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A Game Changer for the Political Economy of Economic Development Incentives

Stephen E. Ellis
The University of Oklahoma

Grant M. Hayden
Southern Methodist University, Dedman School of Law

Cynthia L. Rogers
The University of Oklahoma

A GAME CHANGER FOR THE POLITICAL ECONOMY OF ECONOMIC DEVELOPMENT INCENTIVES

Stephen Ellis,* Grant Hayden** & Cynthia Rogers***

State and local governments have embraced their authority to offer economic development incentives for the purpose of attracting, retaining, or enhancing economic activity within their borders. Collectively, these programs represent an enormous, but largely overlooked, transfer of wealth from public entities to private firms. The increasing use of economic development incentives runs counter to the guidance offered by academic researchers. With their proliferation comes the increasing need for accountability in the decision-making process. We consider whether the duty of care standard used in corporate governance should be applied to the public decision-making context regarding economic development incentives.

Table of Contents

* Associate Professor of Philosophy, University of Oklahoma. B.A., M.A. University of Kansas; Ph.D. Rutgers University.

** Professor, Hofstra Law School. B.A., M.A. University of Kansas; J.D. Stanford Law School.

*** Associate Professor of Economics, University of Oklahoma. B.A. Kent State University; Ph.D. University of Pittsburgh.

INTRODUCTION

The recent Detroit bankruptcy has focused the public's attention on the perilous state of local government finances. To some degree, municipalities are at the mercy of the larger economic tides and must brace themselves for the financial implications of broader downturns. Local officials do, however, try to stem the tides. In our system of fiscal federalism, state and local governments enjoy a considerable degree of autonomy regarding their taxing and spending decisions. Such fiscal autonomy allows them to offer economic development incentives for the purpose of attracting, retaining, or enhancing economic activity within their borders. This authority has not been neglected. The proliferation of development incentives programs is notable due to the sheer number of programs available, the number of firms receiving incentives, and the overall dollar value of incentives that have been offered. At this point, the use of such incentives is endemic in local government, resulting in the transfer of tens of billions of dollars every year from public coffers to private firms.

The growth of incentive activity is related to the nature of the economic development "game." Policymakers seek to attract firms that are likely to generate high net value for the community. Such firms, however, attract competition from other jurisdictions. Competition drives up the value of the incentive offers. The prospect of achieving a positive net benefit by offering incentives in this setting is dubious. The academic literature points out numerous pitfalls associated with incentive competition, mostly related to ignorance of costs and benefits. It is possible to subsidize the wrong firm—firms that have low value or aren't influenced by the subsidy—or to oversubsidize the right firm. The empirical evidence suggests that offering incentives, in general, does not work.

So why do policymakers persist in such a questionable practice? The positive motives vary from case to case, but such behavior persists because the political structures within which incentive offers are made provide decision-makers with no real reason to look into their effectiveness—and some reason not to look. Given the (mere) surface plausibility of the view that incentives are effective, government officials have no cause to dig any deeper. We offer an approach that counters the ignorance that characterizes current decision-making regarding economic development incentives.

When communities try to attract firms, they behave like businesses trying to attract customers. Economic development incentives serve as "rebates" that reduce the "price" of what a community has to "sell." Our proposal is based on this symmetry. Private firms have a fiduciary duty of care to their shareholders; we believe state and local governments—when they engage in the business-like activity of attracting firms in order to improve economic conditions—owe a duty of care to their citizens as well. The duty of care for private firms is sharply limited by the business judgment rule: courts will not second-guess substantive economic decisions, but will only enforce a procedural standard; firm decision-makers must ask the right questions and look at the right sort of information. Likewise, governmental decision-makers should be required to consider all relevant information and issues before they make decisions about incentives.

A procedural duty of care would serve to strengthen political constraints on state and local policymakers. Concerned citizens would be enabled to determine whether their elected officials had avoided the various difficulties of offering incentives and, if not, they could try to rally other citizens to hold officials responsible at the polls. Even just calling officials to their duties as good community stewards might have a salutary effect on their decision-making. In the end, we believe that if both of the parties negotiating over economic development incentives—private corporations and local governments—are deemed to owe their constituents a similar duty of care, they will engage in the kind of behaviors that lead to better decision-making on such agreements.

I. LOCAL GOVERNMENTS AND ECONOMIC DEVELOPMENT INCENTIVES

Economic development incentives are widely used by states and localities to encourage growth in their communities. Nearly every government unit at every level offers some type of subsidy in an attempt to influence firm location decisions.[1] The most common incentives, according to national surveys conducted by the International City/County Management Association (the professional organization for municipal, city, town, township, and county managers), are those that involve direct spending, such as investment in infrastructure, and those that involve a diversion of tax revenues, such as tax abatements and tax increment finance districts.[2] Good Jobs First, a watchdog group, tracks the value of state and local incentives; its database includes information on more than 249,000 subsidy awards from 427 programs in all 50 states.[3]

Collectively, these programs involve enormous sums of money. According to a recent series in *The New York Times*, local governments provide at least 1,874 incentives programs worth over $80.4 billion each year.[4] More than

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1. *See* Mildred Warner & Lingwen Zheng, *Economic Development Strategies for Recessionary Times: Survey Results from 2009*, *in* THE ICMA MUNICIPAL YEAR BOOK 2011 33–42 (2011) ("In 2004, 72% of local governments used business incentives, but in 2009, 95% reported using them.").

2. *See* Laura A. Reese & Gary Sands, *Trends in Local Economic Development: Management, Conflict, and Ethics*, *in* MANAGEMENT POLICIES IN LOCAL GOVERNMENT FINANCE 319–42 (John R. Bartle et al. eds., 2012); Lingwen Zheng & Mildred Warner, *Business Incentive Use Among U.S. Local Governments: A Story of Accountability and Policy Learning*, 24 ECON. DEV. Q. 325 (2010). Tax increment finance districts provide a funding mechanism by which revenues generated by new development in an area (typically a blighted inner-city neighborhood) are spent on basic infrastructure improvements in the designated area. The idea is that the investment will improve business activity over time.

3. *See* *Subsidy Tracker 2.0*, GOOD JOBS FIRST, http://www.goodjobsfirst.org/subsidy-tracker (last visited Oct. 9, 2014) (subsidy tracker). Good Jobs First is a national policy resource center; its subsidy tracker site aggregates data from public sources.

4. Louise Story et al., *Explore Government Subsidies*, N.Y. TIMES, http://www.nytimes.com/interactive/2012/12/01/us/government-incentives.html (last visited May 8, 2013) (searchable database of state and local government subsidies); *see also* Louise Story et al., *United States of Subsidies: As Companies Seek Tax Deals, Governments Pay*

5,000 companies received incentives worth $1 million or more, and 48 of those companies have received more than $100 million worth of incentives since 2007.[5] Somewhat surprisingly, these figures represent only a fraction of all incentives offered: not only are many subsidy programs unreported, but many localities do not know the value of the incentives they provide.[6] Thus, at least at their inception, economic development incentives involve huge transfers of wealth from public entities to private firms.

A. The Theory Behind Economic Incentives

Economic development incentives are not charitable contributions: state and local governments expect a return on their investments. Proponents claim that incentives lead to community economic prosperity by creating partnerships with private firms.[7] In this Article, we argue that each community, then, should think of itself as something like a business that sells certain kinds of resources—infrastructure, amenities, and access to markets—to private firms in return for jobs, taxes, access to goods and services, and other benefits that attend economic growth. Each party receives something of value from, and brings something of value to, citizens (who are the "shareholders" of the community as well as the consumers of the firm). Each party *profits* when it values what it gets more than what it gives. It is vital to see that a locality's profit doesn't come at the expense of its *own* customers—the firms for which it already provides services. As with any other purchase, a private firm should make a deal with a community only if it sees the product offered as worth the price charged. Not every locality is a fit for every attractive firm; not every attractive firm is a fit for every locality.[8]

Of course, private firms can, and often do, make decisions to locate or expand facilities in particular places without any specially tailored arrangements made by the relevant state and local governments. Incentive packages offered by these governments amount to *special offers*, e.g., sales, rebates, upgrades, on what those communities ordinarily provide. The point of such offers is to use relatively

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High Price, N.Y. TIMES, Dec. 1, 2012, at A1 [hereinafter Story et al., *United States of Subsidies*].

