Boston convened a symposium of experts to examine and critique existing theoretical and empirical evidence concerning the effectiveness of state and local tax, spending, and regulatory policies as instruments of economic development.

The participants generally agreed that, contrary to the conventional wisdom of the 1960s and 1970s, policies pursued by subnational governments do affect the pace of economic development within their borders. However, they concluded that these effects are generally modest. Evidence is inconclusive about which policies exert the greatest effects and under what circumstances. The conditions under which state policies can significantly influence business location and economic growth are limited, mainly because the most important determinants of a jurisdiction's relative rate of economic growth are largely beyond the control of state and local governments—for example, labor costs, the availability of appropriately skilled labor, energy costs, climate, and the availability of natural resources. A few experts also noted that competitive forces have narrowed differences among states in both business tax burdens and business incentives, dampening the effectiveness of any new measures.

Participants concluded that public policy differences between jurisdictions are most likely to affect business location when those differences are large, but the jurisdictions are otherwise very similar. For this reason, public policy is a more effective instrument of economic competition within metropolitan areas than between them, or between states or regions.

Most participants agreed that individual policies designed to stimulate economic development sometimes work at cross-purposes, suggesting a need for greater coordination in development strategy and tactics. For example, tax incentives, which can foster development by reducing business costs, can also indirectly impede development if they reduce expenditures on public services that businesses value. Similarly, deregulation may cut the costs of production, but it can also diminish the attractiveness of a location if it causes a deterioration in environmental quality. A further consideration is that policymakers have additional goals besides economic development, including an equitable distribution of income and the even-handed treatment of different business activities.

Participants were split on the issue of whether intensifying economic competition, especially in the form of narrowly targeted incentives, is a positive or negative development. However, the consensus was that whether interstate competition is good or bad on net, neither the Congress nor the Supreme Court should attempt to restrain it.

Theories of Interjurisdictional Competition

In her paper, presented in this issue, Daphne Kenyon analyzes theories of interjurisdictional economic competition, the process that drives most state and local economic development policies. She identifies three forms of such competition: active competition, implicit competition, and yardstick competition. Jurisdictions engage in active competition when they consciously attempt to win a scarce, mobile resource from their rivals or avoid a particular cost; an example is the "bidding" that occurred among states hoping to attract the Saturn automotive plant. They engage in implicit competition when they modify their pursuit of other policy goals in order to mitigate anticompetitive consequences. They are driven to engage in yardstick competition when their citizens evaluate their policies by referring to the policies of rival jurisdictions.

Kenyon argues that interjurisdictional competition is especially intense in the United States because public authority is fragmented among a large number of highly autonomous, self-sufficient subnational governments. Despite this competitive intensity, she notes, economists disagree on how a jurisdiction should identify its economic rivals and evaluate its competitive standing.

Kenyon evaluates six models of interjurisdictional competition, focusing on their implications for competition's benefits and costs. Her evaluation indicates that under conditions approaching those of a perfectly competitive market, interjurisdictional competition promotes an efficient geographic allocation of resources, an efficient mix of public and private goods, and an efficient operation of state and local governments. Such "competitive market" conditions include the presence of many competing jurisdictions with similar fiscal capacities and costs, the absence of "spillovers" from taxes or public services in one jurisdiction onto the residents of other jurisdictions, voters and policymakers who have full information about specific policies, and governments that aim to maximize the well-being of their constituents.

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Kenyon notes, however, that one or more of these conditions usually is violated in the real world. Knowledge is imperfect and governments, voters, and businesses do not all share equally in the available facts; some jurisdictions have ample fiscal resources or low fiscal cost, giving them an inherent advantage in the competitive process; public officials may pursue interests other than their constituents' economic welfare; and governments may engage in strategic behavior that can lead to zero-sum or negative-sum outcomes. In addition, interjurisdictional competition is not compatible with the view that fairness requires levying taxes according to the ability-to-pay principle. Thus, Kenyon concludes, interjurisdictional competition can impose costs that policymakers should take into account in pursuing competitive advantage.

