Rethinking Tax Incentives

by Timothy J. Bartik

The closest thing to a place-based U.S. industrial policy is state and local business tax incentives. Many current incentives are poorly designed. They cost too much, and they do too little to promote more jobs at higher wages.

Reforms are needed to rein in incentives, by targeting incentives more at high-multiplier jobs in higher-wage industries. The funds saved could be devoted to more effective policies to create local jobs, such as those in customized business services to small businesses.

Incentives Large and Growing

According to my recently developed incentives database, state and local tax incentives to attract businesses are large and growing (Bartik 2017). As of 2015, incentives had an estimated total annual cost of $45 billion. This is roughly the same as the amount that state governments collect in corporate income tax revenue.

From 1990 to 2015, incentives tripled in size. As shown in Figure 1, incentives for the average incented business increased from 9 percent of business taxes in 1990 to 30 percent in 2015. Incentive growth was most rapid in the 1990s. Growth then slowed down from 2001 to 2015.

But the recent incentives offered by bidders for a new Foxconn factory and Amazon’s second headquarters may reignite incentive wars. Wisconsin’s offer to Foxconn was at least eight times as costly per job compared with the average incentive package. Offers to Amazon are also well above average.

Incentives Poorly Targeted

Many incentives are poorly targeted, both geographically and by firm. Across states, incentives have little correlation with state unemployment rates. Adjacent states offer widely different incentives with no clear rationale. As of 2015, incentives were six times as large in New York as in Connecticut, two-and-one-half times as large in South Carolina as in North Carolina, and twice as large in Indiana as in Illinois.

Across industries, incentives show little correlation with industry characteristics that might predict greater local benefits. Incentives have little correlation with whether the industry is more research intensive. As shown in Figure 2, incentives have little correlation with whether the industry pays higher wages.
Incentives Can be Counterproductive for Local Economic Development

Poorly designed incentives can reduce local earnings. Incentive benefits are less than economic developers commonly claim. Incentives can have large opportunity costs by undermining productive local public services.

Research suggests that typical incentives induce less than 20 percent of incented location decisions. For at least 80 percent of the incented firms, the same location decision would have been made without the incentives.

Research suggests that, because of in-migration, only a portion of new jobs increase local employment rates. In the long run, for every ten local jobs created, at least eight jobs go to in-migrants, meaning that only two jobs increase the local employment rate.

Fiscal benefits of incentives are often less than claimed. New jobs do increase tax revenue. But increased population requires more public spending to maintain service quality (e.g., more teachers for more public school students). Increased spending needs will often absorb more than 90 percent of the increased tax revenue. Fiscal benefits are less than incentives’ budget costs. Incentives are not a free lunch. Financing incentives will require raising other taxes or cutting public spending.

In another recent report, I used a simulation model of local economies to look at the net effects of incentives under different scenarios (Bartik 2018). I found that if incentives are financed by cutting K–12 education, those incentives reduce local earnings per capita.

Alternative Policies to Increase Local Earnings per Capita

Without an alternative, tax incentives are likely to expand. Governors and mayors face political pressure to do something to create jobs. If incentives are the only game in town, governors and mayors feel they must play that game to win.

The Politics of Incentives

The political challenge is that incentives have benefits that are concentrated and of short duration. Most incentives go to large businesses. A governor or mayor can hope for a ribbon cutting this year, with many incentive costs postponed to the term of the next governor or mayor.
Incentive reforms’ benefits are more diffuse and long term. The immediate beneficiaries are smaller businesses that are less visible. Local residents benefit from fewer cutbacks in services such as K–12 education, but many such benefits are longer term.

This political bias toward the short-term and toward business “bigness” can be countered. Both news media and interest groups should encourage local debate about what best promotes broad-based economic development over the long term.

References
IT TAKES WORK TO SHAPE OUR FUTURE.

ILR School