5. Story et al., *Explore Government Subsidies*, *supra* note 4.

6. Story et al., *United States of Subsidies*, *supra* note 4.

7. *See, e.g.*, Larry Gigerich, *Forging a Winning Business-Community Partnership Through Incentives*, AREA DEV. SITE & FACILITY PLAN., Spring 2013, at 58; ARIZONA COMMERCE AUTHORITY, http://www.azcommerce.com/about-us (last visited Aug. 17, 2014) ("The Arizona Commerce Authority (ACA) is the leading economic development organization with a streamlined mission to grow and strengthen Arizona's economy. The ACA uses a three-pronged approach to advance the overall economy: recruit, grow, create—*recruit* out-of-state companies to expand their operations in Arizona; work with existing companies to *grow* their business in Arizona and beyond; and partner with entrepreneurs and companies large and small to *create* new jobs and businesses in targeted industries.").

8. Consider, for example, the case of Vertex Pharmaceuticals, which has "has failed to create the 500 net new jobs through 2015 that it promised in order to qualify for up to $72 million in state and local subsidies." Jeff Jacoby, *The Bitter Pill of Failed State Tax Incentives*, TOWNHALL.COM (Nov. 6, 2013), http://townhall.com/columnists/jeffjacoby/2013/11/06/the-bitter-pill-of-failed-state-tax-incentives-n1740094/page/full.

small expenditures to leverage larger returns: there is no point in giving a private firm a little extra income if all it will do is spend a bit more on inputs to produce just a bit more output for the locality to tax. At best, this is a waste of effort: the locality would do better to spend the money itself and avoid giving the firm a share. (At worst, of course, the locality could lose the whole expenditure.) The ability of communities to identify cases where a small incentive would have a large effect on a firm's trajectory is a crucial issue in determining whether an incentives policy will be successful. Again, the goal of economic development incentives is to induce business behavior that will pay off for the community. It is vital, then, not to confuse *sales volume*—the number of firms that do business in a community—with profit. Any business could increase its customer base by selling below its costs, but no business could make a profit that way. A policy of making unprofitable deals with new firms would lead a community to hurt both its *shareholders*—local citizens—and its current customers—existing firms.

B. The Problems with Economic Development Incentives

Despite their widespread use, the efficacy of economic development incentives has not been substantiated. The academic literature on incentives is massive and growing. Fortunately, there are a number of articles that summarize and review the state of the research. We will start by summarizing the results of statistical analyses of aggregate empirical data, and then move on to examine the reasons behind those results, including data issues, estimation difficulties, methodological flaws, and limitations of generalizing from case study analyses.

Consider first the effect of incentives on firm behavior. A few different scholars have provided summaries of the key articles in this literature. Alan Peters and Peter Fisher described the consensus that has evolved from the early 1960s through 2002 as follows: "There are very good reasons—theoretical, empirical, and practical—to believe that economic development incentives have little or no impact on firm location and investment decisions."[9] Dan Gorin reviewed more recent studies—ones that use better data and more sophisticated empirical methods—and concluded that, while the extent to which incentives induce new investment remains unknown, there are several fundamental reasons to doubt their value.[10] Carlianne Patrick provides the most up to date summary of the literature, noting that evidence regarding the impact of incentives on location decisions is ambiguous but unpromising—small, insignificant, and negative effects have been documented.[11] Thus, the weight of the evidence suggests that economic development incentives have little impact on the firm decisions they are designed to influence.

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9. *See* Alan Peters & Peter Fisher, *The Failures of Economic Development Incentives*, 70 J. AM. PLAN. ASS'N 27, 32 (2004).

10. *See* Dan Gorin, *Economic Development Incentives: Research Approaches and Current Views*, 93 FED. RES. BULL. 69 (2009).

11. Carlianne Elizabeth Patrick, Essays in Growth and Development Policy 4 (2012) (unpublished Ph.D. Dissertation, The Ohio State University) (https://etd.ohiolink.edu/!etd.send_file?accession=osu1343152438&disposition=inline).

If economic incentives do not influence firm behavior to any great extent, then it stands to reason that incentives are unlikely to produce anticipated beneficial economic outcomes. This conclusion is supported by the research investigating the impact of incentives on economic development outcomes such as net job, investment, and income growth. In her research, Patrick considers the evidence of the most prominent empirical studies and concludes that there is no support for a positive impact.[12] The fiscal impact of offering incentives on communities has also been investigated. A positive effect has not been established: offering incentives is associated with either no fiscal impact or fiscal deterioration.[13]

Empirical investigations of incentives programs are difficult on many levels, but none of the problems would suggest that these studies *underrate* positive results. For example, one obvious issue is the lack of reliable data about costs, especially where projects involve public spending on infrastructure, tax expenditures, or property tax abatements. Costs that do not appear on any balance sheet are difficult to include in research.[14] A second concern is separating the effects of policy variables from other factors. Outcome variables may be driven by nonincentive policies or events that occur at the same time as incentives programs. This makes it difficult to determine what is leading to observed outcomes. Positive outcomes may be mistakenly attributed to incentive policies. Even the most sophisticated statistical methods can suffer from this sort of omitted variable problem.[15]

To summarize, the empirical research does not provide evidence that development incentives serve as engines of growth for communities. This doesn't mean that every possible incentives deal is doomed to fail, or that each actual incentives program has, in fact, failed. It does strongly suggest, however, that failure is common and, in particular, much more common than success. Thus, there are compelling reasons to think that, in general, economic development incentives *do not work* to induce business behavior that will pay off—in terms of jobs, sales, and ultimately tax revenues—for the community that offers them.

All of the foregoing raises concerns about who pays for, and who benefits from, economic development incentives. To the extent that incentives fail to produce net economic gains for a community, existing residents wind up paying for benefits (in the form of subsidies) that accrue to new firms (and, of course, their investors). In the final analysis, such incentives appear to be wasteful spending that either increases the tax burden or crowds out expenditures for public

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12. *See id.* at 34.

13. *See* Gorin, *supra* note 10; *see generally* LEGISLATIVE DIVISION OF POST AUDIT, STATE OF KANSAS, ECONOMIC DEVELOPMENT: DETERMINING THE AMOUNTS THE STATE HAS SPENT ON ECONOMIC DEVELOPMENT PROGRAMS AND THE ECONOMIC IMPACTS ON KANSAS COUNTIES 29–31 (2008).

14. *See* Story et al., *United States of Subsidies, supra* note 4; *see generally* LEGISLATIVE DIVISION OF POST AUDIT, *supra* note 13.

15. Econometrics textbooks discuss omitted variables problems as a fundamental problem in empirical research. *See, e.g.*, JEFFREY M. WOOLDRIDGE, INTRODUCTORY ECONOMETRICS: A MODERN APPROACH (3d ed. 2006).

goods that people want, such as infrastructure and education. (If you spend money on one thing, you can't spend it on something else; if you still want to buy the latter thing, you will need to raise other funds.)[16]

The evidence about economic development incentives programs strikes many as surprising—offering subsidies to induce favorable behavior makes intuitive sense. Unfortunately, this is one of those areas where intuitions mislead, analogous to famous optical illusions such as the Muller–Lyer,[17] the Ebbinghaus,[18] and the Café Wall illusions.[19] Just as mistaken visual perceptions persist even after measurements are taken, intuitive judgments about the efficacy of incentives seem to persist even in the face of the sorts of empirical evidence we cite above.[20] To escape being misled by the pull of either visual illusions or economic development incentives, it helps to keep referring to the empirical evidence to keep it firmly in mind.

