Making Sense of Incentives

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Chapter 6

An Ideal State Incentive Program, Taking Account of Economic and Political Realities

Given what we know about incentives, what state incentive program makes sense for governors and legislators?

A state incentive program’s design should maximize net economic benefits for state residents’ per capita income. But the incentive program’s design should also minimize the temptations for state politicians to direct the program to achieve their own political goals, rather than the interests of state residents. Designing an ideal state program requires considering both economics and politics.

PRINCIPLES

For both economic and political reasons, a state’s incentive program should be guided by the following principles:

- **Target firms in tradable industries in distressed areas, and firms in high-tech tradable industries in a few high-tech cluster areas.** Incentives should not go to locally oriented firms that compete with other firms in the same state, but rather to firms in tradable industries, which compete in national or international markets. As described in Chapter 4, state residents benefit far more from incentive programs that target distressed areas or high-tech industries in areas that already have a significant high-tech cluster. New jobs in distressed areas, with an ample supply of workers lacking jobs, will be more likely to go to state residents. The expansion of high-tech firms in an area with a significantly above-average high-tech
cluster will have higher job multiplier effects that will create more jobs in local suppliers and retailers. As noted previously, such high-tech cluster communities comprise about 60 or so of the roughly 700 local labor markets in the U.S. Do not confuse high-tech aspirations with current realities!

- **Emphasize customized business services more, business tax incentives less.** Customized business services have more job creation effects per dollar than business tax incentives (see Chapters 3 and 4). The political demand for customized business services is more limited, compared to business tax incentives. All businesses will always demand more business tax incentives or other cash, even if the incentives do not alter business’s decisions about job creation. Customized business services only benefit a more limited number of mostly smaller businesses that need such services, and are only demanded if the services have some usefulness.

- **Structure incentives to limit the temptation to provide excessive long-term incentives to large corporations.** Upfront incentives have a higher benefit-cost ratio (see Chapter 4). If the state’s rule is that the term of incentives must be limited, governors will be less tempted to strike deals that are excessive, as they will have to immediately deal with incentives’ budget costs. Mega-deals with large corporations are politically tempting for governors because of the publicity. But incentives for smaller businesses can be at least as effective at actually creating jobs.

- **Finance incentives by higher business taxes, not by cutting public spending that promotes economic development.** Incentive design and budgeting procedure should minimize the risk that incentives reduce spending on programs that promote economic development, such as public schools. Ideally, a state’s choice to devote more resources to incentives should
be paid for by increasing the state’s business tax rate, which exports some of the costs to nonresidents.

AN IDEAL PROGRAM

Based on these principles, what would be an ideal state incentive program? Here are some ideas for a possible state strategy.

- **Target counties.** The proposed state strategy would target state-funded economic development efforts on appropriate counties. These counties would be of two types. First, the state strategy would target economically distressed counties—that is, counties that by some objective measure lack adequate jobs. Second, the state strategy might target a few counties with high-tech clusters—those whose share of jobs in high-tech industries was at least one-third greater than the national average. For the state targeting to be meaningful, less than half of the state’s population should be in targeted counties.

- **Start with the basic services supporting economic development.** Before funding incentive programs to help specific businesses, make sure that target counties have the funding they need for adequate services to support economic development. Such supportive services include adequate infrastructure and high-quality programs for skills development.

- **Next, prioritize funding for customized business services.** Targeted counties could be provided with a block grant supporting a wide array of customized business services. The state funding would have to go to firms in tradable industries. In counties eligible only because they have a high-tech cluster, the assisted firms would also have to be high tech. Eligible services would include manufacturing extension services, small business development centers, business incubators, cus-
tomized job training, and discretionary hiring subsidies for firms that hire into newly created jobs local nonemployed residents referred and placed via local workforce agencies. The block grant should aim at a funding level of customized business services so that all targeted firms that need such services could receive quality services. Such a funding level would be significantly greater than what is currently provided—at a guess, at least three times the current national $3 billion in such funding, or around $10 billion per year.

- **Make tax incentives totally state funded, limited in costs, up front, open to tradable firms of all sizes.** Tax incentives should be nonrefundable—that is, limited to a business’s state and local tax burden. For example, incentives could be limited to be no more annually than the sum of the business’s income tax liability plus its local business property tax liability. The term of the incentive should be limited, for example, to no more than three years of the business’s income taxes and property taxes. But the incentive should either be legally an entitlement for eligible firms in eligible counties, or else administered so that smaller firms as well as larger firms are in practice equally eligible. One hundred percent state-funded incentives, rather than local incentives, would help the target counties more, and limit impact on local public services supporting development.

