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Rethinking State Economic Development Strategies

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Rethinking State Economic Development Strategies

Or, how to maximize benefits for state residents' earnings per capita

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For more short thoughts on these topics, see:

2-part interview w/ Dr. Bartik at CityLab:

<https://www.citylab.com/solutions/2019/11/economic-development-place-based-policies-inequality-jobs/602014/>

Washington Post op-ed summarizing Bartik's work on helping manufacturing-intensive communities:

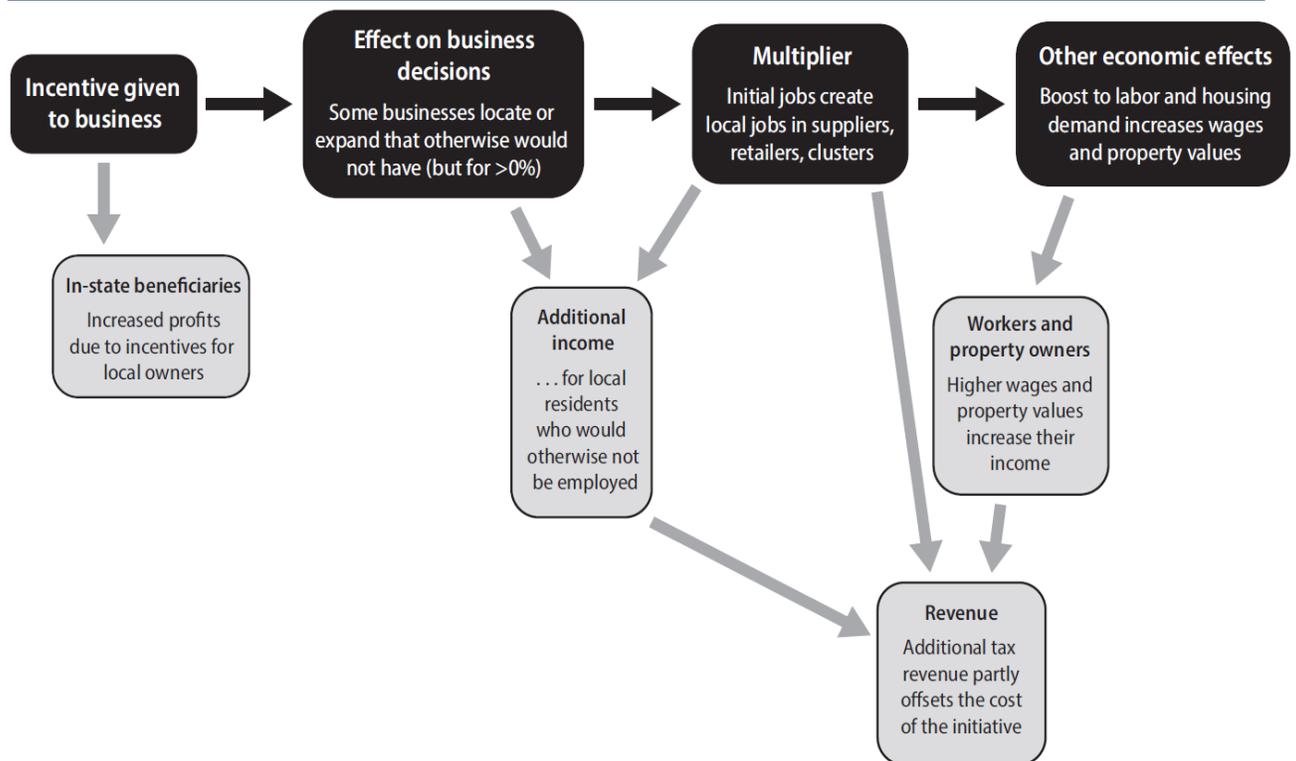
<https://www.washingtonpost.com/news/posteverything/wp/2018/05/09/helping-u-s-manufacturers-what-works/>

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I'm going to talk today about how we can have better economic development strategies. By "economic development strategies", I mean state programs whose primary goal is job growth. Now, my first big point is that although these policies' immediate goal is job growth, that is not their ultimate goal. Job growth is primarily valuable because it has the potential for increasing state residents' earnings per capita, by increasing employment to population ratios in the state, which both directly increases earnings per capita of state residents, and indirectly increases earnings per capita by putting upward pressure on wage rates. Why emphasize this point? Because overlooking it can lead to some key mistakes in policy. Specifically, different types of job growth in different areas will have very different effects on employment to population ratios. In addition, job creation is not the only way to increase earnings per capita; as I will explain, there are alternative policies that will increase earnings per capita even if they do not increase overall job creation very much.

