Dr. Dave. Do state and local economic development tax incentives help state and local economies?

A. In the vast majority of cases, the answer is no. Robert G. Lynch, Chairman of the Department of Economics at Washington College sums up the thinking of most economists. There are "little grounds to support tax cuts and incentives—especially when they occur at the expense of public investment—as the best means to expand employment and spur growth."[1]

Billions of dollars a year are "spent" by states, counties, and cities on economic development incentives in various forms (e.g. tax abatements, tax reductions, direct grants, infrastructure investment, etc.) Government officials and private sector applicants argue that these tax expenditures pay for themselves in additional revenue created by new or expanded businesses and job creation.

Over the last 30 years, hundreds of public and private sector analyses have evaluated the impact and value of economic development incentives.[2] Their conclusions vary widely; most often because of variations in the way they approach the analysis.

Any study of the value of economic development incentives must first decide what to count as costs and benefits. Most analyses, remarkably, count only benefits. A report by the Massachusetts Budget and Policy Center concludes that a series of studies suggesting that corporate tax incentives lead to job growth "appears to be fundamentally flawed, as it simply assumes that the Commonwealth does not have to pay for corporate tax incentives."[3]

More sophisticated studies include the negative, as well as the positive side, of the equation. That means taking into account a number of different costs.

1. Additional public and private costs generated by a large new business. For example, increased congestion, higher overall labor costs, environmental deterioration, new infrastructure costs, and additional public service costs such as police and fire protection.

2. Loss of tax revenue resulting from the negative impact of the new business on existing businesses.

This is particular true for incentives to businesses that only sell their product or services to the local community (e.g. retail). Having a Wal-Mart or a Home Depot move into the area does not increase overall spending on groceries or light bulbs. It redirects spending for those items that would otherwise go to other local businesses.

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[1] Robert G. Lynch, Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development, Economic Policy Institute, March 2004.

[2] A recent report by the Massachusetts Budget and Policy Center summarizes the findings of the leading studies. *Tax Expenditures and Economic Development*, Massachusetts Budget and Policy Center, April 27, 2004.

[3] *Ibid*.

Retail incentives are almost always a net revenue loser. (See the New Rules Retail Sector for a list of studies and local initiatives in this area).

Incentives to sports arenas have a similar negative net impact, although some might argue that there may be an important qualitative benefits attached to such incentives (e.g. being a "major league" city).

3. Budget cuts that result from spending on economic development incentives.

This is especially important to consider when, as is the case today, overall budgets are tight or being cut. Which brings up another important feature of tax incentives. Direct appropriations – everything from education, to transportation, to maintaining state office buildings – must be approved each and every year. Tax expenditures, on the other hand, carry over automatically, with no need for annual approval and without regard to existing fiscal conditions.

The national trend in the 1990s was to reduce business taxes and create or expand incentives for business investment. At that time, state tax receipts were growing at about 6 percent a year. By 2000, however, state forecasters were already predicting that tax revenues would barely keep pace with inflation as delayed tax cuts began to take full effect.[4] Today those incentives are still draining money from local and state treasuries even while core budgets are being cut.

As one observer notes, "Rather than requiring a vote in favor of continuation, a tax expenditure continues until a vote in favor of eliminating it occurs."[5] And such a vote requires political courage, for it is viewed as a tax increase. It is far easier to cut direct expenditures than it is to cut tax expenditures.

4. Reduced economic development because of cuts in public services.

Ironically, economic development incentives can lead to less economic development if they lead to cuts in public services. Studies have consistently found that spending on public services – especially education and infrastructure – has a positive effect on economic development.[6]

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[4] Robert Tannenwald, "Are State and Local Revenue Systems Becoming Obsolete?" *New England Economic Review*, Federal Reserve Bank of Boston, Issue 4, 2001.

[5] Massachusetts Budget and Policy Center, *Op. Cit.*

[6] See, Ronald Fisher, "The effect of state and local public services on economic development", *New England Economic Review*, Federal Reserve Bank of Boston, March/April 1997; Timothy J. Bartik, "Growing State Economies: How Taxes and Public Services Affect Private Sector Performance", Economic Policy Institute, 1996. Robert G. Lynch, "The effectiveness of State and Local Tax Cuts and Incentives: A Review of the Literature," *State Tax Notes*, September 1996.

A review of existing literature on incentives conducted for the Louisiana Department of Economic Development in 2003 concluded tax incentive programs “often have no measurable impact on growth, and even when they do, it is likely that they are not cost-effective…most economists in the field would recommend economic development policy based on sufficient and appropriate infrastructure investment and service provision, and a balanced, predictable and fair tax system.”[7]

5. Benefits that would have occurred without the incentives.

Often the benefits credited to tax incentives would have occurred anyway. A number of studies focusing on the role of tax credits in job creation have found that 55-70 percent of the tax credits granted to employers are payments for workers who would have been hired without the subsidy.[8] One analysis mockingly concluded, “incentives have very little effect on actual growth, but they have a substantial positive effect on announced growth.” Studies of Enterprise Zones, the new darling of advocates of government involvement in economic development, indicate that most of the incentives are used by existing businesses that would have expanded anyway.[9]

The Special Case of Manufacturing?

