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Improving Economic Development Incentives

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POLICY BRIEF

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BRIEF HIGHLIGHTS

- *Business tax incentives are often costly: only a minority of targeted jobs are created due to the incentives, and fiscal benefits offset only a modest portion of direct costs.*
- *How incentives are paid for is key to their net benefits. Education cuts reduce future wages.*
- *Incentives are more cost-effective if targeted at industries that create more jobs in other local businesses.*
- *Customized services to small and medium-sized businesses are a cost-effective way to create local jobs.*
- *Reforming incentives is politically difficult because there are many large beneficiaries in the short-run, while the costs due to lower wages occur over the long-run.*

For more details and recommendations, see the full report's Executive Summary, *Economic Development Incentives: Who Benefits? Who Pays the Costs? How Can They Be Improved?*

For additional details, see the full report, *Who Benefits from Economic Development Incentives?*

These can be found at www.upjohn.org.

State and local governments increasingly rely on business incentives, such as job creation tax credits and property tax abatements, to attract jobs. Costs of incentives have tripled since 1990, reaching $45 billion per year, or about what state governments take in from corporate income taxes. Recent incentives to Foxconn and Amazon suggest this competition may escalate.

Incentives can have large local benefits. If incentives tip a business's location decision, this directly creates local jobs. This job creation has "multiplier effects": other local jobs are created in supplier industries or retailers. Job growth helps local workers and boosts tax revenue.

But costs of incentives can be high. If incentives paid for themselves through increased tax revenue, as economic development agencies often assert, their costs would be no issue. However, research shows that average-sized incentives tip less than 20 percent of business location decisions, meaning that over 80 percent of targeted jobs would still have been created without the incentives. State and local governments thus give away more than $30 billion a year in incentives that create zero jobs. In addition, local job growth attracts in-migrants, which increases public spending needs. As a result, the fiscal benefits from incentives are far less than their direct costs. Budget costs of incentives must be paid for by higher tax rates or public spending cuts. These budget changes can harm local economies, such as by hurting public school quality and thus the skills of local workers.

Incentive reforms should rein in costs while promoting job growth. I make three recommendations:

1. **Put budget caps on tax incentives.** These caps help avoid financing incentives through cuts in important services such as public education. When public school spending is cut, future wages tend to fall.
2. **Restrict tax incentives by targeting only high-multiplier industries.** Tax incentives can make sense if, for every job created directly by the incentives, five other local jobs are created—that is, the "job multiplier" is 6. Some industries, particularly in advanced manufacturing, have higher multipliers and provide more benefits per dollar of incentives.
3. **Expand customized services to locally owned, small and medium-sized businesses.** Customized business services such as specialized job training and manufacturing extension can be 10 times as effective as tax incentives in creating local jobs. These services are most useful to small and medium-sized businesses, which often lack the funds and information of larger businesses. Locally owned businesses spend more on nearby suppliers and retailers, further boosting local job creation.

Incentives financed by cuts in public schools reduce per-capita income of state residents by over 4 percent.

The Effects of Different Economic Development Incentive Policies

To compare different incentive reforms, I conduct several "thought experiments" that illustrate how a specific reform affects a key outcome: the average incomes of a state's residents. For an apples-to-apples comparison, I assume each policy involves the government offering incentives equal to 1 percent of the state's personal income each year. This magnitude is in line with the offerings of high-incentive states and localities.

I create a baseline incentive policy against which to compare reforms. This baseline policy makes two assumptions that reflect characteristics of typical incentive policies:

- The baseline incentive policy is paid for by an even split of increased taxes and public spending cuts. This choice is arbitrary but neutral. Based on average state and local budget patterns, 11 percent of financing comes from cuts in K–12 education spending alone.
- For every job created directly by the incentives, 1.5 other local jobs are created in supplier industries and local retailers. This means the job multiplier is 2.5, which is common for average manufacturing industries.