The practice of offering economic development incentives is fraught with difficulty. A community that adopts standard incentives policies will almost certainly fail to achieve its economic development goals. In order to do better, it must, at a minimum, educate itself about the common pitfalls of such policies and, in turn, adopt strategies to avoid them. There are basically three problems for a local government to avoid: (1) giving money to firms for doing what they would have done anyway; (2) eroding the net benefit of an incentive by competing with other localities for a firm; and, (3) failing to fully count the costs of attracting a firm and so suffering the "winner's curse."

The first major pitfall occurs when states and localities decide to subsidize the wrong firms. To assess the profitability of an incentives offer, a locality must compare what will happen if it makes a particular incentive offer with what will happen if it does not. Suppose, for example, that a locality offers a subsidy to get a firm to expand a plant: the locality doesn't gain anything at all if the firm was going to expand the plant anyway, it just loses the incentive. To

16. *See* Gorin, *supra* note 10.

17. The Muller–Lyer illusion involves a pair of equal length line segments, one of which has stylized "arrowheads" pointing in at each end and one of which has stylized "arrowheads" pointing out. The line segment with the inward pointing "arrowheads" appears longer than the one with outward pointing "arrowheads." *Muller-Lyer Illusion*, WIKIPEDIA, http://en.wikipedia.org/wiki/M%C3%BCller-Lyer_illusion (last modified Oct. 9, 2014).

18. "[T]wo circles of identical size are placed near to each other, and one is surrounded by large circles while the other is surrounded by small circles. . . . [T]he central circle surrounded by large circles appears smaller than the central circle surrounded by small circles." *Ebbinghaus Illusion*, WIKIPEDIA, http://en.wikipedia.org/wiki/Ebbinghaus_illusion (last modified Oct. 14, 2014).

19. "The café wall illusion is a geometrical-optical illusion in which the parallel straight dividing lines between staggered rows with alternating black and white 'bricks' appear to be sloped." *Café Wall Illusion*, WIKIPEDIA, http://en.wikipedia.org/wiki/Caf%C3%A9_wall_illusion (last modified Oct. 9, 2014).

20. On the persistence of visual illusions, see *Optical Illusion*, WIKIPEDIA, http://en.wikipedia.org/wiki/Optical_illusion (last visited Oct. 20, 2014). The persistence of intuitions about the efficacy of incentives is based on the personal experience of authors Ellis and Rogers in talking with other academics and local policymakers.

leverage public money, a locality must catch a firm at a critical junction where a small inducement can tip a decision—e.g., where a firm is indifferent among expansion possibilities. As we note above, one reason why development incentives fail to pay off is that communities make deals that do not actually influence firm behavior. A firm might, for example, be attracted to a particular community precisely because the local economy was already growing at a healthy rate. No incentives would therefore be needed. The impact of an incentive should be measured as the deviation from the community's predicted growth trend, not the level of growth.

From a decision-theoretic perspective, the elusiveness of the "but for" question raises serious information issues. Economic fundamentals rarely leave firms in equipoise, so they are rarely at the relevant crucial junctures. More importantly, whether a firm is at such a decision point is proprietary information that it has strategic reasons not to disclose. In addition to the downside risk of competitors finding out, a firm might be able to get a subsidy for doing what it would have done anyway.[21]

The risk of subsidizing the wrong firms is greatly exacerbated by human psychology. In general, local policymakers want to be helpful to potential partners and empathize with business representatives (they often run businesses themselves). This pro-business bias is particularly evident in the economic development realm. Herbert Rubin, after conducting a series of open-ended interviews with economic development practitioners, discovered that:

> Whether we are talking about small accommodations or massive relocations for industrial development, the tilt seems to be toward the business community. It is through the day-in-day-out relationship that emerges as the practitioner tries to survive in a difficult work environment, that the public sector's bias toward business needs is increased. A set of business demands (or requests) becomes a checklist that changes an undefinable task into one with a set of concrete sequential steps.[22]

Under such circumstances, policymakers find it hard to view targeted firms as having adversarial interests. Humans are influenced by the views of others in social situations.[23] This is largely independent of the evidence offered for those

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21. Economists do have methods to address this issue. These methods, however, are very "data hungry." Quasi-experimental methods, for example, require reliable data for the communities that were "treated" with the incentives program as well as comparable data for communities that did not give incentives. *See* James J. Heckman et al., *Matching As An Econometric Evaluation Estimator*, 65 REV. ECON. STUD. 261 (1998). Sophisticated statistical models often rely on the ability to get data at the community level over multiple years. Such panel data on incentives values and outcome measures, however, are not readily available.

22. Herbert J. Rubin, *Shoot Anything that Flies; Claim Anything that Falls*, 2 ECON. DEV. Q. 236, 249 (1988). *See also* Harold Wolman & David Spitzley, *The Politics of Local Economic Development*, 10 ECON. DEV. Q. 115, 138–40 (1996).

23. *See* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE 53–71 (2008).

views; what matters is the coherence of the story being told.[24] People are highly susceptible to one-sided interpretations—*spin*, as the pundits would say—even when they recognize it as such.[25]

A second common pitfall involves competing with other localities for a firm. When a firm really is at a tipping point, a juncture where incentives can change its behavior, it has reason to advertise that fact so that many localities will compete for it. This creates a serious game-theoretic problem: competition among localities leads to a "bidding war" where the incentives offers eat up the whole advantage of attracting a firm in the first place.[26]

Again, the competition problem is exacerbated by human psychology. In the first place, humans, particularly entrepreneurs, have a strong tendency to neglect the strategic element of their decisions. They focus on their own plans and skills, and not the equally-relevant-to-the-outcome plans and skills of their opponent.[27] This sort of competition neglect leads to overconfidence, over-commitment, and poor outcomes.[28] More speculatively, people want to win when they compete for anything. This increases the likelihood that local decision-makers will emphasize "winning" the firm rather than focusing on the quality of the deal itself. This dynamic, where the fact of competition undermines the point of the competition, is familiar from everything from little league sports to cheating scandals. This is a species of the more general tendency to substitute easier questions for harder ones.[29]

These first two pitfalls of economic development incentives interact in a particularly negative way. Even a firm with established plans, one that shouldn't be subsidized, will want to get communities involved in a bidding war. Such a competition would drive up the cost of the first pitfall. Together, the first two pitfalls form something of a dilemma: some firms aren't worth subsidizing, so it is a mistake to offer them incentives; and firms that it would be worthwhile to attract are likely to draw competition, which ultimately will bleed away the (net) benefit of offering them incentives in the first place. This dilemma is not inevitable, but it does describe a pattern that often undermines the case for offering incentives.

The third pitfall involves neglecting the costs of incentives (and economic development more generally), which leads to the "winner's curse." Even if a locality manages to influence a firm to change its behavior without sparking a bidding war, it doesn't follow that a good deal has been made. The cost of altering behavior may exceed the benefit. There is no uncertainty that assessing the value of a development incentive requires comprehensive accounting of the expected direct and indirect costs as well as the benefits. Unfortunately, as we saw before, assessing the effectiveness of development incentives programs is notoriously

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24. *See* DANIEL KAHNEMAN, THINKING FAST AND SLOW 87 (2011).

25. *See generally* Lyle A. Brenner et al., *On the Evaluation of One-Sided Evidence*, 9 J. BEHAV. DECISION MAKING 59 (1996).

26. *See* Stephen Ellis & Cynthia Rogers, *Local Economic Development as a Prisoners' Dilemma: The Role of Business Climate*, 30 REV. REG. STUD. 315 (2000).

27. *See* KAHNEMAN, *supra* note 24, at 259–61.

28. *See id.*

29. *See id.* at 97–104.

complex[30] and it may be beyond the capacity of many local governments. According to a *Pew Center on the States* analysis, only 13 states have systems in place to rigorously analyze economic development incentives programs so as to inform policy.[31] Local governments are even less inclined to investigate the effectiveness of development incentives programs *ex post*. Accounting for the opportunity costs of extending a particular subsidy to a particular firm is related to the counterfactual question in the first pitfall. It is difficult to put a value on what the community gave up: was it an amenity, or were overall taxes higher than they would have otherwise been? Here is where both lack of data and *ex post* analysis are big problems.

