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The Impact of Economic Development Incentives : A Review of the Literature

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Policy Brief

THE IMPACT OF ECONOMIC DEVELOPMENT INCENTIVES AND PROGRAMS: REVIEW OF THE LITERATURE

by Dave N. Norris and Elizabeth M. Higgins

Overview of Report

Economic development policy is a priority issue for most public officials, and business incentives are a popular tool for achieving economic development objectives. Among the challenges facing legislators seeking to produce effective policy is a lack of objective, independent information on the true benefits of specific programs. Dr. Dave Norris, Jr. and Elizabeth Higgins, both of Louisiana Tech University, have conducted of review of research on the topic of economic development incentives and programs, and determined the implications of the evidence for policy in Louisiana. The purpose of the study, contracted by the Louisiana Department of Administration and submitted to the Louisiana Department of Economic Development, is to provide information for policy-makers to help answer many of the questions about economic development policy.

This report is based on a review of over 40 studies, including single research projects, meta-analyses of empirical studies, previous literature reviews and theoretical papers. The evidence provides support for certain policy directions. This is the first in a series of reports under the "Independent Economist Project." The final Report, due in November 2005, will include a comprehensive review of Enterprise Zones, Economic Development Awards Program, Quality Jobs, Small Business Loan Program, BIDCO, CAPCO, and the Act II oil and gas exemptions for inactive wells. It will also contain a comparison of Louisiana's business tax environment to that of the surrounding states.

Research Results

Taxes and Tax Incentives: A state's tax burden will affect economic activity to the degree that it deviates from relevant comparison states. But while specific types of taxes may vary significantly from one state to the next, research indicates that the variation in overall, effective tax levels is generally not large enough to matter. Consequently, taxes do not appear to have a substantial effect on economic activity among states. Also, several studies suggest that since incentives cannot offset the effects of state and local tax systems, ad hoc tax reforms are not effective tools for improving the business climate or resolving systematic deficiencies in a tax or fiscal system.

Other specific results reported in this area of the literature include the following:

- Incentives tend to offset higher taxes on businesses located in low-income areas and reinforce existing differences between wealthy and distressed regions.
- More often than not economic development policies are not cost-effective, meaning the long-term economic benefit is less than the cost in foregone tax revenue or government expenditures. Economic development incentive programs are more likely to pass a benefit cost test if: local unemployment is high, the jobs pay well relative to the skills required, and many of the jobs go to local residents.
- Business taxes generally are not high enough for cuts to make a significant difference in business costs and, subsequently, in economic growth. And political factors as well as the fiscal realities of providing adequate funding for public services often make large cuts infeasible.
- From 50 to 70 percent of the jobs tax credits granted to employers are payments for workers who would have been hired even without the subsidy, making these programs cost-ineffective. Incentives have not increased the number of new jobs created in expanding a company, and companies have been overestimating the number of jobs they will create to receive better incentive packages.

Special Incentives Packages: Most research, including employer surveys, indicates that state and local tax incentives and financial inducements are not the only or even the primary influence on business location and expansion decisions, and most factors in the decision are beyond the purview of government. Analysis indicates that taxes are relatively insignificant when compared to other factors such as labor, transportation, and utility and occupancy costs, and as a result, incentives have little impact on business location or expansion decisions. Tax levels matter more as a desirable location factor rather than a "must" factor; and they become more relevant near the end of a site search when firms are choosing between similar communities within a state after the choice of states has been made.

Other specific results reported in this area of the literature include the following:

- Research indicates that states tend to offer incentive packages that are not cost-effective and end up with fewer jobs and tax revenues than they had anticipated, partly due to a lack of information. Most incentive-targeted firms would have undertaken their projects without incentives.
- Incentive packages and policies geared toward building regional clusters are more likely to produce positive economic benefits.
- Incentives provide an unfair advantage to large firms with leverage to negotiate favorable deals with governments. These policies can penalize existing businesses by increasing their share of the tax burden to subsidize relocating firms and can harm their growth prospects by pitting them against subsidized competitors.

Enterprise Zones (EZ): The trend in states with long-standing EZ programs has been to increase the maximum number of zones allowed. Studies indicate that the overall incentive packages have the effect of reducing business labor costs, but do not seem to have a large effect on location decisions. This is partly due to the fact that existing EZ businesses are more likely than others to take advantage of the incentives. As a result, EZ programs have not had a significant impact on local employment in most states. Research also indicates that most state EZ's programs have been relatively ineffective at addressing deep-rooted problems such as racial inequality, welfare dependency or urban decay. Many of these problems would be better addressed directly. However, some analysts argue that if the number of zones was significantly restricted and the EZ incentives were larger, properly targeted, and managed correctly, they could be effective.

