

The next frontier in government policy: bidding for Beckham

Abstract: Should Wellington city council be in the business of paying David Beckham to play a soccer game in our city? What was our government thinking when it offered New Line Cinema a tax break worth \$300-400 million to shoot the *Lords of the Rings* trilogy in New Zealand? Are these really the same thing and, more importantly, should taxpayer money be spent on this?

I live in Canada. A country with a large neighbor snapping up domestic firms, a budget surplus taking on ridiculous proportions, and a currency appreciating 30% over the last couple of years. Sounds familiar? Another thing that New Zealand and Canada have in common is that the drum beating for government support to aid ailing manufacturing firms is getting louder. The list of calls urging the NZ government to aid firms contemplating relocating overseas or to spend money trying to attract foreign direct investment grows longer by the day: Prof. Michael Porter, the Progressive Party, the New Zealand Institute, the WTO, the OECD.

One difference is that in the icy north, politicians have to a surprising degree warmed to the call. Over the last three years, initiatives worth more than \$6 billion CAD (7.8b NZD) in public support have been launched by the federal and provincial governments; most of it in the form of investment subsidies.

Great, you might say. At least the NZ government is resisting these populist calls which feed on people's insecurity over globalization. Governments should not be picking winners. Small wonder that these Canadian deals are hatched in secret, far from public scrutiny, only to be announced at a big press conference in some economically distressed area.

But just maybe, the government is neglecting a crucial role as steward of the economy. Shouldn't it try to stem the exodus of manufacturing jobs to China, or intervene when exporters are getting trounced on international markets? The financial support enjoyed by the film industry has received as much criticism as praise and the government has been reluctant to extend it to other sectors.

City councils have shown less restraint. In 2005, Wellington poached the World of WearableArts awards show away from Nelson and recently Christchurch pulled a similar coup, attracting the Ellerslie International Flower show from Auckland. In 2007, Terry Serepisos' Wellington Phoenix staged a friendly soccer game against Beckham's LA Galaxy. Several locations vied for the honor of paying \$2 million to host the game and Wellington city council graciously chipped in an undisclosed amount, rumored to be \$300,000, to seal the deal.

To bid or not to bid

What to make of this? Does it make sense for governments to spend money to attract FDI or local events, or does it just wastes taxpayer money? I will argue that it depends crucially on two things: the presence of externalities and the competition of other jurisdictions.

The subsidies rely on the simple logic that you have to spend a dollar to make a dollar. The government will spend some, and the community will reap rewards in multiples, either directly through tax revenue or indirectly as the local economy is boosted. For example, Wellington city council has adopted a benchmark of generating \$20 of additional revenue for each \$1 of support given to an event. It is not clear how they established the multiple, but in principle a sufficiently high multiplier must exist that makes the subsidy worthwhile.

The tricky part is to determine which revenue is 'additional' and what multiplier to use. If Beckham had not played in Westpac stadium, how many of the 31,000 supporters would have spent their money elsewhere in the city? Also, the required multiplier for breakeven is clearly lower if Wellington pubs make a \$3 profit per pint rather than \$1. The real test is whether every dollar spent by city council generates an extra dollar of economic profit locally, which is hard to measure. Enter the somewhat arbitrary, but cautiously large 20-to-1 multiplier.

When you are handing money to Toyota to build a new assembly plant, a frequent occurrence in North America, you can predict with some confidence that for each job created directly an additional six to seven will be created in the parts sector. If you shoot a blockbuster movie in New Zealand, it will create jobs for crew, extras, and production houses, but also for carpenters, hotels, and catering firms.

But how much are these jobs really worth? How much 'extra' activity is generated? Without the assembly plant or movie shoot, these people would not have sat by idly. Most would have been gainfully employed in some other occupation, contributing to the economy in another way. When politicians are gloating in front of the cameras, boasting about all the extra jobs they created, they conveniently forget about the opportunity cost of all that labor input.

Perhaps they can be forgiven as the concept of opportunity cost is one of the harder ones in economics, but that does not make it less important. Briefly, the opportunity cost is the value of the resources in their next best application. If an extra had not battled orgs in Middle Earth, how much would he have earned in his next best employment opportunity or how much would he have enjoyed his free time?