Unfortunately, human psychology includes a tendency to lose track of the full costs of actions.[32] In the abstract, it is easy to see that revenue isn't the same thing as profit (profit equals revenues minus costs); in practice, however, the distinction can get lost. This is especially likely where analysts use economic impact analyses of the usual sort. These simple multiplier models[33] provide some evidence about the (gross) benefits to expect from a proposed project, e.g., tax revenues.[34] What states and localities need to look at, however, are costs as well as benefits. This sort of calculation is the distinctive feature of a fiscal impact analysis.[35] Only a fiscal impact analysis, then, looks at development from the perspective of the community-as-business.[36] Even when a community does a fiscal impact analysis, however, it is important to realize that costs aren't necessarily linear with scale (as fiscal impact models usually assume). There can be certain startup costs regardless of the size of an incentives deal, and cost thresholds can be passed as deals get larger, e.g., the need for a new school or the fact that newer developments can be more expensive than average because of distance or constraints imposed by existing amenities.

Again, there is a great deal of negative interaction among all of these pitfalls. The real benefits of a deal are often overstated because of the first two pitfalls. The real costs of proposals are underestimated because of the third.

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30. *See* Jonathan Q. Morgan, *Analyzing the Benefits and Costs of Economic Development Projects*, CMTY. & ECON. DEV. BULL., Apr. 2010, at 6.

31. *See* PEW CTR. ON THE STATES, THE PEW CHARITABLE TR., EVIDENCE COUNTS: EVALUATING STATE TAX INCENTIVES FOR JOBS AND GROWTH (2012) [hereinafter PEW CTR.].

32. *See* Stephen Ellis, *Market Hegemony and Economic Theory*, 38 PHIL. SOC. SCI. 513 (2008); Grant Hayden & Stephen Ellis, *Law and Economics After Behavioral Economics*, 55 KAN. L. REV. 629 (2007).

33. For example, IMPLAN (IMpact analysis for PLANning) or REMI (Regional Economic Model Incorporated) models.

34. In such models, a vector of economically relevant inputs is multiplied by a matrix that is supposed to represent the effects of economic processes to output another vector of economic predictions. Such models are pretty simplistic but they do suggest the direction and rough magnitude of (gross) economic impact. *See* Morgan, *supra* note 30, at 3–5.

35. Using, for example, LOCI (LOCal economic Impact model) or FIT (Fiscal Impact Tool) models.

36. *See* Carlieanne Patrick Crotty, *Fiscal Impact Analysis Creates a Win-Win for Projects and Communities*, ECON. DEV. AM., Spring 2007, at 7.

The foregoing considerations suggest at least three necessary conditions for doing reasonable economic development incentives:

> (1) Good information about economic counterfactuals, to avoid subsidizing the wrong firms;
>
> (2) Propitious circumstances that are unlikely to spark a "bidding war" for a firm;
>
> (3) A full accounting of costs, not only of the incentives themselves, but also of the project being promoted.

Best practice requires using the appropriate analytic tools to determine that these conditions are being met before proposing incentives. It is important to note that looking at these conditions precedes but does not preclude the standard considerations about making deals stick once it is determined that they are worthwhile. That is, local governments should structure their contracts in ways that tie incentives to performance and specify clawback provisions in case outcomes are overstated. But they should also take great care in obtaining information about likely outcomes up front, including honest assessments of possible costs, before extending economic incentives in any particular case.

The fact that economic development incentives rarely work is generally unrecognized, so it is no surprise that the reasons why they fail go unappreciated. There is no need to postulate ill will in order to explain why: none of the primary decision-makers has a structural incentive to become better educated about the pitfalls of incentives. Firm managers are receiving something they want from people who are giving it voluntarily—not much reason to look too closely at that "gift horse." Local officials think they are actually attracting firms and can seek political rewards for doing so—they have no obvious reason to "rock the boat." Most citizens of communities don't know what they don't know about incentives. It only takes a few vocal advocates of economic incentives, then, to give this low-information equilibrium a measure of stability. Economic incentives appear to be win–win situations and so they continue to be offered.[37]

II. CURRENT CHECKS ON LOCAL GOVERNMENTAL ACTION

This Part discusses two forms of accountability that local governments face in decision-making. Political accountability stems from the democratic process via local elections. Market-style accountability arises via the ability of individuals to sue the government for damages or violations of state or federal law. As we discuss below, these two forms of accountability are related.

A. Political Accountability and Its Limits

Local governments are primarily accountable for their actions through the election process. In order for this mechanism to work effectively, however, there needs to be public access to governmental information and decision-making. There also need to be adequate protections of the electorate's voting rights. At this point,

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37. Margaret E. Dewar, *Why State and Local Economic Development Programs Cause So Little Economic Development*, 12 ECON. DEV. Q. 68 (1998).

every state provides public access to governmental information through its freedom of information or public access laws.[38] Most states also have open meeting, or "Sunshine Laws," that, with a few exceptions, require local governments to take action in meetings that are open to the public.[39] Most federal and state protections of the right to vote extend to the election of members of local governmental entities that exercise general governmental powers.[40] On the face of it, then, elections would seem to provide a straightforward check on poor governmental decision-making—the public knows what local officials are doing and is empowered, when necessary, to "throw the bums out."

In practice, however, the mechanism of political accountability is a bit more complicated. No political system is perfectly responsive to the will of the electorate (nor should it be). There are many reasons why elected officials may not pay a political price for even manifestly awful decisions. Elections are only held every few years, and campaigns to recall elected officials are usually quite difficult to mount, much less win.[41] The electorate's memory fades. Sometimes, the poor decisions are too insignificant or poorly understood to really pose a threat to an incumbent's chances at reelection. As Harold Wolman and David Spitzley note, "[T]he costs of many of the standard local economic development activities are relatively invisible."[42] And even when important information exists, it may not come to the attention of the voting public. A competitive political environment or a robust local media would be a necessary condition for public oversight, but even that might not be sufficient. There is some evidence that local officials try to diminish public participation in local economic policy decisions.[43] At a minimum, they tell a "public story" that tries to preserve electoral support.[44] The reality of

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38. *See* RonNell Andersen Jones, *Litigation, Legislation, and Democracy in a Post-Newspaper America*, 68 WASH. & LEE L. REV. 557, 580, n.115 (2011) (listing state statutes).

39. *See id.* at 580–81, n.114 (listing state statutes); *see also* ANN TAYLOR SCHWING, OPEN MEETING LAWS § 1.1 (3d ed. 2011) (discussing the genesis and purpose of open meetings laws). This treatise, as its title implies, provides a comprehensive survey and classification of the open meetings laws in all 50 states. Negotiations over economic development incentives, however, are often exempted from state sunshine laws. *See* Aimee Edmondson & Charles N. Davis, *"Prisoners" of Private Industry: Economic Development and State Sunshine Laws*, 16 COMM. L. & POL'Y 317, 323–27 (2011).

40. *See, e.g.*, Kramer v. Union Free Sch. Dist. No. 15, 395 U.S. 621 (1969) (applying constitutional guarantee of right to vote under the Equal Protection Clause to local governments); Avery v. Midland County, 390 U.S. 474 (1968) (applying constitutional guarantee of equally weighted voting under the Equal Protection Clause to local governments); Voting Rights Act, 42 U.S.C. § 1973 (2012) (applying the act's guarantees to states and political subdivisions).

41. *See* Timothy Pack, Comment, *High Crimes and Misdemeanors: Removing Public Officials from Office in Utah and the Case for Recall*, 2008 UTAH L. REV. 665, 678–80 (detailing recall laws in many states and describing some of the hurdles involved in mounting a recall).