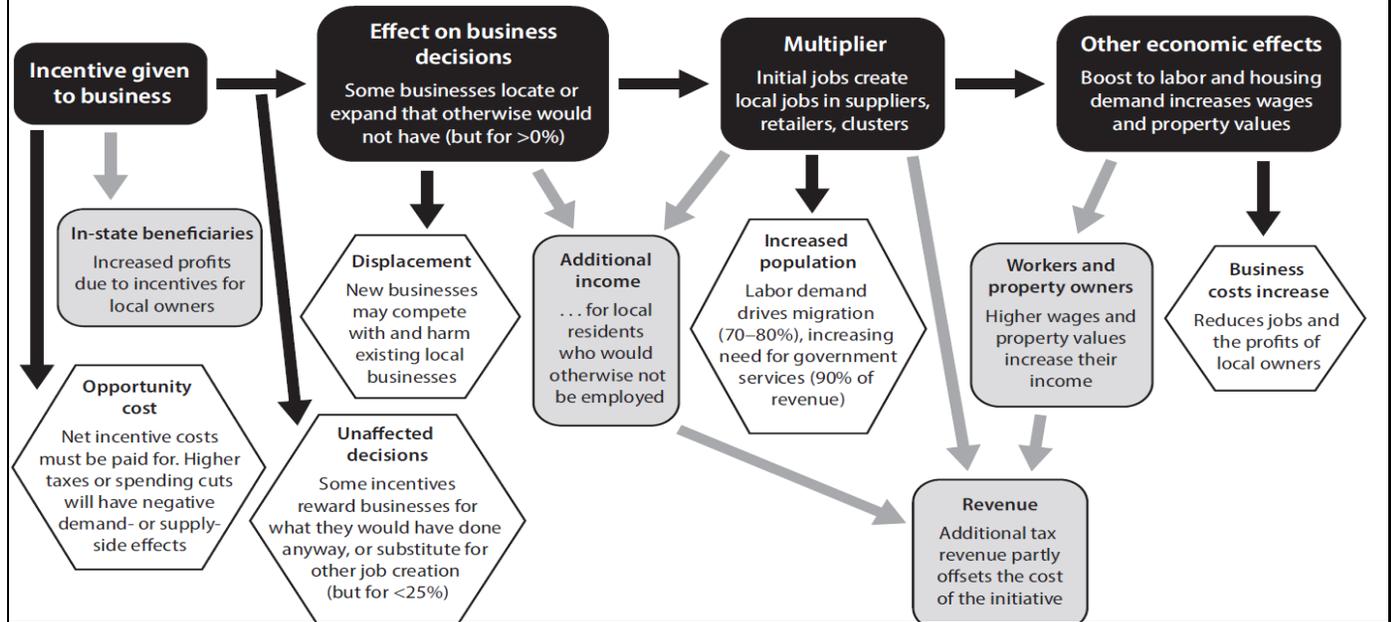
Now, the main economic development strategy pursued by most states is economic development incentives, by which I mean business tax breaks or other cash assistance to individual businesses to encourage job growth. Such incentives can have significant economic benefits, but also costs.

The sunny side of incentives



The logic of incentives' benefits begins with the notion that the job creation decision we're incenting might not have occurred "but for" the incentive. The added jobs in the incited firms have some multiplier effects – jobs go up in local suppliers to the incited business, and the extra earnings of workers in the incited business increase jobs in local retailers. The added jobs increase the employment rates and wage rates of local workers, and property values of local property owners. And the increase in local income, consumption, and property values all tend to increase tax revenue. And in fact frequently you will hear the argument is that at long as the incentive doesn't give away all the tax revenue from the incited business and its associated activity, it must have no net cost – as long as the incentive is less than the sum of the tax revenue from the incited business, its suppliers and induced activity in local retailers, and added tax revenue from local workers and property owners, then state and local governments make a profit on the entire deal.

Realistic incentive costs



But incentives also have costs. First, a large proportion of incentives are wasted because the incented jobs would have been created anyway. Studies show that at least 75% of the time, the jobs created by the incentive would have been created anyway, and in less than 25% of the time are the jobs actually induced by the incentives. Second, many new jobs do not benefit local residents. Studies show that in the long-run, 70-90% of new jobs lead to population in-migration, and only 10-30% lead to increases in employment to population ratios. These large population growth effects increase public service costs: the new people will require hiring additional teachers and police, and building additional infrastructure. As a result, the net “fiscal benefits” from incentives – added tax revenue minus added public service costs – will typically be 20% or less of the gross incentive costs. Incentives do NOT pay for themselves. This doesn’t necessarily mean that incentives are a bad idea – the purpose of state government is not to make money for the government – but does mean that incentives are not a “free lunch”, but rather have a budget cost that must be compared with their economic benefits, which are mostly the increase in state residents’ per capita earnings.

