# Better business incentives for better prosperity

Making Sense of Incentives: Taming Business Incentives to Promote Prosperity. By Timothy J. Bartik. Kalamazoo, MI: W. E. Upjohn Institute for Employment Research, 2019, 181 pp., $14.99 paperback.

Are you a legislative representative who wonders how to create jobs in your district? Are you a local resident or a social development expert who seeks to understand the benefits and costs of business incentives in a region? If the answer to any of these questions is yes, you may want to read Timothy J. Bartik's new book, *Making Sense of Incentives: Taming Business Incentives to Promote Prosperity*. The book, divided into seven chapters, uses an economic model and empirical data to examine the costs and benefits of incentives, identifies best practices for evaluating the effects of incentives, and offers recommendations on how state, local, and federal policymakers can reform incentives to foster prosperity.

The author defines incentives as business assistance programs that provide companies with benefits such tax breaks, cash grants, free land, and free job training. These programs, offered by local governments, aim to encourage businesses to locate or expand in a local area and boost growth. The first U.S. incentive program, launched in Mississippi in 1936, was the state's "Balance Agriculture with Industry" program. This program provided for low-cost land and no property taxes, aiming to develop the local agricultural industry and promote job growth. Since 1990, incentives provided to firms have tripled, reaching an annual level of $50 billion nationwide. In 2017, the state of Wisconsin provided more than $3 billion to electronics manufacturer Foxconn, which agreed to build a new manufacturing plant for flat screen panels. Between 2017 and 2018, numerous states offered over $7 billion to Amazon for its planned second headquarters.

MAKING SENSE OF INCENTIVES

Taming Business Incentives to Promote Prosperity

Timothy J. Bartik
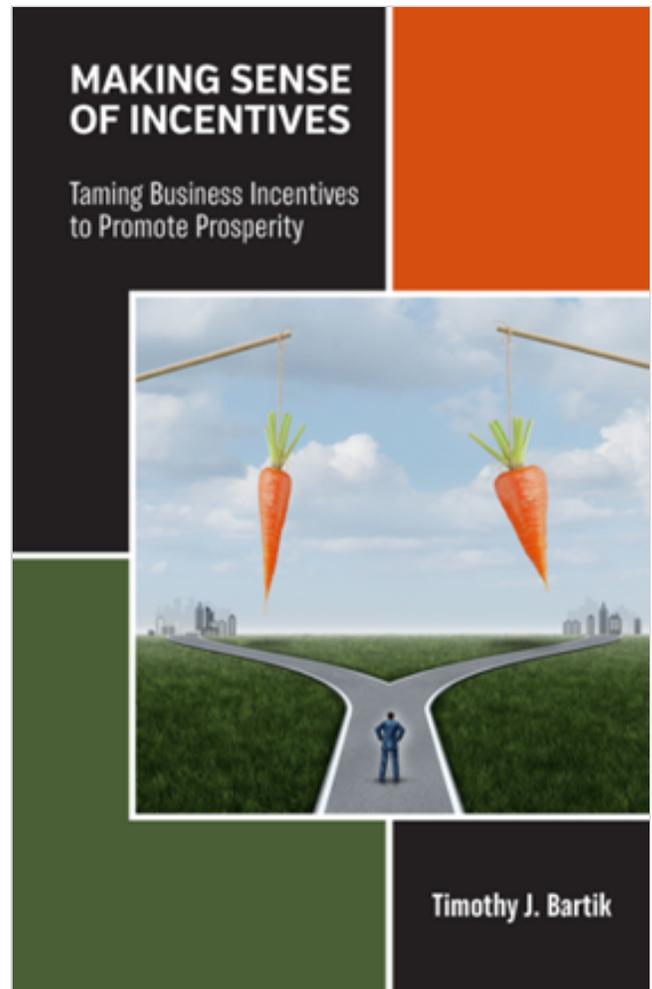
Rafia Mijiyawa
mijiyawa.rafia@bls.gov

Rafia Mijiyawa is an economist in the Office of Employment and Unemployment Statistics, U.S. Bureau of Labor Statistics.