In her comments, Caroline Hoxby calls for clearer thinking about methods for identifying competing jurisdictions and evaluating a jurisdiction's competitive standing. In her view, jurisdictions are competitors to the extent that they share underlying similarities that make business owners or workers compare them when deciding where to locate. These fundamental similarities usually involve climate, geography, the availability of natural resources, or legal and cultural history. Similarities among jurisdictions in tax structure or even industrial mix may result from the competitive process, rather than being pre-existing characteristics of potential competitors. For example, she notes, Alabama should not be considered a competitor of Maine simply because the paper industry plays a relatively large role in the economies of both states; rather, they are competitors in that they both have a large supply of harvestable trees. Similarly, an indicator of a jurisdiction's competitiveness that includes its relative tax burden is flawed, in that its relative tax burden is likely to reflect an attempt to compensate for unobserved differences in more fundamental characteristics between it and its rivals.

Hoxby also calls attention to an important insight provided by one of the models reviewed by Kenyon: McGuire's (1991) model of "destructive competition." In Hoxby's view, McGuire's analysis illustrates how competition among jurisdictions makes it impossible for governments to use ability-to-pay taxes rather than benefit taxes to finance local public services. Ability-to-pay tax regimes cause high-income households to subsidize public goods consumption for low-income households, but competition will cause jurisdictions to offer tax breaks to the high-income households that might provide such subsidies, thereby bidding away the net subsidy. Hoxby maintains that this type of competition, rather than being "destructive," may enhance allocative efficiency, and argues that this example illustrates how interjurisdictional competition constrains a wide variety of policies and institutional structures that might otherwise provide "rents" to specific groups.

Andrew Reschovsky's comments also focus on the constraints that interjurisdictional competition imposes on state and local governments' ability to undertake redistributive activities. He notes that the Oates and Schwab paper reviewed by Kenyon endorses the efficiency-enhancing role of interjurisdictional competition only when the federal government plays a central role in assisting low- and moderate-income families, yet U.S. public policy is currently moving in the opposite direction. He warns that competitive forces will make it extremely difficult for state governments to offset impending reductions in the federal social safety net, many of which will occur as cuts in federal grants to state governments. He raises the possibility that states will respond to these cutbacks, as they have in the past, by reducing assistance or shifting fiscal responsibilities to local governments, which also operate in a highly competitive environment where it is self-defeating to levy ability-to-pay taxes. The result is likely to be less redistribution among income classes. Invoking Paul Courant (1994), Reschovsky urges policymakers to evaluate their economic development policies in terms of the degree to which they alter the level and distribution of their residents' economic welfare, not narrowly according to how many new jobs or investment dollars they generate.

General State and Local Policies Regarding Taxation and Public Services

Michael Wasylenko summarizes the research examining the economic development effects of state and local taxation. He points out that most analysts and policymakers start with a strong prior that "tax policy influences economic behavior." Yet researchers have had difficulty determining the degree to which employment, investment, or business location responds to differences in state and local taxes. Interstate or interregional studies typically find small effects: The central tendency of tax elasticity estimates is around −0.2, implying that a 10 percent reduction in

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taxes would be associated with about a 2 percent increase in economic activity. Furthermore, the range of estimates obtained in individual studies is quite wide. Wasylenko concludes that tax differentials do not have a substantial, reliable effect on levels of economic activity in states.

Wasylenko argues that much of the uncertainty in the empirical literature about tax responsiveness is attributable to measurement and definition issues. He specifically highlights differences in the inclusiveness of the list of other variables explaining activity levels and differences over time. Tax studies tend to model economic activity (measured as jobs, investment, income, or the like) or changes in activity as a function of states' or localities' tax characteristics along with other traits thought to influence activity levels. One key difference among studies is whether measures of government service levels are included along with taxes; excluding them causes an underestimate of the tax elasticity because services may attract economic activity and service levels tend to be higher where the taxes that finance them are higher. Results also vary depending on the nature of the business activity being modeled—employment, income, investment, or location—and depending on whether it includes only manufacturing, a comprehensive list of specific industries, or aggregate business activity.

Wasylenko surveys a considerable number of studies in which a tax elasticity is estimated, adding more recent studies to Timothy Bartik's 1991 survey. Most interregional or interstate studies find estimates in the −0.1 to −0.6 range. International studies (of foreign direct investment in U.S. states) yield estimates near the high (−0.6) end of the range. Intraregional studies estimate markedly higher elasticities (at least quadruple the interregional ones) because the nontax cost factors are likely to be similar among possible business locations within a metropolitan area, making tax differentials more important.

Given small or uncertain responses of business activity to interstate differences in taxes, Wasylenko asks what advice researchers can give to policymakers who want to keep their states' economies growing. He suggests that they pay attention to maintaining a stable business tax system with low rates and broad tax bases that can efficiently support the service levels preferred by businesses and residents of the state, rather than to ad hoc "competitive" tax reductions possibly accompanied by cuts in service levels or rising deficits.