What can state policymakers do to maximize positive vs. negative effects? A lot of things, but for the moment I want to just mention 3 things. First, we can try to target higher multiplier firms, which I will return to in a moment. Second, we can try to increase the proportion of new jobs that raise the employment rate. The most straightforward way to do this is to target economically distressed areas, in which the proportion of jobs that go to the local non-employed are 2 to 3 times higher than in more prosperous areas. I will come back to this point later. Third, we can try to identify policies that have a lower cost per job created, which I turn to next.

Other labor demand policies can have lower cost per job created than typical incentives

Annual cost per job-year created (\$ at 3% discount rate)



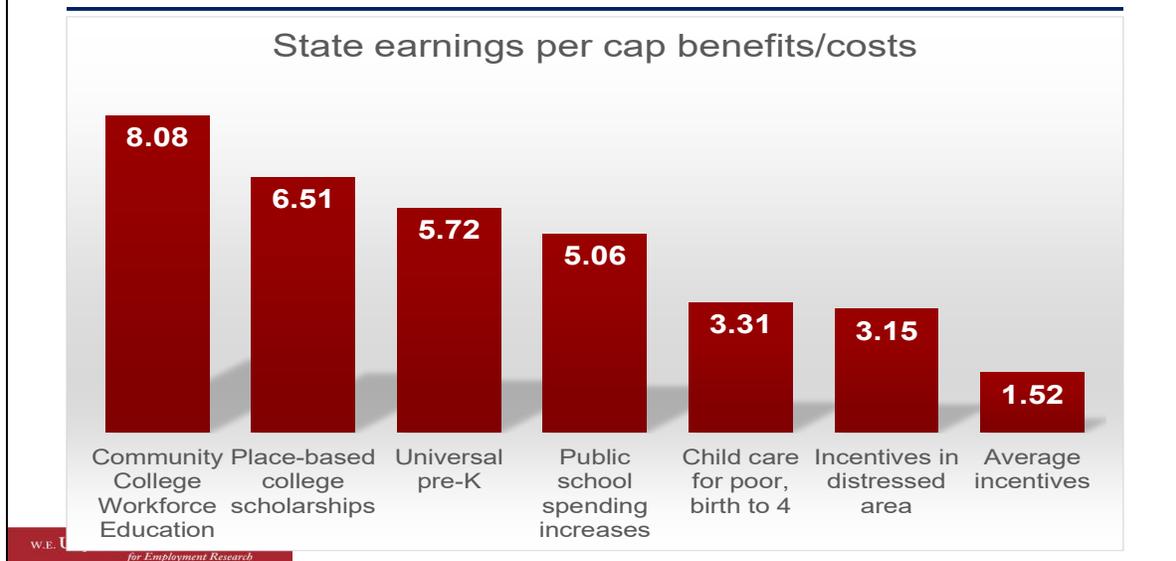
In cost per job, incentives are cheaper than across-the-board business tax cuts, because incentives are targeted on businesses which sell goods and services outside the state, and which have higher multipliers. Across the board business tax cuts go to all businesses, including retail businesses such as fast food restaurants, which have few benefits for local economies. We can get still lower costs if we target incentives at high-multiplier businesses. This can be done by targeting high-tech businesses in areas with clusters of high-tech businesses, which tend to have higher than average multipliers.

But one could further lower costs per job by providing services to business. One example is customized job training, under which local community colleges provide businesses with free training. Another example is manufacturing extension, under which smaller manufacturers are provided with advice.

Lower costs per job can also be achieved by making quality land more available for businesses. We can redevelop neighborhood business areas, or clean up a brownfield site. Or we can increase the quality of business sites by adding business infrastructure.

This comparison of cost per job overlooks two important facts. First, these low costs for business services and business land development policies are contingent on these policies being run in a high-quality way. No one is saying that you will get low costs per job created from a poorly run job training program, or from a manufacturing extension office giving lousy advice, or from building the proverbial “bridge to nowhere”. Second, there are some inherent limits to the scale at which these business services and land development programs can be run at: only so many manufacturers need manufacturing extension advice, and only so many brownfields need to be redeveloped. In contrast, cash incentives are easy to hand out and have no real limits to their size.