When it comes to manufacturing, where most of the product is exported out of the state or country, it can be argued that significant new revenues are generated. In general, however, surveys of business and studies of business activity have found that tax incentives are considered too small a business cost to influence location decisions. Other factors such as labor, transportation, utility and occupancy costs play a greater role.[10]

In the cases where the incentives are large enough to affect that decision, they are usually so large that the costs far outweigh the benefits. In recent years, bidding wars have broken out among localities and states to attract new manufacturers. Sometimes these are targeted on a specific firm, sometimes on specific sectors. The incentives can reach remarkably high levels. For example, Kentucky offered steel mill incentives worth over $200,000 per job, not including the cost of infrastructure and service demands. These large incentives are virtually never cost effective. They may even result in a loss of

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[7] Dave N. Norris and Elizabeth Mansager Higgins, *The Impact of Economic Development Incentive Programs: A Review of the Literature*, Louisiana Tech University, 2003.
[8] Dagney Faulk, “Do State Economic Development Incentives Create Jobs?” *National Tax Journal*, Vol. 55, No. 2, 2002; U.S. Government Accountability Office, *Targeted Jobs Tax Credit Employer Actions to Recruit, Hire, and Retain Eligible Workers Vary*, GAO HRD 91-33, February 1991.
[9] Daniele Bondonio and John Engberg, “Enterprise zones and local employment: Evidence from the states’ programs,” *Regional Science and Urban Economics*, Vol. 30, No. 5, 2000.
[10] Terry Buss, “The effect of state tax incentives on economic growth and firm location decisions: an overview of the literature,” *Economic Development Quarterly*, Vol. 15, 2001; Robert Ady, “Taxation and Economic Develoment: The State of the Economic Literature,” *New England Economic Review*, Federal Reserve Bank of Boston, March/April 1997.

efficiency for the overall economy if businesses are induced to locate in an area that will eventually provide less return on investment than another location.[11]

Performance Contracts and Clawbacks

A growing number of communities require recipients of local and state incentives to sign a legally binding performance contract listing the specific public goals the company promises to achieve.[12] At least 43 states, 41 cities and 5 counties, a total of 89 jurisdictions now attach job quality standards to at least one development subsidy. This is a dramatic increase since 1994 when only 6 jurisdictions were using this tool.[13]

The state of Minnesota, for example, requires all state agencies and municipalities to develop explicit benchmarks for awarding subsidies.[14] Recipients must enter into subsidy agreements that list wage and job goals, and include obligations if the goals are not met.

These contracts take many forms. For example, a Connecticut statute governing a below-market rate loan program states that, "Business is prohibited from relocating during the term the loan is outstanding or for ten years after receiving assistance, whichever is longer."[15]

Some performance-based contracts do not provide any assistance to a company until it meets the specific level of performance. For example, a firm receives an income tax benefit only after it has hired a certain number of workers at a designated minimum wage. Chicago requires that Tax Increment Financing (TIF) incentives be distributed on a "pay-as-you-go" basis. This means that the developer initially pays the costs of the project and is only reimbursed as the municipality collects the incremental property taxes.

Rachel Weber, Assistant Professor at the University of Illinois, notes that the use of accountability mechanisms cuts across political persuasions. "Some of the most conservative, pro-business local regimes have passed the most stringent laws requiring the use of these contractual safeguards."

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[11] Dave N. Norris and Elizabeth Mansager Higgins, *The Impact of Economic Development Incentive Programs: A Review of the Literature*, Louisiana Tech University, 2003.

[12] For an excellent recent overview of local and state efforts in this area see: Anna Purinton, Policy Shift to Good Jobs: Cities, States and Counties Attaching Job Quality Standards to Development Subsidies. Good Jobs First. November 2003.

[13] *Ibid.* The report contains a list of all jurisdictions and a discussion of the standards each uses. Job quality standards may include: wage levels; employer-provided health care benefits; number of jobs created, number of jobs offered to local residents, etc.

[14] Minnesota Statutes, 116J.994 Regulating State and Local Business Subsidies

[15] See for examples of such contracts and an overview from the perspective of the local government negotiating the contract. Rachel Weber, Negotiating the Ideal Deal.

Communities that require a written contract specifying performance and aggressively audit performance must be prepared also to impose penalties when the companies fail to achieve their goals. Often the company is simply banned from receiving future incentives, or the interest rate on a low-interest loan is raised modestly. In some cases communities enforce a "clawback" provision in which the company is required to return any incentives it has received.

Unfortunately, the benefits gained from cutting workers or moving operations often outweigh the cost of penalties. And if a business goes bankrupt, there is little the government can do.

Communities rarely exercised clawback options in the 1990s. The Missouri State Auditor's Office reports that from 1992 to 2003, the state only once imposed a clawback provision on a company that failed to live up to the state requirement that it create and maintain jobs over a 5-year time frame in return for state incentives.[16]

More clawback provisions are being enforced now that cities and states are facing financial crises. But, according to the *Financial Times*, these penalties tend to be enforced only against small businesses, and only by economically successful cities and states.[17]

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[16] Office of the State Auditor of Missouri, Report No. 2003-32, April 8, 2003. In New York, 139 companies received $25 million in subsidies since 1996. Of these, 45 percent failed to create the jobs they pledged. Many more would have failed except for the clause exempting from penalties any company that makes 85 percent of its goal. As punishment, some companies with combination loan and grant assistance have had their interest rates raised from 4 percent to 6 percent. *Newsday*, March 17, 2002.

[17] *Financial Times*, February 2, 2003.