Ronald Fisher takes up the expenditure side of state and local fiscal policy, looking at the effects of public services on economic development. He summarizes a body of research examining the impact of specific types of services on economic activity (in some cases, by sector) in states, regions, or local jurisdictions. As in the literature examined by Wasylenko, a variety of conceptual and measurement issues have made it difficult for researchers to determine how important public services are in business location decisions. But Fisher concludes that at least "*some* public services clearly have a positive effect on *some* measures of economic development in *some* cases."

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The literature reviewed by Fisher has focused on three types of public services: transportation, public safety, and education. The positive relationship between services and economic development is strongest for transportation services, especially highway facilities. The results for public safety spending are less consistent than those for transportation, and the evidence for a link between education spending and economic development is weakest.

A key difficulty in the public services literature is that spending measures, which are relatively easy to develop on a consistent basis, may bear little relation to the actual service levels that businesses care about in making their location decisions, and service levels are notoriously difficult to measure. Fisher notes that the relationship between spending and service levels may be particularly variable for education. Furthermore, because today's education spending is largely an investment (from the business point of view) in future, not current, workers, the substantial mobility of American society implies that much of the effect of any community's education spending will spill over to other jurisdictions. Indeed, spillovers (and externalities more generally) for education or other investments in public infrastructure imply that these policies might have positive effects on national economic activity even if no local effects can be detected.

While his review suggests several techniques for obtaining better estimates of the effects of public services on economic development, Fisher states that a more important question relates to what one would do with such estimates if one obtained them. He argues that analysts must first ask, "What precisely is the objective of both development policy and public service provision?" In this context, researchers must examine not only the immediate local employment or investment impacts of specific policies, but also their longer-term effects on both local residents' well-being and the functioning of the broader economy. In particular, he argues, researchers need to develop a better understanding of who benefits from spending policies in order to evaluate more completely "the welfare implications of economic development that arises from public services."

Timothy Bartik focuses his discussion of Wasylenko's and Fisher's papers on a key question they both raise: how research can better inform policymakers. He lists five themes that characterize both papers: (1) the research results quantifying the impacts of taxes and public services on economic activity are often quite fragile, in part because (2) both taxes and public services are difficult to measure and, at least as measured, (3) they may result from, rather than being a cause of, economic development. Nonetheless, (4) a consensus has developed that taxes and public services do affect economic development, although (5) the focus on economic development is incomplete, or too narrow.

To address the first three issues, Bartik suggests studies that examine the outcomes of "natural experiments" when states undergo major shifts in their tax or expenditure regimes. With respect to the narrowness of the current focus on economic development, Bartik argues that analysts should be investigating how and why the effects of state and local tax and spending policies on economic development are important for social well-being—how are fiscal variables' effects on economic development relevant for public policy? For example, he says, we care about local employment growth because wages often do not clear labor markets—some potential holders of the created jobs would otherwise be unemployed. This suggests that high-unemployment areas might see more benefits in undertaking tax and spending policies aimed at economic development than would low-unemployment areas. More generally, he argues, a complete cost-benefit analysis of tax and spending policies would include their indirect benefits (enhanced economic development) as well as direct benefits to residents, and would also consider the feedback effects of additional economic activity on the demands and needs for services as well as on the tax base.

Harley Duncan agrees with Bartik that Wasylenko and Fisher have succeeded in summarizing an extensive research literature on the relationships between state and local tax and expenditure policies and economic development, as well as the conceptual and methodological difficulties faced by such research. He focuses his comments on a by-product of those difficulties: While Wasylenko and Fisher have made the research findings more accessible and understandable, Duncan argues that those findings do not yield a clear course for policymakers. This lack of usable advice is especially frustrating when tax cuts for attracting business are a hot topic in many state legislatures. He concurs in Wasylenko's guidance regarding the importance policymakers should place on general tax policy, rather than tailoring tax policy to stimulate investment or, worse yet, engaging in bidding wars for specific facilities.

Duncan similarly agrees with Fisher that one should not infer from the inconclusive statistical evidence of a relationship between public expenditures and economic development that government services have no value and should be eliminated. Rather, public expenditure and investment policies must be considered in the context of an overall strategy. For example, if a state is seeking to foster business activities that require particular types of training and infrastructure, then public spending should be oriented in those directions.

