Tax Incentives Bring on the Prisoner’s Dilemma
by Andrew Brod
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Tax incentives, the subsidies and tax abatements that are targeted at specific businesses, are big news these days. For many voters, the referendum on baseball in the Triad came down to whether or not public money should subsidize a private business.

The same question has been raised by those opponents of the FedEx hub who are concerned about more than just airport noise. And there are many more examples.

Critics of such incentives note that the competition among states is destructive, and argue that the practice should be eliminated. They’re right, but here’s the bad news. We may be doomed to put up with incentives.

To an economist, competition among states via tax incentives falls under the rubric of “The Prisoner’s Dilemma,” a famous problem of strategy in which two rivals are each faced with a choice between two actions.

In the original Prisoner’s Dilemma, the options facing two criminal defendants who couldn’t communicate with each other were Keep Quiet vs. Squeal. In general, we can think of two rivals facing off, each other armed with two options: Cooperate vs. Don’t Cooperate.

Cooperating yields the biggest reward to both parties, but only if both choose to do it. The dilemma is that regardless of what one’s rival does, one can do best by not cooperating. If your rival opts to cooperate, you can gain by “cheating” on him; if the rival opts to cheat, you’d better follow suit.

Therefore, both parties will always tend to cheat, and their rewards will be less than if both had cooperated. And yet a unilateral decision to cooperate is risky, because what if your rival follows his narrow self-interest and cheats?

In the real world, not all strategic situations qualify as Prisoner’s Dilemmas, but there are numerous examples. In certain industries, firms can all increase their profits if they band together to form a cartel. However, once the cartel is formed, cheating on the cartel by undercutting the jointly established price always pays off, and this is why most cartels are unstable and tend not to last.

But back to tax incentives. Suppose two states are trying to attract a commercial facility. Taken together, the two states will be best off if neither uses tax incentives targeted to that facility, with each instead competing on the basis of its natural amenities, economic conditions, and general tax structure.

But if State A refuses to use targeted incentives for that facility, State B can gain a competitive advantage by using them. If State A does use them, State B would be shooting itself in the foot by *not* using them.

So employing firm-specific tax incentives always wins out, and this is why they're so common these days. No state will unilaterally renounce incentives, because it has no assurance other states will follow suit.

In general, the way around The Prisoner's Dilemma is to establish a formal agreement, or at least an informal understanding, that provides for punishment for those who deviate from the agreement.

Such agreements are not always possible. The prisoners in the original Prisoner's Dilemma were not allowed to talk and hence could not know whether to trust each other.

Similarly, a cartel of American firms would run afoul of federal anti-trust laws, which means that the communication necessary to coordinate and enforce the cartel agreement would have to be secret and difficult.

Could states negotiate an agreement to ban tax incentives? In principle, yes. For example, small groups of states have gotten together to allow each other's college students to pay in-state tuition. However, it would be difficult to enforce adherence to a pact governing tax incentives.

But wait a minute. We already have a vehicle by which states can coordinate and enforce rules governing interstate affairs. It's the federal government. So if we really want to ban tax incentives and end the destructive competition among states, our only hope is federal legislation.

The basis for such legislation is the Commerce Clause of the U.S. Constitution, which has been used (or overused, depending on one's political views) to justify all sorts of federal involvement in the nation's commerce. But in this case, the Clause's applicability is clear.

The Commerce Clause was written to ensure that the union among the states would also be an economic union. The ruinous trade wars among states that prevailed under the infant nation's Articles of Confederation illustrated vividly to the framers of the Constitution the need for rules governing interstate commercial relations. The need is no less now.

But let's be realistic. How likely is federal legislation? Won't political conservatives complain that states' rights would be infringed by such a law? Won't states' economic development directors agree?

Still, unless a comprehensive federal law against tax incentives is enacted, we may well be stuck with them. They don't make sense in each and every case, but I wouldn't want

North Carolina to forswear them unless all other states agree. Unilateral “disarmament” might be noble, but it wouldn’t be smart.