TEXAS BUSINESS REVIEW

Bureau of Business Research • College and Graduate School of Business • The University of Texas at Austin
June 1999

The Horse Before the Cart: Toward a More Rational Management of Economic Development Incentives

Michael D. Oden
Assistant Professor
Community and Regional Planning
University of Texas at Austin

Abatements and other tax expenditures are the most popular and widely used incentives to attract business investment. Indeed, the number and dollar value of tax incentives grew significantly in the 1990s, prompting many to complain about an economic war among the states. Horror stories abound about the soaring costs of the battle for business investment: for example, the $250 million package (about $200,000 per job created) from Alabama for a Mercedes Benz factory or the $80 million incentive provided by Michigan to a paper recycling plant employing 34 workers.

Critics argue that competing for jobs with increasingly generous tax breaks wastes scarce public resources and degrades the efficiency of markets. Facing extreme pressures to attract business investment, local officials tend to "overpay" for jobs so that the costs of forgone tax revenues exceed the economic benefits for residents. Localities surrender a portion of their tax base, and incentives can limit funds for essential public goods like education and infrastructure.

Moreover, if incentives encourage firms to select inferior locations, public subsidies may be used to cover private sector inefficiency. For example, Northwest Airlines received a generous subsidy to build a maintenance facility in Minnesota even though the company could have saved 30 percent by locating in more temperate Louisiana. In addition, because incentive deals are used most frequently to attract large company facilities, they may create market-distorting competitive disadvantages for small- and medium-sized firms.

However, the case against development incentives is far from clear cut. Economic theory and empirical evidence show convincingly that under certain conditions tax incentives can yield net benefits and lead to improvements in the distribution of opportunities and income to local citizens.[1] This proposition is based on the prevalence of market failure. Involuntary unemployment or underemployment and underinvestment in human capital formation and research and development are examples of market failures that can affect regional economies. Specific tax incentives can be justified if they overcome these market failures and yield new economic activity that would not be forthcoming without such public sector intervention.

The debate over the value of tax incentives as an economic development tool is primarily based on disagreement over the ability of state and local governments to act rationally and competently to improve the welfare of their residents. The real challenge, then, is to develop decision rules and regulations that would encourage officials to act with greater fiscal integrity in the granting of tax incentives.

Conditions for Welfare-Improving Tax Incentive Deals

For a tax incentive deal to yield net benefits for local residents, a number of conditions must be met. First, it must be shown that the investment in question would not have occurred without incentives. If a firm would have made the same investment without the subsidy, the incentive simply represents a transfer from taxpayers to company owners. Many factors—for example, land costs, labor supply, quality of services—influence companies' location decisions. The tax environment is usually low on the list of locational concerns. It is important for local development officials to develop a "big picture" view, determining the overall competitiveness of the region in terms of other locational factors. If land and labor costs, hard and soft infrastructure, and other important amenities are either clearly superior or clearly inferior to competing locales, then tax incentives are unlikely to yield net benefits, being either unnecessary or inordinately expensive if used to compensate for major cost disadvantages.

Second, the investment induced by tax incentives must generate new economic activity for the region, not displace existing business. A simple principle applies here: goods or services that are sold to firms or residents in other regions ("tradable" goods) are more likely to generate net economic activity. On the other hand, tax incentives for new retail development, office construction, or sports/leisure activities rarely yield significant new jobs and income for a region. Instead, such investments simply move economic activity from existing stores to the new mall, from downtown to the new office park, from local movie theaters to the sports stadium.

Third, the actual net income gains to employees of a new (or expanded) enterprise must be significant given their other options in the local labor market. This condition implies that new jobs going to unemployed or underemployed workers yield the most significant benefits. The correct assumption is that most new employees would be employed elsewhere without the incentive, so the only net economic gain is the extra income provided by the incentive-induced job. If a new or expanding facility hires a number of entry-level workers at good wages in a high unemployment region, net income benefits could be significant.

Finally, for benefits to exceed the tax incentive contributions made by current residents, a significant share of the new jobs must flow to local residents rather than in-migrants. Otherwise, equity and fairness are compromised. Evidence suggests that a significant share (60?90 percent) of new jobs in metropolitan regions typically go to in-migrants.[2] Obviously, in a region with low unemployment rates and high labor force participation rates, new facilities would be forced to hire nonlocal labor. Such would also be the case with industries that use a disproportionate share of skilled technical or professional workers. Correspondingly, industries requiring less specialized, lower skill workers would be more likely to hire locally, as would many types of small businesses. In addition, certain indirect costs can be tied to the share of jobs going to in-migrants. Higher levels of in-migration can increase the need for new services, schools, and infrastructure. In terms of fiscal effects, migrating workers and their families often consume more in local public services than they contribute to local tax revenues.

Are State and Local Governments Using Tax Incentives Effectively?