For example, one can imagine a state-funded tax-incentive program that would include an investment tax credit, and a job creation tax credit for full-time permanent jobs that exceeded both last year’s jobs and some base year’s jobs. If this tax incentive program was designed so that its magnitude did not exceed three years of the typical income and property tax liability of a tradable-industry firm, such an incentive package would be about $18,000 per full-time-equivalent (FTE) job. The state/local budget cost of such an incentive package would be less than two-thirds of the current typical state and
local tax incentive package. Because less than half of the state would be eligible for the incentive package, total national costs of such incentives would probably be less than one-third of current national costs for tax incentives of $47 billion: total tax incentive costs would not exceed $15 billion.

However, the incentive package could only be taken against the firm’s actual state and local income and property tax payments over three years, with no carry forwards of unclaimed credits to future tax years, so if the state’s existing business tax system had low taxes, the incentive package would be limited by the lack of any incentive refundability or lengthy carry-forwards. The incentive package would also include some clawbacks if the created jobs and investment were not maintained.

Summary

Table 6.1 summarizes this incentive “ideal” vs. current typical incentive practices. Compared to current incentive policies, the ideal incentive package is more geographically targeted, cheaper, and more oriented toward customized business services. Compared to current tax incentives, the ideal tax incentives would be much shorter term and limited by the firm’s tax liabilities but would be more broadly available to smaller businesses.

POSSIBLE QUESTIONS, WITH RESPONSES

Here are some critiques of the design of this ideal package, with my response.

Why do incentives at all? Why not just do skills development programs or infrastructure programs, which often have high returns? (See Figure 4.2.) First, incentives that are customized business services often have benefit-cost ratios that are even higher than skills development or infrastructure programs (see Table 4.2). Sec-
Table 6.1  Comparison of Current Incentives vs. “Ideal” Incentives

<table>
<thead>
<tr>
<th>Current</th>
<th>Ideal</th>
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<tbody>
<tr>
<td>Untargeted</td>
<td>Targeted at distressed counties and high-tech counties</td>
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<tr>
<td>$50 billion annual costs over all states</td>
<td>$25 billion annual costs</td>
</tr>
<tr>
<td>94% tax incentives, 6% customized services</td>
<td>60% tax incentives, 40% customized services</td>
</tr>
<tr>
<td>One-quarter local property tax abatements</td>
<td>100% state funding</td>
</tr>
<tr>
<td>Tax incentive features: often discretionary, up to 20 years, refundable</td>
<td>Tax incentive features: entitlement, limited to 3-year term, nonrefundable (credited against income &amp; property taxes)</td>
</tr>
<tr>
<td>Average tax incentive: 1.3% of value-added</td>
<td>Average tax incentive: 1.0% of value-added</td>
</tr>
<tr>
<td>Often no budget limit for tax incentives</td>
<td>All incentives part of state business tax budget</td>
</tr>
</tbody>
</table>

SOURCE: Author’s calculations.

ond, the job creation from incentives may benefit persons unlikely to benefit from skills development programs. For example, older workers may benefit because of the jobs created by incentives but are less likely to benefit from job training or education programs. Third, incentives create jobs and higher earnings per capita immediately, whereas the economic benefits from skills development programs or new infrastructure are more delayed. High-quality preschool takes decades to have its biggest benefits. A new highway provides some construction jobs now, but the biggest economic benefits for state jobs and earnings are indeed “down the road.”

**Why not abolish tax incentives, as customized services have much higher benefit-cost ratios?** Customized business services have limits in scale, as such services are only useful to certain types of businesses at particular stages in their development. Tax incentives can be more easily scaled up and are more broadly useful to a wider
variety of firms. In distressed counties or high-tech counties, business tax incentives can have sufficiently high benefit-cost ratios for state residents, as shown in Chapter 4.

**Why not have a fixed budget for tax incentives, rather than a projected budget for tax incentives that are entitlements to eligible firms?** Wouldn’t a fixed budget give states more control over these tax incentives? A fixed tax incentive budget, if enforced, would imply that a state might refuse tax incentives for large projects in targeted counties toward the end of the fiscal year, if the tax incentive budget was insufficient. Such refusal does not make much economic sense: why forego opportunities for new investment and job creation? Such a refusal is unlikely to be politically sustainable: What governor or mayor would want to be perceived as refusing incentives for a significant new economic development project?

The ideal package does significantly limit tax incentives by limiting their amount to no more than three years of the firm’s additional income tax and property tax liability. In addition, the state would seek to each year project the overall net business tax budget, with tax incentives included in the budget. Net business tax receipts, after these incentives, should be no harder to project for state budgeting purposes than is currently the case for business tax receipts. Furthermore, given that incentives will tend to go up with more firm investment and job creation, net business tax receipts should be less volatile with the business cycle than gross business tax receipts.