42. Harold Wolman & David Spitzley, *The Politics of Local Economic Development*, 10 ECON. DEV. Q. 131 (1996).

43. *Id.* at 143–45.

44. *See* Dewar, *supra* note 37.

local government is that many decisions may fly beneath the radar of the electorate and never really factor into the probability of an incumbent's reelection.

In the context of decisions to extend economic development incentives, the problem may even be worse. As detailed above, the success or failure of a particular incentive grant may not be fully realized for years, or even decades, from the initial decision to grant it, and there's very often no requirement to study the ultimate effects of the grant. More important, freedom of information laws only require local governments to disclose information they possess; they do not force governments to generate any new information.[45] One of the principal problems with decisions regarding development incentives is that they are made on the basis of very little evidence or ordinary due diligence on the part of elected officials. Again, the knowledge needed to avoid the pitfalls of incentives policies is seldom readily available, even to the localities that offer incentives. Special analysis is needed for each incentive offer. The information that is crucial to political accountability often simply does not exist.

B. Market Accountability and Its (Current) Limits

In addition to being responsive to electoral pressure, government actors may also be subject to a sort of market discipline through the imposition of liability for wrongful actions. This was not always the case. Under the traditional doctrine of sovereign immunity, the king could do no wrong.[46] That doctrine largely survives and provides that governments and officers acting on their behalf cannot commit legal wrongs and thus are not subject to civil or criminal liability for their actions.[47] This baseline of broad governmental immunity, however, has been limited in cases where a governmental entity consents to be subject to liability for certain kinds of actions or where a superior governmental entity abrogates the immunity. The federal government, for example, has consented to be sued for many ordinary torts in the Federal Tort Claims Act,[48] and has abrogated state sovereign immunity with respect to certain actions by state officials in violation of federal law in § 1983 lawsuits.[49] And while state law varies widely, most states have also consented to be sued in certain situations, mainly when they act in roles that are more proprietary than governmental.[50]

Local governments, however, are another matter. They are not typically viewed as sovereigns in the same way as the federal and state governments, but, rather, as legal "persons" that are a creation of state government.[51] Their potential liability for wrongful actions is entirely up to federal and state law. And while the

45. *See* Lee Levine et al., NEWSGATHERING AND THE LAW § 12.02 (4th ed. 2013).

46. *See* 3 WILLIAM BLACKSTONE, COMMENTARIES *254; *see also* SANDRA M. STEVENSON, UNDERSTANDING LOCAL GOVERNMENT § 9.1 (2d ed. 2009).

47. *See* Aaron Tang, *Double Immunity*, 65 STAN. L. REV. 279, 285–92 (2013); Gregory C. Sisk, *A Primer on the Doctrine of Federal Sovereign Immunity*, 58 OKLA. L. REV. 439, 446 (2005).

48. 28 U.S.C. §§ 2671-2680 (2012).

49. 42 U.S.C. § 1983 (2012).

50. *See* STEVENSON, *supra* note 46, at § 9.2.

51. *See, e.g.*, Monell v. Dep't of Soc. Servs. of N.Y., 436 U.S. 658 (1978) (holding that local government was a person for the purposes of § 1983).

law originally saw a clear divide between ordinary corporations and municipal corporations when it came to the issue of liability, that divide began to break down over the last half century. Local governments, and their officials, are subject to liability in a wide range of circumstances.

The main source of local government liability under federal law is § 1983.[52] This statute provides a mechanism by which persons operating under the color of state law may be held responsible for actions that violated the U.S. Constitution or other federal law.[53] While a state is not considered a "person," for the purposes of § 1983,[54] local governments *are* persons and hence may be subject to suit for damages and prospective relief under the statute.[55] Thus, local governments may be sued directly for damages and prospective relief from local laws and regulations that violate federal law.[56] If, for example, a city council passes an ordinance that restricts the free speech of its citizens in violation of the First Amendment, affected citizens may sue to recover damages caused by the ordinance as well as to declare it unconstitutional and prohibit its enforcement. While local governments are directly responsible in this way, the officials who pass or administer the law are entitled to absolute or qualified immunity in actions for damages depending upon the nature of the function they serve. Legislators, for example, are typically entitled to absolute immunity;[57] subordinate, non-elected officials, such as police officers, are only entitled to qualified immunity, meaning that they are shielded from liability unless their actions violate "clearly established" federal law.[58]

Local government liability for more ordinary torts—such as negligent operation of a motor vehicle—is largely determined by state law. For years, municipalities had the benefit of the same sort of immunity from suit as that

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52. 42 U.S.C. § 1983.

53. *Id.*

54. State officers and employees, however, may be sued under the section for injunctive relief, see Will v. Mich. Dep't of State Police, 491 U.S. 58 (1989), or may be sued in their personal capacity for damages, see Hafer v. Melo, 502 U.S. 21 (1991). Qualified immunity, however, may protect some of these defendants from liability.

55. *See Monell*, 436 U.S. at 698–99.

56. *See id.*; Owen v. City of Independence, 445 U.S. 622, 657 (1980); *see also* Fred L. Morrison, *The Liability of Governments for Legislative Acts in the United States of America*, 46 AM. J. COMP. L. 531, 541 (1998).

57. *See* Acevedo-Cordero v. Cordero-Santiago, 958 F.2d 20, 22–23 (1st Cir. 1992); Haskell v. Washington Township, 864 F.2d 1266, 1277 (6th Cir. 1988); Aitchison v. Raffiani, 708 F.2d 96, 98–100 (3d Cir. 1983); Reed v. Village of Shorewood, 704 F.2d 943, 952–53 (7th Cir. 1983); Espanola Way Corp. v. Meyerson, 690 F.2d 827, 829 (11th Cir. 1982), *cert. denied*, 460 U.S. 1039 (1983); Kuzinich v. County of Santa Clara, 689 F.2d 1345, 1349–50 (9th Cir. 1982); Hernandez v. City of Lafayette, 643 F.2d 1188, 1193–94 (5th Cir. 1981), *cert. denied*, 455 U.S. 907 (1982); Bruce v. Riddle, 631 F.2d 272, 274–80 (4th Cir. 1980); Gorman Towers, Inc. v. Bogoslavsky, 626 F.2d 607, 611–14 (8th Cir. 1980).

58. *See* Harlow v. Fitzgerald, 457 U.S. 800, 818 (1982); Procunier v. Navarette, 434 U.S. 555, 565 (1978); Wood v. Strickland, 420 U.S. 308, 322 (1975); *see also* Morrison, *supra* note 56, at 541.

enjoyed by federal and state governments.[59] But a series of legal changes in the second half of the twentieth century—first in state courts and then state legislatures—pulled back from this position of absolute immunity and began to subject local governments to liability under ordinary state tort law.[60] The judicial inroads into municipal immunity largely turned on whether the entity was engaged in a governmental (still immune) or proprietary (not immune) function.[61] Soon after, many states adopted statutes that largely ignored the governmental-proprietary function distinction and either waived immunity for certain kinds of tort claims, e.g., negligent operation of a motor vehicle, or provided a blanket waiver and then enumerated certain exceptions to immunity.[62] A few states, such as Washington, went so far as to waive municipal immunity such that local governments are liable "to the same extent as if they were a private person or corporation."[63]

In any case, however, local governments largely retained immunity for the discretionary acts of their officials.[64] Similarly, those officials are still afforded absolute or qualified immunity, depending upon their positions and authority, for discretionary actions taken in the context of their official duties.[65] Most importantly for our purposes (and consistent with § 1983): local elected officials are typically entitled to absolute immunity for any actions taken in their legislative capacity.[66] This includes, for the most part, the promulgation and administration of economic development incentives.

C. The Relationship Between Political and Market Accountability

The relationship between political and market accountability for elected officials is far from straightforward. The Supreme Court obviously thinks, for example, that local government liability for constitutional violations provides some deterrent effect.[67] Others, particularly Daryl Levinson, argue that local government

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59. *See* STEVENSON, *supra* note 46, § 9.1; DANIEL MANDELKER ET AL., STATE AND LOCAL GOVERNMENT IN A FEDERAL SYSTEM 535 (6th ed. 2006).

