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Economic Development Incentive Wars

State and local competition for business expansions and new plants has grown fierce. Governments are offering businesses a wider variety of incentives—not only property tax abatements, but wage subsidies, worker training, new roads, and land. Incentive packages are getting larger. Alabama's 1993 incentive package for a new Mercedes plant was $168,000 per new job. Tennessee's 1980 bid for a new Nissan plant was "only" $11,000 for each new job.

How successful are these lavish incentive packages in influencing expansion and business location decisions? What are the costs and benefits that should be considered by state and local governments in designing their policies toward economic development incentives? These questions can be answered from two points of view: the perspective of a state or local government, and the national perspective.

The State and Local Perspective

Research and case study analysis suggest the following guidelines for state and local governments to use in incentive policy deliberations.

1. **Economic development incentives are costly per job created. Incentives are not a free lunch.**

Econometric research suggests that the effects of incentives on business location and expansion decisions are modest. Many location and expansion decisions are unchanged by incentives. The cost of incentives to businesses whose location decisions are unchanged exceeds the taxes from businesses whose location decisions are changed. The average net governmental cost per job created by incentives is equivalent to around $4,000 annually for the life of the plant. While policy makers may try to use incentives only when needed to tip the location decision, it is difficult to read the minds of business executives to tell whether an incentive will prove decisive.

2. **Incentives should focus on maximizing labor market benefits for local residents. Fiscal benefits from incentives are often elusive, and should not be the main focus of incentive design.**

Increased local employment has large labor market benefits for local residents. Increasing a metropolitan area's employment by 10 percent raises the average real earnings of local residents by 4 to 7 percent. About half of the increase in real earnings results from higher employment rates of local residents. The other half occurs because local residents move up to better-paying jobs.

Growth in local employment has greater benefits for disadvantaged groups. The earnings of the less-educated increase by a greater percentage than those of the more-educated; the earnings of African-Americans increase by a greater percentage than those of whites (see figure below from Bartik, “Economic Development and Black Economic Success” - Not available in this electronic document).

The earnings effects of local employment growth are greater for new jobs in high “wage premium” industries, which pay well compared with the skills they require. Metropolitan areas with more high wage premium jobs have greater labor force participation rates.

Because labor market benefits of growth are so important, greater incentives should go to firms that create more jobs at higher wages. Training incentives may also help target more new jobs to local residents.

The claimed fiscal benefits from new jobs often reflect incomplete accounting. New jobs attract people; on average, four out of five new jobs in a local economy will go to people who otherwise would have lived elsewhere. Additional population requires spending on schools and infrastructure that is unlikely to be fully recovered from household taxes.

3. The social benefits of employment growth are greater in high-unemployment areas. High-unemployment states or metropolitan areas should be more aggressive in offering incentives than low- unemployment areas. States should consider targeting incentives to high-unemployment areas.

Benefits of employment growth are greater in high-unemployment areas because the unemployed there are more desperate for jobs. In low-unemployment areas, it is easier for people who place a high value on having a job to find one. Those who remain unemployed usually have preferred alternate uses of their time, such as child care, job training, or education. In high-unemployment areas, more of the unemployed will be people who place a high value on having a job but cannot find one.

4. Incentives provided up front may be more cost-effective than long-term incentives. Up-front incentives force politicians to face the costs of incentive policies. Incentives should be designed so that some funds can be recovered if the project does not work out.

Corporate executives discount future cash flows heavily. Surveys show that executives discount future cash flows using a “real interest rate”—the interest rate minus the inflation rate—of 12 percent (i.e., a nominal rate of 15 percent when inflation is 3 percent). This real interest rate far exceeds the interest rate that society should use to discount future benefits and costs, and it far exceeds the interest rates at which state and local governments borrow. Providing larger incentives now, and smaller incentives later, may have greater effects on business location decisions and also cause fewer long-run fiscal problems.

Up-front incentives also encourage politicians to be appropriately cautious in their use of incentives. Although the economic benefits of new jobs are long term, the political benefits are immediate, and the governor or mayor who announces the new plant gets the political credit. If politicians can pass incentive costs on to their successors, they may be tempted to offer excessive incentives.

The risk of up-front incentives is that the business location or expansion may fail, and the incentive funds will have been wasted. This risk can be reduced by attaching “clawback” provisions to incentive offers. Under “clawback” rules, some of the incentive must be repaid by the business if the new jobs do not last for a specified period.

The risk of up-front incentives can also be reduced by providing more of the incentive package as training or infrastructure. If a training incentive provided generally useful skills, then the trained workers should still be more productive and better paid even if the new plant leaves. Roads would still provide benefits for local residents and businesses with or without the new plant. A better-trained workforce and better infrastructure may also help in attracting other jobs.

The National Perspective

From a national perspective, the benefits of attracting jobs to one area are at least partially offset by the loss of these jobs to other areas. Some net national benefits will remain from incentives that attract jobs to high-unemployment areas. Some national benefits may also occur from incentives such as worker training and improved infrastructure. Overall national productivity should increase if training and infrastructure improvements are provided efficiently.

Federal policy makers should consider discouraging economic development incentives in low-unemployment areas. They should also consider encouraging state and local governments to focus more on productivity-enhancing incentives. The federal government could encourage better incentive policies by attaching penalties to development-related federal grants. The current political mood, however, is to reduce federal intervention in state and local government.

Perhaps national benefits from the incentive wars will increase as state and local governments become more sophisticated. Incentive packages are tending to focus more on employment expansion, higher wage jobs, worker training, and infrastructure improvements. The press and state legislatures are beginning to force economic developers to analyze the benefits and costs of incentives. If such scrutiny results in some low- unemployment areas refusing to offer large incentives while high-unemployment areas continue to do so, the nation will benefit. This state and local competition will then help redistribute jobs to the places and people that need jobs the most.

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Suggested Readings

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