To determine if the use of tax incentives leads to overall improvements in economic welfare, two questions must be addressed. First, do tax incentives lead to an overall increase in private investment and employment? Second, do they encourage investments in areas with high unemployment and/or excess infrastructure where positive net benefits would be greater?

The vast majority of recent studies suggests that state and local tax incentives can be positively associated with investment and other measures of economic activity. However, the influence of tax differentials on investment, while significant, is overshadowed by other factors, such as quality of the workforce and public services. The best evidence indicates that tax incentives have, at most, a very modest influence on business investment and are much less powerful than other factors (e.g., education) that might also be affected by state and local policy.

There is even less support for welfare gains from tax incentives moving jobs from low to high unemployment states or cities. A recent study of tax incentives across the nation found they did little to induce investment in high unemployment areas.[3]

A study of 374 tax abatement agreements in Texas found that taxes abated averaged $11,553 per job created.[4] Although the benefits associated with these abatements were not estimated, this cost-per-job number represents a high threshold to exceed for incentives to yield positive net benefits. Because abatements affect mainly property and franchise taxes, it is hard to imagine that tax incentives are strongly redistributive in Texas. It therefore seems questionable that tax incentives for development in Texas have unambiguously improved economic welfare or yielded positive net benefits for the state.

The preponderance of evidence suggests that the use of tax incentives for development is, at best, an inferior means to improve economic welfare. Yet the political attractiveness of incentive deals makes it unlikely that states and localities will limit tax breaks and turn to more effective economic development strategies. Given this reality, it is crucial to consider ways that tax competition could be regulated or made more efficient.

Better Control or Management of Economic Development Incentives

A number of mechanisms have been proposed to limit or better manage tax competition for business. The most stringent proposals call for federal initiatives that would effectively eliminate tax incentives by state and local government or require that the value of an incentive be reported as income and taxed at 100 percent. Such policies would face enormous political obstacles, but might also have a chilling effect on innovative and effective state and local economic development policies. Banning the use of incentives in high unemployment, high poverty areas might produce negative equity and welfare effects and could eliminate job training and small business assistance programs with high payoffs.

A more feasible and effective approach would be for states to legislate a series of simple requirements and best practice standards. These would require disclosure and accountability on the part of local development authorities and would create incentives for adherence to decision-making rules that would increase the likelihood of economic welfare gains. For example, Texas could pass a state law that required that every tax incentive deal offered to a private entity be accompanied by a publicly accessible report (see below).

Such a reporting requirement would go a long way in limiting excessive and wasteful tax incentive deals. The rules would encourage communities to carry out a logical sequence of steps to determine if incentive deals would lead to welfare gains or losses. The procedure implied by the reporting requirements further encourages development authorities to put the horse before the cart, that is, estimates of the benefits of incentive deals should logically be made and debated before the incentive is offered. The value of total benefits accruing to local residents should represent the upper cap on the value of the incentives offered, which would preclude overbidding. Upfront analysis would also help ensure an appropriate match between local economic conditions and those desired by industries offered tax incentives and deter opportunistic deal making. The final requirement for a clawback agreement would ensure that the tax incentive offered related directly to the actual investments made instead of promises that may not be fulfilled.

Notes

1. Timothy Bartik, "The Market Failure Approach to Regional Economic Development Policy," *Economic Development Quarterly*, 2, 1990; "The Effects of State and Local Taxes on Economic Development: A Review of Recent Research," *Economic Development Quarterly*, 6:1, 1992; Joseph Persky, et al., "How Do We Know That ‘But for the Incentives’ the Development Would Not Have Occurred?" in Bingham and Mier, eds. *Dilemmas of Urban Economic Development*, 1997.

2. Timothy Bartik, "Who Benefits from Local Job Growth: Migrants or the Original Residents?" *Regional Studies*, 27:4, 1993.

3. Peter Fisher and Alan Peters, *Industrial Incentives: Competition Among American States and Cities*, 1998.

4. Thomas Kelly, et al., "The Efficiency of Tax Abatement in the Market for Jobs," *Journal of Economics*, 23:2, 1997.

5. Melvin Burstein and Arthur Rolnick, "Congress Should End the Economic War Among the States," *The Region*, Federal Reserve Bank of Minneapolis, March 1995.

Proposed reporting requirements for tax incentive deals

- A statement outlining how pro-posed tax incentives relate to broader economic development strategies.
- A rigorous, standardized estimate of the direct and indirect benefits that would accrue to local residents from the incentive-induced investment.
- A full disclosure of all incentive costs and estimates of indirect costs related to providing services to in-migrating employees.
- A formal cost benefit estimate that demonstrates that the project yields positive net benefits.
- A "clawback" agreement to ensure that if the company does not live up to the agreement (e.g., makes fewer hires or investment expenditures that promised), tax abatements will be adjusted.

---

21 June 1999
Comments to: *sallyf@mail.utexas.edu*