Therese McGuire questions whether a consensus that taxes matter really exists, citing Wasylenko's own research in this area which finds different effects of taxes on economic development in different time periods. She argues also that the evidence from studies of specific tax incentives and enterprise zones, which suggest only small effects on business location, undermines the conclusion that taxes matter. She (like Duncan) would like to see more research to reconcile the literatures on broad tax policy and incentives.

McGuire makes symmetric arguments on the expenditure side, concurring in Fisher's finding that the literature is inconclusive regarding the effects of public services on economic development. Having argued that the effects of both taxes and public services on economic development are uncertain, McGuire urges humility among researchers in offering advice to policymakers.

Robert Ady brings a different perspective to his discussion of the effects of tax and expenditure policies on economic development, that of a consultant to business firms seeking to start up, relocate, or expand their facilities. He reports that firms use a variety of criteria in selecting a location, which can be grouped into three categories: operating costs, operating conditions, and quality of life. Taxes are one source of variation in operating costs. Public services may affect operating conditions (and perhaps the quality of life).

The first step in selecting a location is to identify the broad area of search and individual states for initial consideration. Taxes are a relatively minor factor at this stage, as the focus is on broad wage and transportation differentials as well as any key "fatal flaws" specific to the firm. Even at this stage, however, a state with dramatically higher taxes than its neighbors or competitors may be eliminated.

In the second step, specific locations within the search area are identified and preliminary estimates of operating costs are compared. Ady estimates that taxes comprise only 4 to 5 percent of the "geographically variable operating costs" being considered at this stage, with much higher weights on labor and transportation costs; even utility and occupancy costs are more important than taxes. Public expenditures on highways and other transportation infrastructure can affect the transportation costs associated with specific sites a firm is considering. The expenditure side of the budget will also be important to the degree that education expenditures produce a more qualified work force in some locations than others. A handful of locations (three to five) proceed to step three, in which detailed calculations yield estimates of "net" taxes, considering all taxes as well as abatements and incentives.

Ady points out that insights from this site selection process are consistent with Wasylenko's and Fisher's careful reading of the research. First, when considering locations across broad geographic areas, other cost variations are almost certain to swamp the effects of tax differentials on business location. In particular, he argues, "the quality of the available work force is the single most important factor in site selection today," but the link between public expenditures on schools and labor force quality is difficult to analyze. Second, site selection is highly firm-specific; that is, responsiveness to differential taxes or public services varies considerably across sectors, industries, and firms.

State and Local Regulatory Policy

Robert Tannenwald reviews studies estimating the impact on economic development of selected state and local regulations, specifically those related to environmental protection, labor markets, and financial institutions. He finds little consistent evidence that regulatory policies significantly affect firm location, the rate of business formation, or the rate of growth in employment and income. He attributes this lack of evidence to the ambiguous nature of regulations: while they usually raise the cost of doing business in a particular jurisdiction, often they also enhance the jurisdiction's attractiveness as a place in which to live, work, and vacation. Furthermore, the stringency of regulatory enforcement, a potentially important locational factor, is often difficult to measure.

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With respect to environmental regulation, Tannenwald notes that most econometric studies find a negative relationship between a jurisdiction's regulatory stringency and its economic performance. The estimated effects tend to be small, however, and the models generally explain little of the interjurisdictional variation in economic performance. He points out several sources of bias and imprecision in the environmental literature. For example, he criticizes the use of a county's air quality as a proxy for the stringency of its environmental regulations. While dirty air triggers higher regulatory standards, thereby raising business costs, it also can stunt a county's economic growth by making it an unattractive location for workers, regardless of the stringency of its regulatory regime.

With respect to state regulation of labor markets, some research has examined workers' compensation, but most studies focus on the impact of right-to-work laws. Tannenwald finds considerable evidence that these laws have exerted a positive, statistically significant impact on economic activity. He argues, however, that evidence documenting the ways in which right-to-work laws purportedly promote economic growth is elusive. For example, right-to-work laws may weaken unions, thereby constraining growth in labor costs. Alternatively, weak unions, and the underlying attitudes that weaken them, may promote the enactment of right-to-work laws. Nor have investigators found evidence that right-to-work laws exert a negative effect on wages independent of their effect on unionization.

With respect to state regulation of financial institutions, Tannenwald finds evidence that the relaxation of regulatory constraints on banks by Delaware and South Dakota brought large positive employment and income effects in both states. However, other states trying to emulate their success have not enjoyed comparable results.

