



## The Double-Edged Sword of Economic Development Incentives

By Rachel Barkley

State and local governments can be in stiff competition with international locations, other states, and even neighboring jurisdictions for development.

Economic development incentives are offered to some degree by almost every state and can play a key part in state and local government's ability to compete for business relocations and expansions. Lately, they've been used to an increasing degree to spread economic activity to underdeveloped areas, diversify the economy, or increase the concentration of a perceived in-demand industry, with 12 states mentioning some type of incentive in their 2018 State of the State addresses.<sup>1</sup>

States and local governments can be in stiff competition with international locations, other states, and even neighboring jurisdictions. On a theoretical level, incentives lead companies to either expand or relocate in a particular area. On a local level, these companies generate jobs and pay property taxes, while they contribute to corporate income and sales tax contributions for states. Depending on the size of the companies and the concentration of the sectors in the area, they may also drive the location of similar companies or complimentary enterprises, such as suppliers, due to benefits from agglomeration.

This can, in certain cases, lead to an escalation or bidding war among competing jurisdictions, as seen on a grand scale currently with cities competing for the upcoming Amazon secondary headquarters (HQ2). It also occurs on a local level between neighboring

jurisdictions, in instances that are not as widely reported. Frisco, Texas, was recently forced to increase its incentive package for Rockwell Collins, a defense contractor, with an additional \$400,000 grant after the nearby City of Plano put in a competing offer to house the company's planned expansion.<sup>2</sup>

The amount of incentives granted in any year varies greatly, based on who is measuring them and what is included. The Upjohn Institute has found that incentives for exporting industries totaled \$45 billion in 2015 alone,<sup>3</sup> while other studies have found total incentives to range from \$65 billion<sup>4</sup> to \$90 billion annually.<sup>5</sup> However they are measured, the general trend of incentives seems to be increasing, with incentives more than tripling since 1990.<sup>6</sup> In Texas alone, municipal economic development corporations increased their annual incentives granted increased by 53 percent from 2007 to \$139 million in 2015.<sup>7</sup> Incentives may take the form of property tax abatements, job creation tax credits, research and development tax credits, grants, customized job training, and infrastructure, with property tax abatements and job creation tax credits being the most commonly awarded incentive in recent years.<sup>8</sup>

These incentives can have a direct impact on budgets. The State of Michigan's \$454 million fiscal 2015 general Fund gap was driven by business tax credits.<sup>9</sup> The costs of these credits had increased by more than \$200

million annually from original projections and are slated to continue until 2032, despite the program being closed since 2011.<sup>10</sup>

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ARE THEY EFFECTIVE?

As these incentives affect government finances, it makes sense to study their effectiveness. Numerous academic studies have been undertaken to identify the impact of incentives on economic development. Unfortunately, the results are mixed, leading to no clear consensus.<sup>11</sup> (See Exhibit 1.)

The Upjohn Institute has found that incentives can positively influence corporate location decisions to some degree.<sup>12</sup> The ability to influence loca-

tion decisions decreases as the availability of incentives often ranks below other concerns for corporate executives. In terms of site selection, tax exemptions rank fifth below highway accessibility, labor costs, the availability of skilled labor, and quality of life in importance, while other state and local incentives rank ninth.<sup>13</sup>

The importance of other factors in site selections was seen earlier this year when the State of North Carolina offered \$1.5 billion in incentives in hopes to win a Toyota-Mazda auto plant, which chose instead to locate the facility in the State of Alabama, which provided \$380 million in incentives.<sup>14</sup>

Historically, however, when incentives have affected firm location decisions, they often haven't led to a positive return on investment for governments due to the awards not being strategically targeted.<sup>15</sup> A recent study by the University of Texas, Austin, which evaluated state incentive programs in Maryland and Virginia, supports these findings. Both states monitor incentive firms on an ongoing basis and have the

ability to cancel incentive agreements and claw back awards if job creation milestones are not met. As a whole, incentivized firms were found to generate no additional jobs, compared to non-incentivized firms.<sup>16</sup> The relative ineffectiveness of the programs were found to be due to how they were awarded, as roughly 70 percent of the firms receiving incentives had already decided to locate or expand in that particular area.