High-quality skills programs: higher ratio of earnings benefits/costs than incentives, but different effects on younger/older workers & different timing



We have other options for increasing earnings per capita than through job-creation programs, for example earnings per capita can be increased by job skills programs. If high-quality, these job skills programs can boost a state's earnings per capita by 3 to 8 times their program cost. How does this happen? Well, if you create more skilled workers in your state, total jobs may not go up much, but the mix of jobs in your state will shift towards good jobs that pay better. The state's mix of good jobs will increase enough that the increase in the state's earnings per capita exceeds what you would predict if you looked at how skills programs increase the earnings of their individual participants. Some workers getting skills have spillover benefits for everyone in a state.

Incentives can increase their earnings per capita benefits by being more targeted at economically distressed areas. In such areas, a higher percentage of the jobs created will go to the local non-employed, compared to in-migrants. The earnings benefit to cost ratio doubles from about 1.5 to over 3, which is more comparable to what skills development programs can do.

An important point is that skills development programs and incentives increase earnings for different groups and in a different time frame. Skills development programs mainly benefit younger workers. Most benefits take many years to occur – we're not sending former preschool participants into the workforce at age 5. In contrast, incentives have benefits that also go to older workers, and that are more immediate. Therefore, a balanced portfolio of policies to increase earnings per capita for all groups, and in both the short-term and long-term, should include job creation policies – not just incentives, but also business services and land development policies --as well as skills development programs.

Ideal state economic development strategy vs. current typical strategies

| Current | <i>Ideal</i> |
|--|--|
| Untargeted | <i>Targeted at distressed counties & hi-tech firms in hi-tech counties</i> |
| \$50 billion annual costs over all states | <i>\$25 billion annual costs</i> |
| 94% tax incentives, 6% customized services & land development | <i>40% tax incentives, 60% customized services & land development</i> |
| One-quarter local property tax abatements | <i>100% state/federal funding</i> |
| Tax incentive features: often up to 20 years | <i>Tax incentive features: upfront, max of 3-year term</i> |
| Average tax incentive: 2.3% of wages, \$30K/job. Some 10x average. Michigan avg > \$40K/job. | <i>Limit max incentive to 1.5% of wages, \$20K/job</i> |
| Often no budget limit for tax incentives | <i>All incentives part of state business tax budget</i> |

Based on this analysis, what state economic development strategy makes sense? First, states should target their most generous incentives more tightly. The highest incentives should be reserved for either economically distressed counties, or for high-tech firms in counties with a high-tech cluster. Why? Because job creation in distressed areas will have more jobs go to state residents. And job creation in high-tech firms in high-tech counties will have higher multipliers.

In addition, the mix of job creation dollars should shift from being almost all cash incentives, to being more equally divided between tax incentives, versus business services and land development programs. We want to do this because business services and land development policies, if run well, are cheaper ways of creating jobs.

We should limit incentives by cutting back on long-term incentives. Long-term incentives are less effective, because business decision-makers are short-term oriented. The tax incentive in year 10 of a project probably has little effect on business location decisions. Also, long-term incentives are too tempting to Governors, allowing a Governor to get political benefits now, but postpone costs to the next Governor.

Finally, there should be some budget limit to tax incentives. State policymakers should decide what mix of household vs. business taxes they think is fair. If we expand business tax incentives, we should accompany that by other business tax changes to achieve whatever our goal is for business tax revenue vs. household tax revenue. By doing this, we avoid financing business tax incentives by, to take one example, cuts in skills development policies. Simulations show that if business tax incentives lead to reductions in public school funding – which, for example, property tax abatements can do – then the net effect on state residents' earnings per capita is actually *negative*.

To sum up: if we want to maximize how state policies increase the earnings per capita of state residents, we should indeed have business tax incentives, but we should limit their size and term, and target the highest incentives at distressed areas or at developing high-tech clusters. We should put more dollars into customized training, manufacturing extension, and other customized business services, and into land development policies, which can all be quite cost-effective in creating jobs. And we need to limit the overall budget for incentives in order to make sure that we have sufficient budget in education and skills development policies, which in the long-run will have the greatest effect on state residents' earnings per capita, not only for those who get the education, but also by shifting the state's economy so it has a greater mix of good jobs.

Sources: For sources on the claims made here, see book by Timothy J. Bartik, *Making Sense of Incentives: Taming Business Incentives to Promote Prosperity*, available for free download at https://research.upjohn.org/up_press/258/