**Why not offer customized business services statewide, as such services appear to have a high benefit-cost ratio even when unemployment is low?** Local economic development authorities in nontargeted counties should certainly be permitted to offer customized business services. However, state funding should be restricted to targeted counties, as the benefit-cost ratio for such services is much higher in such counties. In addition, for distressed counties, local economic development authorities will have a harder time financing such services. In nondistressed counties, the local revenue base to pay for such services is more adequate.
Why not make tax incentives discretionary, so that economic developers can better target incentives on firms whose location decisions are more footloose, or whose multipliers or other benefits for the states are higher? In my view, economic developers do not have enough knowledge to know when an incentive is truly needed to tip a location decision. The firm knows its location options; the economic developer is not privy to such knowledge. Economic developers are not mind readers.

Our knowledge about firms’ multipliers and effects on local employment-to-population ratios is also limited. As discussed in Chapter 3, commonly used input-output models and econometric models of multipliers and local labor market effects do not reflect many complexities of local economies that may alter economic effects of job growth. Our knowledge about incentive benefits vs. costs is not reliable enough to fine-tune the incentives to each and every firm.

What we do know is that incentives have higher returns if targeted at distressed counties, or at high-tech firms in a few high-tech counties. We should limit ourselves to the most reliable knowledge in incentive design.

Discretion in incentives is likely to lead policymakers astray. Discretion allows incentive magnitude to be unduly influenced by a firm’s size, media clout, or political clout.

Rules are a help to economic development policy, not a hindrance. Rules allow incentive targeting and incentive magnitude to be based on some reliable guiding principles, and to not vary because of political pressures. Rules strengthen the negotiating position of states versus firms in the location game. States can tell firms: here are the incentives we have, and our formulas for awarding incentives. We cannot award you more than what is dictated by those rules, but neither will we be treating other firms differently than we treat you.

Why make tax incentive payments up front, in the first three years, with a clawback? Why not just “pay for results” with incentive payments made over time if the initial jobs are maintained, which is what many states claim to do with their current
incentive programs? “Paying for results” means paying incentives for a long time. Long-term incentives don’t make economic sense, as explained in Chapter 3. Firms’ investment decisions about location and expansion are myopic, focused on profits and costs in the first few years. Therefore, long-term incentives have too low effects on location or expansion decisions per dollar of costs.

Long-term incentives also have bad political effects. Governors and mayors are likely to be more excessive with incentives whose costs will incur when they are no longer in office. Better to remove the temptation by eliminating long-term incentives.

If the concern is about firms receiving significant incentives and then downsizing, this can be dealt with by including clawbacks. With clawbacks, some of the up-front incentives can be recovered if the firm downsizes.

Will the ideal incentive package have enough political rewards to be politically attractive to governors? Will there be enough ribbon cuttings and media coverage of economic development triumphs? Can the geographic targeting be politically sustained? These entitlement tax incentives still will involve some substantial economic development awards for large location decisions. Ribbon cuttings can be scheduled, with impressive numbers for press releases.

If the tax incentive averages about $18,000 per new FTE job, a Foxconn that promises 13,000 jobs can be promised over $200 million in incentives. That’s a lot less than the $3 billion that Wisconsin offered, but over $200 million in incentives is certainly enough for a governor to claim credit in a press release.

If the tax incentive averages $18,000 per job created, an Amazon location decision that promises 40,000 jobs can be awarded incentives of $720 million. This is far less than the $3 billion offered by New York, let alone the over $7 billion offered by other states. However, this incentive award is similar to the $773 million that Virginia offered to Amazon. Such an incentive award is certainly enough for a governor to claim credit in the media.
Virginia’s offer to Amazon also shows that it is possible to package infrastructure assistance and jobs skills programs in a way that allows a governor to claim credit. Virginia’s offer to Amazon combined an almost $800 million cash incentive with $1.1 billion in investments in Virginia job skills and $200 million in infrastructure investments. These related investments included locating a new campus of Virginia Tech in northern Virginia and making improvements to highways and mass transit in northern Virginia. Such improvements may make it more likely that Amazon will hire locally, given that the local skills development pipeline will be better. But such investments might also more generally boost the attractiveness of northern Virginia to other high-tech firms. This Virginia package probably has a much higher benefit-cost ratio than a pure cash incentive. But the more important point is that the state was able to frame this package so that political credit for attracting Amazon was given for providing these investments.126

A more challenging issue is geographic targeting: Is it politically viable? It is hard for a state to completely exclude some counties in a state from a state economic development program. One can imagine that it might be more politically acceptable for a state to offer some support for economic development throughout the state, with higher support for economic development in targeted counties. For example, North Carolina follows a system under which the state’s counties are divided based on economic distress into three tiers.127 The amount of economic development awards is higher in the more distressed tiers, and the local government contribution is less. Geographic targeting is challenging, but not politically impossible.

**THE STATE PERSPECTIVE VS. THE NATIONAL PERSPECTIVE**

In this chapter, the ideal incentive program has been designed from a state perspective, what maximizes state residents’ net benefits.
What about the national perspective? Is this incentive competition a zero-sum game, with no net national economic benefits but sizable government costs? What, if anything, should the federal government do about incentives? The next chapter turns to considering these questions.