Tannenwald urges researchers to explore the economic impact of changing state regulations in such areas as health care and energy production. He also calls for improved measures of the character of regulatory enforcement and of the value of regulations in enhancing the quality of life.

Citing evidence from the pulp and paper industry, Wayne Gray supports Tannenwald's contention that the manner in which regulations are enforced is as important as the stringency of regulations in determining where firms locate. Gray also agrees that stringent regulation can be a competitive asset as well as a liability, but only to the degree that the benefits of regulation are reflected in lower wages and therefore capturable by employers. In practice, workers who live in one jurisdiction and work in another may not be willing to sacrifice much compensation for environmental protection in their workplace jurisdiction.

Gray argues that Tannenwald exaggerates the econometric problems of evaluating the impact of environmental regulation on firm location. For example, the most common measure of regulatory stringency based on air quality is a dichotomous variable indicating whether or not the jurisdiction's air quality falls short of federal standards and is therefore subject to especially strict environmental controls. Gray points out that air quality varies widely within these two categories, making it possible to distinguish the impacts of regulatory policy and environmental quality. He also calls for additional research to examine how the estimates of regulatory impacts may differ with different sources of data, time periods analyzed, and estimation methods, as well as how the response to regulation may differ among industries.

Allan Hunt questions whether interjurisdictional differences in the costs imposed by various state and local regulatory regimes are sufficiently large to influence rates of economic development. He buttresses his point with data on workers' compensation costs. Citing John Burton's (1995) study, he argues that interregional differences in these costs are very small. Why then, he asks, do business groups continually rank the costs of workers' compensation as a critical component of "business climate"? Hunt speculates that a lack of timely, comprehensible data on these costs that can be compared across states emboldens lobbyists to play on lawmakers' fear of losing employers to rival states.

Hunt criticizes researchers for focusing too much on factors that are likely to have little effect on economic development, such as interstate differences in the costs of workers' compensation. He urges them to formulate hypotheses concerning which factors are most likely to influence economic development in the future and to develop measures that will enable them to estimate their impact.

Targeted Incentives

The papers by Michael Wasylenko and Ronald Fisher (summarized earlier) address tax provisions and public expenditures that affect businesses in general and were designed with multiple purposes in mind, not just economic development. By contrast, Peter Fisher and Alan Peters examine incentives intended to attract either specific firms to a state or a variety of firms to a specific, typically distressed, location within the state. Examples of such targeted incentives include negotiated property tax abatements, loan guarantees, training subsidies, and reduced tax rates or increased tax credits for activities in designated enterprise zones. Fisher and Peters note that the majority of recent econometric studies conclude that such incentives can influence an area's economic growth, but they caution that these studies are based on deficient measures of incentives, and thus the research is suggestive rather than definitive.

According to Fisher and Peters, the value of a fiscal incentive package should be measured by its impact on a firm's return on new investment. By contrast, existing studies tend to be based on cruder data such as the number of incentives offered, regardless of the size of the incentive or whether firms that qualify for one program are also eligible for another. Furthermore, Fisher and Peters assert that the very definition of an incentive is questionable. For example, local governments in some states may not need to offer a particular incentive because it is encompassed in statewide policy, while elsewhere local governments choose to make up for the lack of state initiative. What is termed a tax incentive in one state may be part of the basic tax code in another. Thus, studies should consider incentives in the broader context of tax and expenditure policies, and they should consider both state and local policies.

Fisher and Peters have developed measures of the dollar value of a locality's standing incentive offer to industrial firms expanding or locating there. They use this measure to examine net-of-incentive after-tax returns for 16 hypothetical firms from locating in 112 alternative cities. Fisher and Peters observe that differences between the highest and lowest rates of return are large—"potentially large enough to influence location decisions." They also find that cities with highly competitive tax packages tend to offer generous nontax incentives as well. Finally, Fisher and Peters find that the geographic variation in incentives does not appear to be associated with other cost differentials; they conclude that if cities are not offering them to offset regional labor, energy, and transportation cost disadvantages, then incentive differentials may indeed sway plant location decisions.