Incentives, especially tax breaks and cash grants, have contributed to economic growth, and this contribution has grown from a very low level in 1990 to almost $20 billion annually today. To analyze the benefits of typical incentives distributed in the U.S. economy, Bartik creates an economic model he names "baseline model." This model uses estimates of state labor market indicators, tax revenues, and local government budgets as inputs. The model is based on four assumptions. First, it is assumed that more than 90 percent of the total incentives provided by a state are tax and cash incentives with a "but for" value of 12 percent, meaning that the incentives account for about 12 percent of firm location or expansion decisions. Second, each state's average unemployment rate is assumed to be 3.9 percent (2018 U.S. average unemployment rate). Third, the effective job-multiplier rate for the incentives is assumed to be 1.75, which means that, for every 100 jobs created by incentives, another 75 jobs are created in the state, for a total gain of 175 jobs. Finally, the incentives are assumed to be paid for by increases in household taxes.

The baseline model finds a benefit–cost ratio of 1.52, indicating that $1 spent on incentives leads to an increase of $1.52 in gross ($0.52 in net) per capita income. In addition, for the lowest income quintile, the percent boost to income is triple the average for all households. However, the benefit–cost ratio depends on each state's circumstances and incentive programs. Cash incentives received by firms and their stockholders are paid either by cutting public spending, which affects social programs and productivity, or by tapping tax revenue from low-income households, which benefits the wealthiest households. The progressive distribution of incentive benefits and the regressive distribution of incentive costs are both captured in the baseline model.

Other incentive programs, such as those providing customized business service incentives and high-tech business clustering incentives, have substantial benefit–cost ratios (16.15 for customized business service incentives and 2.71 for high-tech business clustering incentives). Yet, Bartik finds that these programs are more challenging to implement than tax incentive programs, stating that not all locations are Silicon Valley or biotech centers. Only 60 of about 700 local labor markets in the United States have high-tech concentrations large enough to yield significant multiplier benefits from high-tech jobs. In addition, to develop customized business services, leaders need to implement costly technological and human capital improvements and find new markets.

Bartik believes that, to successfully promote job growth through incentives, evaluators of incentive programs must observe some fundamental principles. One such principle is to avoid bias in selecting which firms receive incentives and instead make such selections by using objective criteria. For instance, evaluators should avoid providing job-retention incentives to firms with a high risk of job loss. They must apply a regression discontinuity design, whereby a quantitative cutoff score is used to assign assistance to firms or geographic areas and avoid implementing the same incentives across areas with different characteristics. Furthermore, evaluators must gather enough sample data to assess the benefits and costs of tax incentives, estimate the proportion of new jobs that go to local residents (versus in-migrants), and assess how this proportion varies with local economic conditions (tax revenues and public spending). For other incentives, such as customized business services, evaluators must use surveys to estimate job-creation effects and make downward adjustments to obtain conservative estimates.

Bartik finds that reforming existing incentive programs can significantly boost prosperity. Incentives received by the average firm offset 30 percent of the overall state and local business taxes that the firm would pay. The Foxconn deal, for example, meant paying Foxconn a wage subsidy of 30 percent for 20 years. According to Bartik, providing such long-term assistance could be costly to state economies. He recommends three solutions. First, local policymakers and governors should limit tax breaks to 3 years and reduce residents' tax rates. Adopting a modest

business tax rate is also important, because high taxes can drive businesses to other states. In Bartik's framework, 60 percent of total incentives would be in the form of tax breaks and the remaining 40 percent would represent other incentive programs. Indeed, savings from reduced reliance on long-term tax breaks can be used to finance public infrastructure projects and skills development programs. In fact, community college workforce programs have a benefit–cost ratio of 8 to 1. Second, policy leaders must eschew their political ambitions and assist firms that produce tradable goods and services, irrespective of firm size. Economically distressed areas with excess labor supply should be particularly targeted. Job multipliers are higher if incentives go to locally owned firms or distressed economic areas, which have a benefit–cost ratio of 3.15. Moreover, because local business incentives have positive growth effects on the overall economy, providing higher incentives to distressed areas stimulates employment and productivity at the national level. Finally, Bartik suggests that the federal government should eliminate all discretionary business tax incentives and provide block grants of between $10 and $20 billion annually for infrastructure projects, skills development programs, customized business services, and housing supply in targeted areas. He states that, compared with tax incentives programs, grant programs are more practical and effective in promoting job growth.

Employment issues have always been at the center of economic and social policy debates. Economists like Bartik continue to search for solutions that could boost employment and growth. Yet, Bartik's proposal for a federal government intervention in state economic policies may be too ambitious, because federal leaders have to deal with other important policy issues, such as those surrounding healthcare, climate change, and national security.

The book will appeal to both those who want to design and implement successful business incentive programs and those with an interest in employment policy. Bartik's ideas and arguments are well articulated and can be understood even by readers with no economics background. The author uses very recent data and presents graphs that simplify and support his analyses.