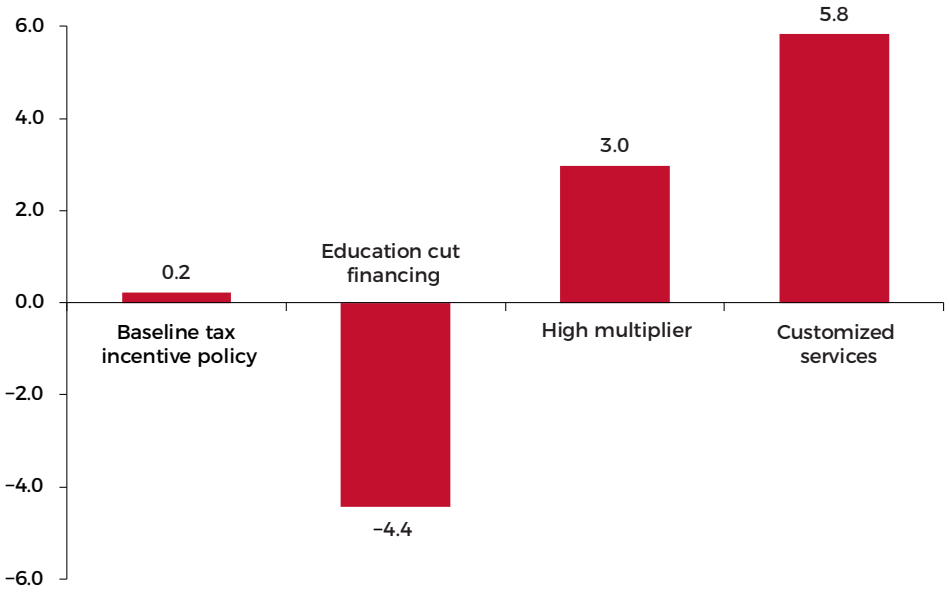
Figure 1 shows how residents' per-capita incomes change for four different incentive policies: the baseline policy and three alternative "thought experiment" policies.

The baseline incentive policy has slight net benefits. Per-capita income rises by 0.2 percent. The incentive policy creates jobs for residents, increases property values, and generates tax revenue. But it also has a high cost per job created. The additional revenue does not fully cover the policy's sticker price, and the share of incentives financed by cuts in public school spending reduces future wages.

Now consider the same tax incentives, with one change: the incentive package is solely financed by cuts in public school spending. This policy reduces average per-capita income of residents by over 4 percent. The short-term benefits of more jobs are outweighed by the long-term losses in wages due to public school spending cuts.

Suppose we return to the baseline incentive financing, but assume that tax incentives are targeted at industries with a job multiplier of 6.0 rather than 2.5. Some high-tech

Figure 1 How Four Different Incentive Policies Affect State Residents: Percentage Effects on Per-Capita Income



NOTE: These four incentive policies all have the same cost: 1 percent of total personal income of state residents.
SOURCE: Executive Summary to Bartik (2018).

Average tax incentives tip less than one-fifth of business location decisions.

manufacturing may have multipliers as great as 6.0. Such high multipliers are in part due to what are called "agglomeration economies" or "cluster effects": a local cluster of high-tech firms can benefit from transferring ideas and workers among each other, and from local specialized services. With the higher multiplier, this incentive policy increases per-capita income by 3 percent, more than 10 times the baseline incentive policy.

Finally, instead of a tax incentive, suppose we provide customized services to locally owned small and medium-sized businesses. These services may include specialized job training and manufacturing extension services. Studies have found these customized services, when done well, can have job-creation effects 10 times those of tax incentives. Because of the target of local businesses, any expansion of sales at assisted businesses may come at the expense of reduced sales at other competing local businesses. However, this is counterbalanced by locally owned businesses and their owners spending more at local suppliers and retailers. This policy increases residents' per-capita incomes by almost 6 percent—over 25 times the baseline tax incentive package.