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Of the 112 cities, 44 contain enterprise zones, which are geographically targeted economic development programs. Fisher and Peters find that the specific benefits offered to firms locating in enterprise zones differ considerably across locations, but on average enterprise zone provisions emphasize labor subsidies, while non-geographically targeted programs are more oriented toward subsidies to capital. On the whole, previous research seems to suggest that enterprise zone programs may be more likely to promote economic growth in their target areas than programs covering a broader territory, since responsiveness to tax differentials is generally greater within a region (where other cost differentials are likely to be smaller) than between regions. However, Fisher and Peters caution that further empirical work is needed. New research would seek to identify the unique contribution of the enterprise zone provisions to the investment or employment growth observed in the zone, with careful attention to the identification of incentive effects on the margin (since firms often are unable to use all the investment or jobs tax credits offered), and to how firms substitute between labor and capital (especially when one is subsidized), as well as the inherent economic disadvantages of the zone at its inception.

In his comments, Dick Netzer praises Fisher and Peters' model of tax and nontax incentives, particularly for its potential to distinguish between capital and labor subsidies. He notes that public discussions thus far have paid too little attention to how incentives should be structured to achieve employment goals. Netzer suggests two future refinements for Fisher and Peters and other researchers. First, they should expand their analysis to nonmanufacturing activity, in light of the generally diminished role of manufacturing in the economy and the fact that older, industrialized cities do not have the large tracts of undeveloped land or other attributes that would enable them to compete for manufacturing firms. Second, researchers should take into account the risk to government units that businesses receiving incentives subsequently renege on their agreement to create jobs or make capital investments.

Referring to Fisher and Peters' review of the literature, Netzer finds they are "much too kind." Some reported studies imply that state or local governments would reap improbably large rewards by making small economic development expenditures or enacting small tax cuts. "Who needs oil wells when a state can be another Kuwait just by increasing the budget of a tiny agency?" Netzer asks rhetorically. He concludes with a call to redirect the thrust of state and local economic development policy, away from an emphasis on making exceptions to the general rules and toward making broad, productive changes in those rules.

Leslie Papke also praises Fisher and Peters' measurement of economic development incentives and indicates one way in which their work can contribute to state policymaking. She notes that the majority of existing studies find that business investment is fairly insensitive to differentials in state and local tax burdens. However, this conclusion might be erroneous if development incentives (not included in those studies) were serving systematically to offset measured differences in tax burdens across areas. Fisher and Peters find, to the contrary, that incentives tend to accentuate basic tax differences, reinforcing the view that business location decisions are motivated largely by factors other than taxation. Moreover, their findings may lead some governments to question the need to offer specialized incentives. If a state already has a low corporate income tax rate, for example, this may be sufficient to establish its competitive position.

In terms of future research, Papke urges Fisher and Peters to refine their calculations so that their summary measure, the value of incentives, varies only with taxes and incentives, and not with firm investment and employment decisions. She also encourages them to distinguish the relative impacts of various types of incentives rather than reporting only the total impact. More generally, she calls for increased attention to the revenue costs of development incentives and to who bears these costs.

Policy Implications: A Panel Discussion

The panelists were asked to reflect on several broad topics related to economic development: the effectiveness of various state and local policies, the proper roles for national and subnational levels of government, and priorities for future research. In addition, moderator Patricia Flynn invited the panel to offer policy advice and to discuss the nature of the firms and jobs for which states and localities should be competing. Citing an example from the *Wall Street Journal* of a German firm in South Carolina that had instituted "management practices that Americans often find idiosyncratic if not obnoxious," she suggests that areas may differ with respect to the type of economic development they are trying to foster, and that what they are willing to pay should be related to the benefits they expect to receive.

Bennett Harrison starts by noting that, contrary to the expectations of many policymakers as recently as the early 1990s, interstate tax competition has not been supplanted by increased government support for activities such as research and development, worker training, and the establishment of collaborative business networks. This has unfortunate implications, as tax competition makes it difficult for state and local officials to achieve a progressive redistribution of income.

Harrison criticizes the models used to analyze interstate competition. For one thing, they do not incorporate dynamic behavior. In reality, strategic interaction between the public and private sectors can create competitive advantages for a region, whether by tailoring education and training to business needs or enhancing local supplier chains. And nothing in the models addresses agglomeration and clustering effects, even though increased attention to such interfirm linkages may suggest that states and localities would be better off eschewing incentives for particular firms and instead pursuing broader policies that lead to critical mass for particular industries.

Flynn suggests that what an area is willing to pay to promote economic development should be related to the expected benefits.

Harrison points to harmful effects of devolution, particularly the heightened difficulty of pursuing redistributive objectives and the potential for costly duplication of programs.

Fox believes that taxation does matter to businesses, but that tax structure may be as important as tax rates.