60. *See* STEVENSON, *supra* note 46, § 9.1; MANDELKER ET AL., *supra* note 59, at 535–41.

61. *See* STEVENSON, *supra* note 46, § 9.1; MANDELKER ET AL., *supra* note 59, at 538, 544. This distinction has been widely criticized as unworkable. *See, e.g.*, Garcia v. San Antonio Metro. Transit Auth., 488 U.S. 889 (1998); *see also* SANDRA M. STEVENSON & CHESTER JAMES ANTIEAU, ANTIEAU ON LOCAL GOVERNMENT LAW § 32.05 (2d ed. 2008) (discussing cases). But it continues to be used by many jurisdictions. *See* STEVENSON, *supra* note 46, § 9.2; MANDELKER ET AL., *supra* note 59, at 544.

62. *See* MANDELKER ET AL., *supra* note 59, at 537–45.

63. *See, e.g.*, WASH. REV. CODE. § 4.96.010 (2013).

64. *See* STEVENSON, *supra* note 46, § 9.2.

65. *Id.* § 8.6.

66. *See* Tenney v. Brandhove, 341 U.S. 367, 373 (1951); STEVENSON, *supra* note 46, § 8.6.

67. *See, e.g.*, Elder v. Holloway, 510 U.S. 510, 514–15 (1994); Memphis Cmty. Sch. Dist. v. Stachura, 477 U.S. 299, 307 (1986); Carlson v. Green, 446 U.S. 14, 20–21 (1980); Owen v. City of Independence, 445 U.S. 622, 651–52 (1980); Butz v. Economou, 438 U.S. 478, 506 (1978); Robertson v. Wegmann, 436 U.S. 584, 590–91 (1978).

officials are largely indifferent to liability.[68] This indifference mostly stems from the fact that those officials do not personally bear the costs of such liability (they are not sued directly or, when they are, they are indemnified by the municipality) and seldom pay for such violations at election time.[69] Voters just aren't that interested in such things and, in some cases, elected officials may actually reap electoral benefits from engaging in unconstitutional behavior toward, say, political minorities.[70] And local officials can also reach confidential settlements (with taxpayer dollars, not their own personal monies) for any actions that may bring unwanted attention.[71] Thus, local officials are free to engage in wrongful conduct without paying any price, personally or politically, and Levinson concludes that this undermines the basic rationale for our system of holding governments responsible for damages caused by their torts.[72]

This story of the complete disconnect between political and market liability, however, does not quite account for many real features in the landscape of local government.[73] Local officials spend much of their time attempting to come up with an optimal mix of taxation and resource allocation.[74] For this reason, they may be quite politically sensitive to any type of tort liability because it decreases the amount of resources that they have to allocate.[75] Anecdotal evidence supports this theory, as local officials often work hard to beat lawsuits and often engage in practices thought to diminish future exposure.[76] Finally, the ubiquity of statutory governmental immunity tells us that liability is thought—by politicians, at least—to exact a political price.[77] Elected officials, then, are not completely indifferent to market liability. The key issue seems to be voter interest. To the extent that voters know and care about behavior that might lead to legal action, officials will be reticent about such behavior.

III. PROPOSAL: MARKET ACCOUNTABILITY LITE

State and local economic development decisions are business-like, so it makes sense to hold them to business standards. While corporate boards of directors have extremely broad discretion, they can't do just anything they want. Crucially, they are subject to market discipline—investors can always sell their shares. Further, they have a legal *duty of care*. In the end, this amounts to a procedural requirement that they ask the right sorts of questions and look at the right sorts of information. State and local governments should be under similar

68. *See* Daryl J. Levinson, *Making Government Pay: Markets, Politics, and the Allocation of Constitutional Costs*, 67 U. CHI. L. REV. 345, 355 (2000).

69. *See id.* at 355–57.

70. *See id.* at 367–70. For example, aggressive policing policies may result in a larger number of constitutional violations, yet a politician behind those policies may well benefit from being viewed as "tough on crime."

71. *See* Lawrence Rosenthal, *A Theory of Governmental Damages Liability: Torts, Constitutional Torts, and Takings*, 9 U. PA. J. CONST. L. 797, 829 (2007).

72. *See* Levinson, *supra* note 68, at 415–20.

73. *See* Rosenthal, *supra* note 71, at 832–44.

74. *See id.* at 832–37.

75. *See id.*

76. *See id.* at 831.

77. *See id.* at 838–41.

constraints. There are differences between the cases, of course. The primary deterrent against bad decision-making by a board of directors is the ability of shareholders to effectively "cash out" or move their investments elsewhere. Duty-of-care requirements protect shareholders from poor decisions that come "out of the blue" and are hasty. Communities, however, don't face much threat from their shareholders—citizens—moving their assets, at least in the short run, because of the large transaction costs involved.[78] Rather, the primary tool for disciplining government officials is the ballot box. This difference, however, makes the need for a nondivestment accountability tool all the more crucial. A procedural requirement that officials must ask the right sorts of questions and look at the right sort of information would strengthen political constraints on state and local policymakers. Citizens who care about local economic development could learn about whether their elected officials had avoided the pitfalls of offering incentives and, if not, attempt to hold officials responsible at the polls. Even just calling officials to their duties as good community stewards might have a salutary effect on their decision-making.

A. The Duty of Care and Business Judgment Rule in Corporate Law

Business corporations, like their municipal counterparts, are organizational structures intended to facilitate certain types of cooperative activity.[79] The corporation itself is a legal structure designed to allocate rights and duties among groups of people devoted to a shared commercial enterprise.[80] The group itself is quite diverse, and may be said to include directors, officers, shareholders, employees, bondholders, suppliers, and even customers.[81]

Although there are a number of features considered crucial to the legal definition of a corporation, the keys to its decision-making structure are shared ownership by investors and delegated management.[82] The three key players in this structure are the shareholders, the board of directors, and the officers. The shareholders, often referred to as the "owners" of the firm, have the right to receive residual profits (the portion that remains after all obligations have been satisfied). Shareholders have the right to elect the board of directors. The directors are, in turn, the locus of authority within the corporation—they represent the firm when human counterparts to the fictional form are required.[83] But the board of directors

78. *See* Charles Tiebout, *A Pure Theory of Local Public Expenditure*, 64 J. POL. ECON. 416 (1956) (arguing that regional fragmentation promotes intermunicipal competition and provides options for highly mobile consumer–voters).

79. *See* Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote, and the False Promise of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445, 464 (2008) [hereinafter Hayden & Bodie, *One Share One Vote*].

80. *See* Grant M. Hayden & Matthew T. Bodie, *Shareholder Democracy and the Curious Turn Toward Board Primacy*, 51 WM. & MARY L. REV. 2071, 2077–78 (2010) [hereinafter Hayden & Bodie, *Shareholder Democracy*].

81. *Id.* at 2078.

82. For a short description of the basic structure of a corporation, *see* Hayden & Bodie, *One Share One Vote*, *supra* note 79, at 465; Hayden & Bodie, *Shareholder Democracy*, *supra* note 80, at 2078–79.

83. *See* ROBERT CHARLES CLARK, CORPORATE LAW 21 (1986).

does not run the day-to-day affairs of the business—it delegates that power to the officers. The officers can, in turn, hire employees. The entire structure is hierarchical, in that shareholders can vote out directors, directors can fire officers, and officers can fire the other employees.[84]

As the principal holders of the residual profits, the shareholders are thought to be in the best position to ensure the overall health of the corporation. For that reason, they alone have the power to elect and remove directors.[85] And while this power is exercised in the midst of the most market-oriented situation imaginable, it is, essentially, a political accountability mechanism. It is not, however, a particularly powerful one. This is because corporate governance structures are much less responsive than their political counterparts.

