Making Sense of Incentives
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Chapter 1

Why Incentives Are Tempting but Problematic

Are economic development incentives out of control?

To attract jobs, state and local governments increasingly provide targeted businesses with incentives: tax breaks, cash grants, free land, free job training. Since 1990, incentives have tripled to $50 billion annually.

Recent incentive offers have escalated:

• In 2017, Wisconsin agreed to provide tech giant Foxconn with incentives of over $3 billion for a new manufacturing plant to make flatscreen panels. The Foxconn deal in Wisconsin was equivalent to paying Foxconn a wage subsidy of 30 percent for 20 straight years.

• In 2017 and 2018, numerous states competed for Amazon’s proposed “Headquarters II.” Several serious offers exceeded $7 billion.¹

Having seen what states were willing to offer Foxconn and Amazon, one can easily imagine business incentives mushrooming. Business incentives may increasingly inhibit the ability of state and local governments to provide public services, such as schools and roads.

WHAT WE TALK ABOUT WHEN WE TALK ABOUT INCENTIVES

Economic development incentives are tax breaks, cash grants/loans, or services that are

1) targeted at an individual firm, or some industry or group of firms; and
2) intended to promote job growth in a state, or in a local geographic area that is big enough to be a local labor market.²

By “local labor market,” I mean an area big enough so that increasing jobs in the area affects job availability for local workers. This size criterion requires that the area be big enough to encompass a substantial share of all local commuting flows. A metropolitan area would clearly be big enough.³ In contrast, moving jobs from one neighborhood to a bordering neighborhood would not affect job availability for workers because few people work in the same neighborhood they live in. Policies targeting neighborhoods are usually labeled as “community development” policies, not “economic development” policies. Community development policies may provide important benefits by improving neighborhood amenities. But economic development policies aim at affecting job availability for local workers. Job growth only affects job availability for local workers if it affects job growth at a larger geographic scale than the neighborhood.⁴

Anything that state and local governments do—every tax or spending policy, every regulation—might affect job growth. What is distinctive about incentives—and what arouses more controversy—is targeting individual firms or industries, sometimes called “picking winners.” Why should a state or local government try to pick winners? Can this targeting strategy achieve a higher “bang for a buck,” compared to more general policies to promote job growth? Or is it doomed to make mistakes, or to be corrupted to help political supporters?

WHY JOB GROWTH?

But we’re getting ahead of ourselves. First we need to ask: Why promote local job growth? What’s wrong with the number of jobs that are produced by the private market on its own, without government intervention?
The private market doesn’t produce enough job growth because jobs have social benefits: labor market benefits for state residents, and fiscal benefits that improve state and local governments’ budget situations. Private employers ignore these social benefits, and therefore do not expand jobs as much as we would like to see in our society.

Local job growth helps more residents get jobs. This added work experience increases residents’ job skills. These greater job skills yield long-run benefits: these local residents will have persistently higher employment rates and earnings.

More jobs also increase state and local tax bases, and thereby increase state and local tax revenue. Governors and mayors have more revenue to work with, without any tax rate hike.

WHY TARGETED INCENTIVES? POLITICAL REASONS

But why pursue local job growth with assistance to targeted firms? Why not just general policies to encourage local job growth?

A political reason for incentives is that they are popular. Targeting the creation of particular identified jobs—which is what incentives do—is rewarded by voters. Voters are more likely to vote for politicians who offer incentives, even if the incentives are unsuccessful. Voters appreciate well-publicized efforts to attract jobs. If a governor or mayor can go after a prominent large corporation with an incentive offer, why not? At least he is trying; he cares.

Better yet, the incentives may be long-term, paid for by the next governor or mayor. Political benefits now, budget costs later.

A governor or mayor can use the threat of competition from other states and cities to appeal to the minority of voters who are incentive critics. She can say, “Look, I would prefer not to offer large incentives, but I have no real choice except to keep up with the interstate competition.”
WHY TARGETED INCENTIVES?
ECONOMIC RATIONALE

Incentives also have an economic rationale. Targeted assistance to some firms may create more local jobs per dollar than more general policies, for two reasons.