Incentives that have been shown to be more effective are those strategically targeted to industries, especially industries that increase international trade.<sup>17</sup> Brookings echoes this in a recent review of city economic development incentives, finding cities would be best served by targeting incentives to increase their comparative advantage, innovation, productivity, wage gains, and trade activity.<sup>18</sup>

THE EVOLUTION OF INCENTIVES

Based on the critiques on the value of incentives, many state and local governments have implemented screening processes to increase the value these programs add. As seen in Virginia and Maryland, many governments now tie incentives to certain criteria being met over a period of time, such as a set level of jobs created or employee payroll, and allow for awards to be clawed back in the event these benchmarks are not met. Between 2015 and 2016, 13 states passed laws requiring incentives to be evaluated on a regular basis,<sup>19</sup> while Connecticut and Pennsylvania passed legislation in 2017. The State of Connecticut now requires lawmakers to hold hearings every three years to address findings of incentive evaluations, while the State

Exhibit 1: Area Development's 2017 Corporate Site Selection Factors Survey Results

| Ranking Factor Respondents      | Percent |
|---------------------------------|---------|
| Highway Accessibility           | 91.3%   |
| Labor Costs                     | 91.1%   |
| Availability of Skilled Labor   | 88.8%   |
| Quality of Life                 | 87.2%   |
| Tax Exemptions                  | 85.9%   |
| Occupancy or Construction Costs | 85.9%   |
| Proximity to Major Markets      | 84.6%   |
| Corporate Tax Rate              | 83.2%   |
| State and Local Incentives      | 81.3%   |
| Available Land                  | 76.9%   |

Source: Area Development

of Pennsylvania will now require the Independent Fiscal Office to review all tax credits at least one every five years.

To improve effectiveness, there is also a trend toward targeting incentives to certain industries that have high average wages or have been shown to have large spill-over effects. The high-tech industry, particularly, fits both of these criteria, including a 6:1 spillover effect, producing six total local jobs for each industry job created.<sup>20</sup> Based on a review of four major U.S. local governments (Cincinnati, Indianapolis, Salt Lake County, and San Diego), advanced industries with concentrated efforts in research and development and science, technology, engineering, and mathematics (STEM) have received 33 percent of incentives, while accounting for only 20 percent of economic output.<sup>21</sup> San Diego especially stands out in this regard. Between 2012 and 2016, 64 percent of its incentives went to advanced industries, which account for 21 percent of area economic output. These four local governments were also found to grant incentives to industries that have average wages well above the area median.

Additionally, states are targeting incentives geographically in order to increase development in certain underdeveloped areas. The State of North Carolina divides its counties into tiers based on their level of economic distress, with tax incentives varying by tier.<sup>22</sup>

These improvements in incentive monitoring and targeting have varied widely among states. Pew grades states on the extent to which they have implemented best practices for evaluating tax incentives, including having a plan to regularly evaluate incentives, mea-

suring the impact and using these findings to inform policy choices.

The states of Connecticut, Florida, Indiana, Iowa, Maine, Maryland, Minnesota, Mississippi, Nebraska, Oklahoma, Virginia, and Washington are currently found to be “leading” states for 2018, with well-designed plans that follow best practices. An additional 16 states are making progress, while the remaining 22 are trailing.

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Perhaps most concerning for analysts, many of the states that are significant issuers of development incentives are not ranked as leading. The State of Alabama, which has used incentives to help it become a leader in the automobile industry, is labeled as “making progress,” having adopted a four-year evaluation cycle in 2016.<sup>23</sup>

Among the “trailing” states, Michigan launched a new sales and use tax exemption for data centers in 2015 but does not yet have an evaluation protocol.<sup>24</sup> This is particularly concerning given its budgetary pressure from previously granted incentives. Georgia, which has used tax incentives to grow its film industry, also does not evaluate incentives, despite allowing an estimated \$414 million in state film tax credits in fiscal 2018 and an additional \$176 million in other economic development tax incentives.<sup>25</sup> California, which estimated that its tax incentives totaled

\$5 billion for fiscal 2013 alone, was advised in a 2016 report by the State Auditor that adopting a comprehensive oversight model would aid the effectiveness of future awards.<sup>26</sup>

## CONCLUSIONS

The use of economic development incentives is not going away. Given their variance in effectiveness and potential budgetary impact, analysts need to be aware of the degree of incentives awarded by states and local governments, how these incentives are targeted, and how they’re monitored.