Enrich believes that tax competition is particularly pernicious, because its costs in terms of eventual higher burdens for nonbusiness taxpayers are well-disguised.

Ebel notes that economies that are decentralized with respect to taxing and spending powers tend to grow faster, and he advises that the U.S. government take a neutral stance with respect to subnational fiscal policies.

Finally, Harrison points to the harmful effects of the ongoing decline in the federal government's commitment to both economic development programs and transfer programs, particularly the heightened difficulty of pursuing redistributive objectives and the potential for costly duplication of programs. He also indicates that state governments are notoriously deficient in evaluating the effectiveness of their programs, a deficiency that assumes greater importance as the center of gravity of more public programs moves to the state level.

William Fox notes that most of the policies discussed during the symposium were developed with multiple objectives. However, in recent years state and local policymakers have been more concerned with their ramifications for economic development. He urges policymakers (and those who would advise them) to be clear about their specific objectives with respect to jobs, incomes, and growth, and to distinguish short-term and long-term effects. For example, Fox found that about a decade after Nissan located a plant in Rutherford County, the income level and growth rate of that county were indistinguishable from those of other Tennessee counties, though a greater share of its employment was in manufacturing.

Fox indicates that economic development policies have a potentially greater effect on a state's residents if the state is able to recruit new facilities that hire locally rather than retaining workers from their former locations. However, many businesses today, especially service-oriented businesses, increasingly are taking advantage of electronic commuting. With this innovation, it becomes less relevant to try to design policies that alter business location.

Fox believes that taxation does matter to businesses, but that tax structure may be as important as tax rates. He advises state policymakers to adopt policies that are not too far out of line with their competitors. He notes further that interstate competition is more harmful socially than is typically acknowledged, because redirecting economic activity to a new site leaves behind idle capital and human resources in the former site. Nevertheless, Fox feels that the federal government is incapable of designing effective rules to curtail interstate competition, and that such competition has the useful effect of helping state and local governments keep their tax and expenditure patterns within a narrow set of bounds.

From the perspective of an attorney involved in state and local tax policy, Peter Enrich finds interstate competition quite harmful. To the extent that economic development policies are ineffective, state and local governments are wasting resources. To the extent that these policies do have an effect, competition will result in localities matching each others' policies and therefore will lead to no lasting benefits for any area. Enrich believes that tax competition is particularly pernicious, because its costs in terms of eventual higher burdens for nonbusiness taxpayers are well-disguised. By contrast, government expenditures in support of economic development at least result in useful infrastructure or improved schooling, and a move to reduce regulatory burdens has a natural limit, as residents object to decreased environmental safeguards or decreased protection for workers.

Enrich reports that a substantial body of case law from the U.S. Supreme Court says that when a state discriminates in favor of local economic activity and against out-of-state economic activity, that violates the Commerce Clause of the U.S. Constitution. Thus, he sees the Commerce Clause as a potential tool for curbing interstate competition. He notes that although businesses that are at a disadvantage are not likely to bring suit, citizen-taxpayer groups or labor unions may be expected to use this vehicle. In an atmosphere of such legal challenges to state policies, the Congress may be prompted to try to figure out a reasonable balance for what states should be permitted to do.

Robert Ebel discusses how the symposium bears on policy advice that might be offered to public officials. He notes that economic models provide imprecise estimates, in part because they exclude the bargaining for preferences that goes on between firms and government bodies, and more generally because actual business tax burdens cannot be determined precisely from the parameters specified in tax laws. Nevertheless, it is important for economists to acquaint policymakers with elasticity estimates emanating from statistical studies, in order to provide some quantification of the relative role of taxes in business location decisions.

Ebel cautions that economic studies may lead to misleading conclusions about local government expenditures and economic development. In particular, cities must spend more than most suburbs to achieve a given service level because they have a disproportionate share of poor residents compared to suburban areas and because they are relatively congested. These (unmeasured) cost differentials tend to bias downward the measured effectiveness of local spending.

Ebel advises that the U.S. government take a neutral stance with respect to subnational fiscal policies. Even though interstate competition has its flaws, international evidence indicates that economies that are decentralized with respect to taxing and spending powers tend to grow faster. Therefore, an effort by the federal government to limit the fiscal powers of states and localities could adversely affect the competitiveness of the nation.

Summary of Key Policy Themes

Throughout the symposium, participants frequently broached two broad policy-related issues: in light of current theory and empirical evidence, (1) how can state and local economic development policies be improved? and (2) is interjurisdictional competition intrinsically good or bad? There was a consensus on the first issue, a split on the second.