One would think that if corporate directors were acting out of self-interest or otherwise making poor decisions, the shareholders could simply elect a different set of candidates. But, despite the fact that shareholders generally vote every year for many or all of the directors, there are a number of features of corporate elections that blunt the ability of shareholders to replace existing directors.[86] In most corporate elections, the board puts forth its proposed slate of candidates (who may all be incumbents), and the shareholders merely ratify those choices.[87] Those nominated are subject to a simple up or down vote, and, since there is typically no majority requirement, a director may, in theory, be retained so long as she receives only one vote.[88] Shareholders may, in theory, propose their own candidates, but they face much higher costs in nominating candidates than do the incumbent board members. Candidates outside the official proxy process must create their own ballots and distribute them to the shareholders.[89] There is no standard ballot, so "outside" candidates must provide their own proxies and ensure compliance with federal securities regulations.[90] "These substantial costs mean that most shareholders never nominate candidates, even if those candidates would be superior directors."[91] This is part of the basic paradigm of modern corporate law: the separation of ownership from control, shareholders from managers.[92] And it

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84. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 555–58 (2003) (detailing the hierarchical nature of a corporation); Hayden & Bodie, *supra* note 79, at 465.

85. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 35–39 (1991); Hayden & Bodie, *One Share One Vote*, *supra* note 79, at 472–74.

86. *See* Grant M. Hayden & Matthew T. Bodie, *The Bizarre Law and Economics of* Business Roundtable v. SEC, 38 J. CORP. L. 101, 126–28 (2012) (describing several features of corporate elections that blunt shareholders' ability to replace existing directors) [hereinafter Hayden & Bodie, *Bizarre Law and Economics*].

87. *See id*; Grant M. Hayden & Matthew T. Bodie, *Arrow's Theorem and the Exclusive Shareholder Franchise*, 62 VAND. L. REV. 1217, 1242 (2009) [hereinafter Hayden & Bodie, *Arrow's Theorem*].

88. *See* Hayden & Bodie, *Arrow's Theorem*, *supra* note 87, at 1240.

89. *See* Hayden & Bodie, *Bizarre Law and Economics*, *supra* note 86, at 126.

90. *See id.*

91. *See id.* at 127.

92. *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 4 (1932).

means that corporate board elections, despite the democratic window dressing, are not actually effective mechanisms of political accountability.

There are, however, more market-oriented checks upon corporate directors. Capital mobility is a barrier to board misconduct. If a firm makes bad choices, shareholders can (and will) sell their stock and do something else with the money.[93] In addition to shareholders' reaction, the directors of most corporations have, by law, certain fiduciary duties to the corporation, including a duty of loyalty and duty of care. The duty of loyalty is essentially a conflict of interest rule, and requires that directors put the interests of the corporation above their own personal interests.[94] The duty of care is a broader requirement that demands that they exercise good business judgment and use ordinary care and prudence in the operation of the business.[95] Application of the duty of care, however, is limited by the business judgment rule, which keeps courts from second-guessing a board's substantive business decisions.[96] Instead, a court will only consider the quality of the board's decision-making procedures, not the actual decisions themselves.[97] Breach of these duties may, in theory at least, subject a director to personal liability for damages.[98]

For many years, the corporate duty of care was thought to provide no real constraint on board decision-making at all. This is because courts had construed the business judgment rule quite expansively, effectively giving boards free reign with regard to their decision-making.[99] That all changed, however, when the Delaware Supreme Court rendered its opinion in *Smith v. Van Gorkom*.[100] In that case, a minority shareholder of Trans Union claimed that the board had breached its duty of care by approving a merger in which the shareholders would receive a certain price for their shares (at a premium over the market price).[101] To the

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93. *See* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 619 (2006).

94. *See, e.g.*, *In re* Walt Disney Co. Derivative Litig. (*Disney IV*), 907 A.2d 693, 751 (Del. Ch. 2005) ("The classic example that implicates the duty of loyalty is when a fiduciary either appears on both sides of a transaction or receives a personal benefit not shared by all shareholders.").

95. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985) (describing it in part as "a director's duty to exercise an informed business judgment").

96. *See id.* at 872.

97. *See id.*

98. We say "in theory" because there are, practically, many reasons why directors may never actually pay damages in such a case. First, in response to the *Van Gorkom* decision, many states, including Delaware, amended their general corporation laws to allow corporations to adopt charter provisions that eliminate director liability. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (1991); Charles M. Elson & Robert B. Thompson, Van Gorkom's *Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 NW. U. L. REV. 579, 583 (2002). Although most corporations have availed themselves of this provision, the case has still had a significant effect upon board behavior. *See* Elson & Thompson, *supra*, at 583–84.

99. *See* Daniel Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW 1437, 1444 (1985).

100. 488 A.2d 858 (Del. 1985).

101. *See id.*

surprise of many, the court agreed.[102] But, perhaps even more surprisingly, the court did not quibble with the substance of the board's decision, but instead found that it had breached its duty by making the decision too quickly, without the right information, and without asking the right questions.[103] The failing was procedural, not substantive.

The Delaware legislature quickly enacted a statute that largely mooted the effect of *Van Gorkom*.[104] The statute allows corporations to include provisions in their foundational documents that remove director liability for damages for breach of the duty of care in the absence of disloyalty or bad faith.[105] Many other states, following Delaware's lead, have passed their own versions of the statute.[106] And most corporations have made use of the option to limit director liability.[107] Thus, if directors today did what the Trans Union directors did, they would not be subject to liability for damages.

But despite these statutory "corrections" of the *Van Gorkom* approach, most observers agree that the decision prompted tremendous changes in the way that corporate boards conduct their business.[108] This may be because boards are still subject to injunctive relief that would put a hold on transactions that are found to have breached the duty of care.[109] In any case, most corporate boards now incorporate a broad range of procedural safeguards into their decision-making processes, from the use of expert consultants on corporate transactions to, more generally, the longer meetings and greater documentation that accompanies other board decisions.[110]

Corporate law scholars have roundly condemned the *Van Gorkom* version of the business judgment rule.[111] Some focus on the fact that the new regime does nothing to deter a board from making poor, or even terrible, substantive decisions—the focus is entirely procedural.[112] Others point to the costs of compliance with the new procedural regime. Longer formal meetings, greater recordkeeping, and the greater use of outside consultants have increased the cost of board decision-making.[113] The duty of care, then, appears to have led to the adoption of a number of formalities without providing any check on whether the resulting decisions are any better than they used to be—form for form's sake.[114]

102. *See id.*
103. *See id.*
104. DEL. CODE ANN. tit. 8, § 102(b)(7) (1991).
105. *See id.*
106. *See* Elson & Thompson, *supra* note 98, at 583.
107. *See id.*
108. *See id.* at 582–87; Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkam *and the Business Judgment Rule*, 96 NW. U.L. REV. 675, 676 (2002) ("The result, critics charge, is unnecessary delay and expense that ultimately harms the firm and its shareholders.").
109. *See* Elson & Thompson, *supra* note 98, at 584–85.
110. *See id.*; Stout, *supra* note 108, at 676.
111. *See* Stout, *supra* note 108, at 676, 690–91.
112. *See id.* at 676.
113. *See id.*
114. *See id.*

These criticisms, as well as others, have led scholars such as Daniel Fischel to deem *Van Gorkom* "one of the worst decisions in the history of corporate law."[115]

But the *Van Gorkom* opinion is only a failure if the changes that it forced in the boardroom give rise to more costs than benefits. The argument is essentially that, without any sanction for substantively bad decisions, board members have little added incentive to make good ones. But, as Lynn Stout points out, this only makes sense if you believe that there's no connection between better procedures and better decisions, and this is far from obvious.[116] In fact, all things being equal, we usually believe that more carefully considered, well-informed decisions are likely to be better decisions.[117]

Stout believes that this is especially true in the corporate boardroom. Without the *Van Gorkom* tweaks to the business judgment rule, directors were, of course, free to ask for more time or more information before making a decision. They could, in her way of conceiving of the issue, act more altruistically, looking out for the good of the firm.[118] But whether people act altruistically often depends upon the social context.[119] Specifically, people are more likely to do so when the personal cost and sacrifice of doing so is not that high.[120] The *Van Gorkom* decision reduces the personal cost of asking for more time and information. Individual directors do not need to ask for the information—much of it, thanks to the new rule, is provided as a matter of course.[121] This also reduces the personal social cost that attends confronting firm officers with respect to their recommended courses of action.[122] Thus, Stout concludes, the duty of care "may play an important role in promoting director diligence by helping to create a social framework that supports altruistic behavior."[123]

B. Proposal: A Duty of Care for Local Governments

Explicit attempts by local governments to promote community prosperity by negotiating arrangements with private firms should be subject to a duty of care. Such a duty would require local officials to exercise good business judgment and use ordinary care and prudence in the pursuit of economic development. Citizens of a locality should be able to file suit to enforce that duty.