The Advantage of Data-Driven Simulation over Development Agency Assumptions

These estimates come from a simulation model built on credible studies of how incentives and job creation affect local economies. Essentially, the model uses the findings of these studies to determine how incentive design affects local job creation, per-capita income, and other local economic outcomes. These outcomes are linked in a causal chain. For example, an incentive policy has some probability of tipping a business location decision, and when scaled by the number of jobs targeted, yields the expected number of local jobs created. Each of these created local jobs in turn can create additional jobs through the job multiplier effect, through either suppliers to the targeted firm or local retailers who sell to the firm's workers. Some of these new jobs go to local residents and increase earnings, while other jobs go to people who move into the area and thus affect population growth. Research has shown that for every increase of 10 local jobs, local population will eventually rise sufficiently that 8 extra jobs go to in-migrant workers.

The new jobs increase state and local tax revenue, but the added population requires additional spending on public services to maintain quality. The extra tax revenue less the required spending represents a fiscal benefit to the government. This fiscal benefit offsets the incentive's "sticker price"—the dollars either paid to incented firms or forgone from not collecting taxes from them. If the fiscal benefit is less than the sticker price, there is a net budget cost for the incentive, which must be paid for; for example, by cutting some other public service (such as education). The model's power comes from flexibility in considering alternatives such as how net budget costs are paid for, the size of the job multiplier, and the cost-effectiveness of economic development programs in creating jobs in targeted firms.

In contrast, economic development agencies often make simpler assumptions that are not research based. For instance, economic developers often assume that every new job created in assisted firms is due to the incentives; that is, it would not have been created "but for" the incentives. Credible studies, however, find that average-sized tax incentives tip less than one-fifth of business location decisions, implying that most targeted jobs would have been created even without the incentives.

Moreover, economic developers often take credit for increases in tax revenue but ignore the effects of extra population on public spending. Studies show, however, that growth-induced spending needs can absorb upwards of 90 percent of the additional tax revenue, and the simulation model takes this into account. Similarly, while economic developers often use the sticker price of incentives as their cost, this can understate the true costs by failing to account for the economic costs of paying for incentives, such as cuts in public spending. As noted above, the simulation factors in these costs. For example, empirical estimates show that a 10 percent cut in K–12 education spending will decrease future wages by 8 percent.

Customized business services can create jobs at one-tenth the cost of tax incentives.

Additionally, economic development policymakers often focus on the short term, but the costs from cutting education or other spending can take a generation to be fully realized. The simulation accounts for incentive effects over 80 years. Finally, although more than 90 percent of incentives are tax incentives, specialized business services (such as customized job training or manufacturing extension) can also help create jobs, especially for local small and medium-sized businesses. What's more, these customized services can create jobs at one-tenth the cost of tax incentives, and the simulation analyzes both policies.

One potential drawback to the simulation approach is that the results may be sensitive to different, but still plausible, assumptions. The full report shows that alternative assumptions can change the magnitude of results, but that the general implications hold up. For instance, consider the effects on state residents' incomes of fully financing tax incentives through public school spending cuts. This mechanism reduces incomes even if the effects of spending cuts on future wages are *only one-seventh* of what is assumed in the simulation. As another example, customized business services to locally owned businesses still have positive effects on incomes even if such services have a job-creation effectiveness *only one-sixth* as great as in the simulation.

Political Challenges of Reforming Incentive Policy

These recommended incentive reforms face political challenges. Demand for tax incentives is unlimited: any business would like the government to provide it with as much cash as possible. In contrast, customized business services are demanded only by the relatively few businesses that find such services useful, usually small and medium-sized businesses at some critical development stage.

Therefore, the political pressure is to expand tax incentives because they have more and larger beneficiaries. But from the perspective of promoting better public policy, customized business services offer an advantage: businesses will clamor for them only if they are perceived to be productive. This provides pressure for development agencies to keep the quality up.

Another political challenge is that tax incentives often have short-run benefits but long-run costs. Governors and mayors are tempted to give away their successors' tax base to obtain short-term political benefits from immediate job growth. The full cost, in lower future wages from lower education spending, will be realized only many years later. This political bias toward the short-term can be countered if news media and interest groups encourage a greater focus on what best promotes economic development over the long term.

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