Million dollar plants

Unfortunately, by their very nature, opportunity costs are impossible to observe. In a recent paper, Enrico Moretti and Michael Greenstone show how to use local property values, which reflect the expected future benefits of living in a certain locality, to cut through the data problems.¹ These capture the collective judgment of all people on the impact of a large scale investment project on the local economy.

¹ Enrico Moretti and Michael Greenstone. "Bidding for Industrial Plants: Does Winning a 'Million Dollar Plant' Increase Welfare?" NBER Working Paper No. 9844. July 2003.

To construct a sample for their statistical analysis, Moretti and Greenstone turned to the corporate real estate journal *Site Selection*. Each issue contains an article titled “The Million Dollar Plant” that reports on the county where a large plant chose to locate (the ‘winner’), as well as the runner-up county (the ‘loser’). If after an extensive site search a company narrowed the choice down to only two counties, excluding thousands of potential locations, we can assume that these final two are quite similar in all relevant aspects. Whether to go with one over the other is often decided by a tiny detail, maybe even a coin-toss. We should expect the fortunes of the two counties to have evolved similarly, with one twist. One now lands a big industrial project, a Million Dollar Plant, and the other does not. We have a so-called natural experiment.

In a sample of 92 counties, the authors find an increase in property values of 1.1% to 1.7% in winning versus losing counties. Some net benefits, taking into account all relevant costs, seem to exist. They also find a 1.5% jump in labour earnings in the new plant's industry in winning counties, suggesting one channel for the positive effects. These results undermine the critics’ view that the provision of local subsidies to attract large industrial plants reduces local residents’ welfare.

The gloves come off

But the case against subsidies runs deeper than measurement problems. If attracting these plants is so valuable, surely counties will be falling over themselves to attract them. Which is exactly what is happening. The authors even expected all potential welfare gains to have been competed away through subsidies offered to the firm.

In my own research, I illustrate how competition to attract these projects can be analyzed using game theory.² Each location brings a different intrinsic value to the firm. In addition, the local government can offer an incentive package to boost its attractiveness, often in the form of training subsidies, tax breaks, or improved infrastructure.

Basically, different jurisdictions are bidding in an auction to attract the project. In the process, a fraction of the externalities—the social value of the project—is transferred to the firm. Take the Ellerslie Flower show as an example. In Auckland, the show attracted 60,000 visitors, generating some \$14 million in economic activity for the city. The previous discussion already stressed that only a fraction of this amount is a net gain because of opportunity costs. When the contract with the Auckland Regional Council came up for renewal, several jurisdictions approached the owners with offers to attract the show. Christchurch prevailed, but it had to pay for the honour.

If bidders are rational, the value of landing the show should exceed the cost, at least in expectation, but by how much? My analysis illustrates that the net value for Christchurch is expected to equal the difference between its own private and social value of hosting the event and the total value at the runner-up location. Perhaps, the Garden City will be able to

² Johannes Van Biesebroeck. “Policy Watch: Governments at the Bidding Table,” ISCR Working Paper, February 2008.

boost show attendance or raise the quality and enjoyment for visitors. Perhaps, it is cheaper to organize the show in a less crowded area or the organizers in Christchurch have a lower opportunity value for their time. Mayor Bob Parker even suggested that the show is a better fit and will create spillovers, perhaps in terms of higher tourist revenues.

Similar arguments are made to defend the movie industry grants, Beckham's visit to Wellington, and Canadian automobile plants. They have merit, but to the extent that benefits would also have accrued to the runner-up location, Auckland or Hamilton in the Ellerslie case, Christchurch has to hand them over to the show's owners. It will only be able to capture those benefits that are unique to its own location.

Exactly those unique benefits are probably hardest to quantify in advance. How to assess "fit"? How can one be sure that these elusive spillovers will materialize, but remain confident that they would not materialize for our bidding competitors? In a world full of uncertainty, it is only natural that voters remain highly sceptical when politicians enter this bidding game with the public's money. Even for projects with demonstrably high value.

Johannes Van Biesebroeck
University of Toronto