Making governments liable to citizen lawsuits is, no doubt, a dangerous thing. Having courts second-guess every decision that some citizen doesn't agree with would be a disaster.[124] Decision-making at the state and local level would

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115. Fischel, *supra* note 99, at 1455.

116. *See* Stout, *supra* note 108, at 676–77.

117. *See id.*; *see also* Ittai Bar-Siman-Tov, *The Puzzling Resistance to Judicial Review of the Legislative Process*, 91 B.U. L. REV. 1915, 1927 (2011).

118. *See* Stout, *supra* note 108, at 677–78, 683–92.

119. *See id.* at 683–87.

120. *See id.* at 687.

121. *See id.* at 688.

122. *See id.* at 688–89.

123. *Id.* at 687.

124. This concern might suggest that a legislative solution to the problem posed by economic incentives might be preferable. While this idea certainly has merit, we see two

become incredibly costly, making governance extremely difficult. That is certainly not the point of this proposal. In addition to excluding nonbusiness decisions from the duty of care, it is important that the substantive decisions of local governing bodies be shielded from review. It is crucial, then, to have a local government version of the business judgment rule in place. Courts should not make economic development policy but merely ensure that policymakers collect information relevant to the possible pitfalls of offering incentives and to reserve time to attend to it.

There are two mechanisms by which problems might be avoided by recognizing a procedural duty of care for local governments engaged in offering local economic development incentives. The first is that such a course would strengthen political accountability mechanisms. Incentive offers rarely achieve their desired goals. Further, they involve important opportunity costs—effort and resources might be better spent, even from the perspective of enhancing local prosperity. These costs are largely unrecognized and so often go unaddressed. A procedural requirement to confront the potential pitfalls of incentives would leave officials free to go ahead with incentives programs, regardless of what their investigations revealed, but the real issues involved would be made available to everyone. Citizens would then be in a position to judge whether the particular incentives policy is what they want. Even a weak, merely procedural duty of care would greatly enhance political accountability, the primary mechanism for providing oversight of local officials. There is evidence that even under existing conditions of inadequate information, greater public participation tends to decrease the use of incentives policies that are perceived to be costly.[125]

The second mechanism by which a duty of care might help ameliorate the problems associated with offering local economic development incentives is psychological. Our analysis of the role played by local officials does not impute to them pernicious motives. Incentives do have *some* intuitive appeal; at present, there is no structural reason why officials should look into things any further. When an incentives package is proposed by sympathetic community members it is, as we saw before, natural for policymakers to get "on board."[126] Elected officials,

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drawbacks. The first is motivational. Legislative solutions require community majorities to recognize that there is a problem first, and, as we noted at the end of Part I, there is relatively stable low-information equilibrium right now. The literature on legislative attempts to spread information about incentives does not make the legislative path look promising. According to the *Pew Center on the States*, only four of the "leaders" in this area look at all state-level incentives packages and only 10 "leaders" have actually performed even a single high quality evaluation of an incentives offer (and only one state—Oregon—has done both). PEW CTR., *supra* note 31. Full information about incentives is unlikely to come from governments without further pressure. One benefit of our proposal is that it allows a minority of citizens to request information without allowing them control over the political process. The second drawback is competitive. State and local officials are loathe to "unilaterally disarm" when it comes to the ability to make incentives offers because they are afraid of the effect it will have on perceptions of business climate. *See* Ellis & Rogers, *supra* note 26. Again, minority pressure may be the key to disseminating information about incentives.

125. *See* Wolman & Spitzley, *supra* note 22.

126. *See* THALER & SUNSTEIN, *supra* note 23.

in particular, are likely to focus in on the purported benefits of the plan.[127] This, in turn, leads to overconfidence in the rosy scenario that has been sketched.[128] And that increases the likelihood that decision-makers will commit the *planning fallacy*—a tendency to underestimate the costs of a course of action, in terms of time, resources, and effort, while overestimating the benefits.[129] In effect, planning can lead people to focus on the best-case scenario, not the most likely scenario. Given all of this, by the time regular citizens get wind of particular projects, policymakers are likely to resist those urging caution. A duty of care that emphasizes procedural rules could short-circuit the foregoing problems. Requiring the decision process to confront potential opposing viewpoints can temper overconfidence. Data-oriented "push-back" from citizens could play the role of a premortem for a project. Conducting a premortem is a decision strategy whereby a group assumes that a proposal has failed and tries to figure out what "happened."[130] The idea is to determine pitfalls that might impede a program in order to avoid them. There is evidence that conducting a premortem mitigates (but does not eliminate) overconfidence.[131] In particular, a procedural requirement that invites a decision-maker to expand the range of considerations she takes into account can "nudge" her toward actually thinking about those things.[132]

CONCLUSION

In this Article, we present a procedural mechanism to counter the pitfalls associated with the practice of offering economic development incentives. Improving the process is important for state and local government fiscal and economic health given the extensive use and enormous value of incentives that are offered. At a minimum these incentives divert funds from other potential investments and from spending on desired local public infrastructure. At best, they serve as risky investments, which, under propitious conditions, have positive net payoffs to communities.

Government officials are woefully ill-equipped to evaluate the costs and benefits of incentives deals so as to make the sort of offers that avoid negative outcomes (the "winner's curse"). Indeed, a growing body of academic research shows that state and local governments are often on the losing end of these agreements. But this research alone will not prompt a change in the situation. For a variety of reasons—both decision theoretic and psychological—government officials are in a disadvantageous position vis-à-vis their business counterparts. As a result, they do not seek out the kind of information that would allow them to avoid subsidizing the wrong firms, to recognize the kinds of circumstances that may lead to bidding wars for the right ones, or to fully account for the costs and benefits of a project. Without changing the incentives structure, there is little reason to expect any change in this situation.

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127. *See* Brenner et al., *supra* note 25.
128. *See* KAHNEMAN, *supra* note 24.
129. *See id.* at 249–51.
130. *Id.* at 264–65.
131. *See id.*
132. *See* THALER & SUNSTEIN, *supra* note 23, at 69–70 (discussing the psychological phenomena of "priming").

We draw from the procedures used in corporate organizations regarding shareholders' rights. In the corporate setting, the board of directors is subject to a legal duty of care, which imposes a procedural requirement that it asks the right sorts of questions and considers the right sorts of information when making decisions. Even when tempered by the business judgment rule, this weak notion of accountability is argued to improve decision-making by establishing a process by which there is pressure to gather and discuss information that is relevant for the decision at hand. The application of duty-of-care requirements to state and local governments seems straightforward in the case of offering economic development incentives, which are explicit attempts by those governments to promote community prosperity via special arrangements with private firms. In this scenario, citizens are the direct benefactors of such dealings. Like shareholders, citizens have a right to a duty of care when decisions are being made on their behalf. The symmetry of the citizen-elected official and shareholder-elected board of directors relationship is apparent. Like the corporate environment, providing for a procedural duty of care can improve public decision-making.