The burden on state budgets may become a credit negative for certain states, especially those who are frequent users of tax incentives that do not follow best practices, and should be watched carefully by analysts. ■

### Notes

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2. Jill Cowan, “North Texas Cities Turn Incentives Arsenals Against Each Other in Fight for Businesses, Jobs,” *Dallas Morning News*, March 29, 2018.
3. Timothy J. Bartik, “A New Panel Database on Business Incentives for Economic Development Offered by State and Local Governments in the United States,” the Upjohn Institute for Employment Research, 2017.
4. Kenneth P. Thomas, *Investment Incentives and the Global Competition for Capital*, 2011.
5. Louise Story, “As Companies Seek Tax Deals, Governments Pay High Price,” *New York Times*, December 1, 2012.
6. Bartik, 2017.
7. Biennial Economic Development Corporation Report 2014-2015, Texas Comptroller of Public Accounts, November 2016.
8. Bartik, 2017.
9. Paul Egan, “Michigan Budget Picture Worsens,” *Detroit Free Press*, January 14, 2015.
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## GFOA Resources

GFOA offers several best practices to help governments with their economic development strategies (available at [gfoa.org](http://gfoa.org)), summarized below.

### Administering Economic Development Agreements

Once an economic development agreement is in place, government officials must ensure proper administration, which includes:

- Creating processes to monitor performance milestones and compliance requirements.
- Communicating progress to the governing body and other interested stakeholders.
- Establishing safeguards to trigger early detection of any problems that may require renegotiation or termination of the contract.
- Managing the agreement requires ongoing assessment of government benefits, monitoring of commitments and requirements, and communicating progress to the governing body.

### Coordinating Economic Development and Capital Planning

Successful economic development strategies require coordinated long-term capital planning to ensure that the necessary infrastructure is in place to support development. GFOA recommends that governments:

- Align the organization-wide goals and objectives.
- Evaluate potential impacts and benefits.

- Coordinate economic development strategies with other initiatives and government entities.
- Optimize the time element of capital planning.
- Recognize the value of public infrastructure as an economic development strategy.
- Estimate the impact of development on existing assets and ongoing maintenance.
- Estimate full life-cycle costs of new capital assets.
- Identify appropriate opportunities for developers to fund capital assets.

### Creation, Implementation, and Evaluation of Tax Increment Financing

Tax incremental financing (TIF) can be an important tool for local governments to attract economic development projects, create jobs, foster infrastructure investment, and/or redevelop blighted areas.

TIF is a technique for funding a qualifying capital project, its related infrastructure, or maintenance of the project from a stream of revenue generated within the geographic area defined as a TIF district. When a redevelopment agency uses TIF, it may share or redirect property or other taxes imposed by other taxing entities. TIF generally relies on incremental property taxes generated in a specific area, but it can also apply to other taxes, including sales taxes.

This best practice provides detailed recommended evaluation and implementation steps.

Evaluation of Maryland and Virginia Programs," University of Texas at Austin, December 2016.

12. Bartik, 2017.

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15. Bartik, 2017.

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17. Ann R. Markusen, "Reining in the Competition," the Upjohn Institute for

Employment Research. 2007; and Marc J. Melitz and Daniel Treffer, "Gains from Trade when Firms Matter," *Journal of Economic Perspectives*, 2012.

18. Joseph Parilla and Sifan Liu, "Examining the Local Value of Economic Development Incentives," Brookings, March 2018.

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Research Center, Andrew Young School of Policy Studies, Georgia State University, 2005.

23. Pew Trusts, 2018.

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25. Georgia Tax Expenditure Report for FY2018, Fiscal Research Center of the Andrew Young School of Policy Studies at Georgia State University, December 2016.

26. Corporate Income Tax Expenditures, California State Auditor, April 2016.

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