First, targeting some firms may increase their job growth more than spreading the same dollars over all firms. For example, smaller firms often lack information on the latest technology, or on possible new markets. Government services that provide information for small firms may be cheap for the government to provide, yet have large effects on these small firms’ growth. Examples of such information services for smaller firms are manufacturing extension services, which offer advice to small- and medium-sized manufacturers on how to improve their competitiveness.

As another example, some firms are actively considering a new location or expansion decision, while other firms have more modest ambitions and are content to stay at the same scale. The former group of firms is easier to affect via government assistance.

Second, targeting job creation on some types of local firms may have higher multiplier effects, which occur when job increases in one local firm lead to job increases in the firm’s local suppliers, or in local retailers serving the additional workers. An expansion of an auto final assembly plant leads to increased sales and jobs at local suppliers of auto component parts. The added workers at the assembly plant and the parts suppliers will buy more at local grocery stores and brewpubs, increasing these retailers’ jobs.

Multipliers are higher for firms producing “tradable” goods or services. For regional economists, tradable goods or services are more than those sold in international trade—they are any goods and services that are sold outside the local economy, such as manufactured goods. For example, Michigan auto plants sell cars to Ohio, so autos would be “tradable” goods for Michigan even if international sales were nonexistent. Nontradable goods or services are sold within
the local economy, such as local restaurants. Helping one local restaurant expand will reduce sales and jobs at other local restaurants. This local competition reduces the multiplier, perhaps all the way to zero: any jobs gained at the assisted restaurant may be offset by jobs lost at other local restaurants. In contrast, local manufacturers compete with firms elsewhere, so incentives may help these firms gain a greater share of the national or even international market.

Multipliers are also higher in high-tech industries in local economies that have many other, related high-tech firms. High-tech firms cluster together, as seen in Silicon Valley. Attracting more high-tech firms may help an already-existing local high-tech cluster to grow and prosper.

WASTEFUL INCENTIVES

Incentives can be wasteful. State and local costs may be large, with little local benefit.

First, many incentives have little effect. As we will review, for typical incentives, only a minority of incented firms will be induced to alter their location or expansion decisions. Yes, there is competition from incentives in other states. But even with this competition, typical incentives are small enough as a percent of firms’ costs that they rarely drive the location or expansion decision.

Second, multipliers often are smaller than claimed. More local jobs will drive up local wages and prices. Increased wages and prices will drive away some local jobs, reducing the multiplier.

Third, most new local jobs eventually go to in-migrants. Local job growth drives local population growth. This reduces the job opportunities that state residents receive from new jobs.

Fourth, increased jobs and population will increase public spending needs. As we will review, these increased spending needs are almost as large as the tax revenue gain from a larger state and local tax base. Incentives’ “fiscal benefits”—the tax revenue gain minus
the increased spending needs—are slight, and almost always far less than the dollar costs of incentives. As a result, incentives do not pay for themselves.

Fifth, the net financial costs of incentives, after netting out fiscal benefits, must come from somewhere in state and local budgets. Some taxes must be raised or some public spending cut. Either tax increases or public spending cuts will hurt the local economy. The economic costs of incentives are more than their dollar costs.

EVALUATING INCENTIVES

Therefore, in evaluating incentives, everything depends on the details: how much in incentives it takes to truly cause a firm to locate or expand, the multiplier effects, the effects of jobs on employment rates, how jobs affect tax revenue versus public spending needs. Do benefits of incentives exceed costs? This depends on the details.

This book is about those details. What magnitudes of incentive effects are plausible? How do benefits and costs vary with incentive designs? What advice can be given to evaluators? What is an ideal incentive policy?

Answering these questions about incentives depends on a model of incentive effects, which this book provides. First, however, the next chapter describes our current incentive practices. How are incentives designed and used by U.S. state and local governments?