The Need for Greater Planning and Coordination

Participants concluded that state and local governments should plan and coordinate their economic development programs more carefully. Most important, the architects of such programs were urged to balance economic development with other public policy goals. If the relevant government objective is to maximize the economic well-being of the jurisdiction's residents, this objective will be furthered by attention to distributional fairness, economic neutrality, the provision of adequate public services, and effective regulation in the public interest, as well as economic development. These other goals are not necessarily inconsistent with economic development; a low-tax environment may not attract and retain employers if public services are substandard and regulation ineffective. Keeping an eye on broader government objectives also encourages policy designers to evaluate indirect as well as direct impacts of proposed policies. For example, a tax reduction undertaken to attract businesses may add to the deficit or force service cuts, and these changes may have second-round effects on economic activity and residents' well-being. Similarly, participants concluded that, in attempting to stimulate job creation, officials should be concerned about the quality as well as the quantity of new jobs created and the long-run effects as well as the short-run effects of development policies.

Participants based their criticism of unbridled pursuit of economic development partly on evidence suggesting that business location depends largely on factors outside of governmental control, such as climate, energy costs, proximity to markets, and the availability of appropriately skilled labor. Their support for thoughtful balancing of diverse policy objectives was also rooted in the imprecision and uncertain policy implications of the empirical and theoretical evidence that they reviewed. They cited the diversity of theories of interjurisdictional economic competition and their often conflicting conclusions regarding the degree to which competition enhances long-run economic welfare. They pointed to the inherent uncertainty of competitive policy outcomes given the potential for retaliation by rival jurisdictions. They identified numerous methodological difficulties inherent in evaluating the effects of state and local development policies. Among the most formidable are determination of the most relevant measure of development (jobs, investment, income) and quantification of differences across jurisdictions in business tax burdens, levels of public services for specific governmental functions, and relative regulatory stringency. Also difficult are isolation of the development impact of a specific public policy from the impacts of other policies and non-governmental factors, and the construction of historical data sets that permit inferences about long-run policy effects.

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Participants also urged policymakers to tailor their economic development policies to the type of economic activity they wish to stimulate and to the traits of their jurisdiction's economy. For example, some jurisdictions may be able to identify a cluster of promising industries whose growth could be stimulated with a few strategically placed public subsidies. If the principal impediment to economic growth is a shortage of workers with specific skills, development programs should concentrate on the alleviation of this shortage. In some situations, tax relief targeted on individuals may be more cost-effective in promoting development than business tax cuts. Incentives most effective in stimulating investment are different from those most effective in creating jobs. No one policy prescription is the best for all jurisdictions at all times.

Is Interjurisdictional Competition Good or Bad?

Most participants expressed the belief that interjurisdictional competition can have both beneficial and detrimental effects. There was general agreement that competition promotes an efficient allocation of resources by encouraging jurisdictions to differentiate themselves in their level and mix of taxes and public services. Competition also encourages governments to operate efficiently. Yet several participants felt that too often competition degenerates into a zero-sum game among a few rivals, in which retaliatory behavior ultimately blunts allocative efficiency gains and benefits only a few powerful interests. Primarily for this reason, many participants expressed skepticism that states and municipalities could easily reconcile competitiveness with the goal of redistributing income from high-income to low-income households. Some participants expressed concern that the trend toward greater decentralization of government is intensifying interjurisdictional rivalry and that more intense rivalry will deter state and local governments from providing offsets to reductions in federal programs, especially those comprising the "social safety net."

Whether interjurisdictional competition is good or bad on net, several participants argued that federal measures designed to restrain it would be difficult to implement and would create more problems than they would solve.

Participants noted that competition is more likely to be beneficial when rival jurisdictions are similarly endowed with taxable resources and face similar fiscal challenges. However, this condition rarely holds; fiscal disparities among states and among communities within most metropolitan areas are wide. As a result, certain jurisdictions are continual winners and others perpetual losers in the competitive process, especially in the absence of equalizing aid from a higher level of government.

Whether interjurisdictional competition is good or bad on net, several participants argued that federal measures designed to restrain it would be difficult to implement and would create more problems than they would solve. Federal policymakers would have trouble deciding whether a specific policy was acceptable or unacceptable practice, any intervention might lead to undesirable incursions of states' rights, and measures to enforce such curbs could cause more harm than unregulated competition.