Public Services and Infrastructure Investment: The key issue in public finance is finding the right balance between tax policy and public spending and identifying the types of public investments that provide the greatest return. In many studies, government spending or public services are found to exert a positive effect on economic development.

Some specific results reported in this area of the literature include the following:

- Because spending for education and transportation investment have been shown to promote growth, business tax reductions financed by cutting education and transportation spending will probably reduce job growth.
- Several researchers have reported that higher taxes, when used to increase spending on health, highways, schools or higher education, could produce a net positive effect on growth. Tax increases used to fund local schools and fire protection can increase the rate of small business creation. Increases in higher education and health spending can boost manufacturing output when financed by property tax increases, but not if financed by non-property tax increases.
- A number of studies suggest that tax cuts paid for by reducing welfare spending, which are transfer payments, rather than public services, may promote economic growth and help create jobs. However, welfare payments are traditionally only a small portion of states' budgets and growing smaller.
- Several studies suggest that business information programs that are locally run, with extensive business involvement can promote growth. Also, entrepreneurial training and customized job training assistance programs can increase the rate at which entrepreneurs start up new businesses and improve business productivity.

Implications for Economic Policy in Louisiana

The Biennial Unified Economic Development Budget Report, due in November 2005, will provide detailed information on Louisiana economic development programs based on the ongoing evaluation study. However, the research reviewed and presented in this report provides some general guidance for policy direction in the state of Louisiana. The policy implications most strongly supported by the research evidence are as follows:

- Require periodic evaluations of incentive programs to ensure policy is effective and cost-efficient. Require cost-benefit studies for large incentive packages and new or revised tax incentive programs or tax cuts. Such studies should weigh long-term benefits against fiscal effects on tax revenues, social impacts, alternative uses of public monies, the impact on non-assisted firms, and other costs of living and doing business as a result of growth.

- Require legally binding performance contracts and truth and disclosure in incentive programs to ensure government and employers are accountable.
- Focus business assistance programs on export-based (out of region) firms for greatest impact. Furthermore, focus on policies that promote higher paying jobs that go to the local residents in areas where local unemployment is high. Award incentives only if they do not put other businesses in less competitive positions in the market or devastate one local economy at the expense of another.
- Do not use ad hoc tax reforms to resolve systematic deficiencies in the tax system or improve the business climate. It is far preferable to promote general tax reform that helps build a balanced, fair and predictable tax system with moderate rates across a broad base and adequate funding for quality public service provision.
- Reduce emphasis on general jobs tax credits programs since they have little impact on new job creation and are not cost-effective. Sizable incentives, targeted at high-wage employment in low wage areas offers more promise if those programs are closely monitored for compliance and effectiveness.
- Reduce emphasis on special incentive packages that have little effect on the location or expansion decisions and often cost more than any long-term benefit. Employ these types of inducements only when there is clear evidence that the firm is comparing locations with similar costs and amenities.
- Avoid using tax incentives for redistributive purposes or as assistance to economically distressed communities. Direct assistance in the form of infrastructure investment and public service expenditure is more likely to be productive in mitigating inequalities and revitalizing depressed regions.
- Avoid tax cut policies that are likely to lead to a reduction in the level and quality of public service provision, especially education and infrastructure, since that will likely reduce job growth. Most research indicates that business taxes generally are not high enough for cuts to make a significant difference without leading to a reduction in the quality of funding for public services.
- Support and encourage business information programs that are locally run and have extensive business involvement. Promote entrepreneurial training and customized job training assistance that has been proven to increase the rate of new start-ups and improve business productivity.

Conclusion

Policy-makers looking to make sound, fact-based policy decisions should not rely on a single study, especially when there is such a vast array of information available. Rather policy should be based on the overall balance of the empirical evidence weighed against common sense, values and feasibility. Most economists would recommend economic development policy based on sufficient and appropriate infrastructure investment and service provision, and a balanced, predictable and fair tax system. If an incentive policy can pass a cost-benefit analysis, is motivated by economic rather than political needs, and fiscal and performance accountability measures are in place, then most economists would argue that it can have a positive impact on growth.