

# Ask Dr. Dave

## Explaining Politics and Policies

January 9, 2006

Dr. Dave: Do state and local economic development tax incentives help state and local economies?

A. In the vast majority of cases, the answer is no. Robert G. Lynch, Chairman of the Department of Economics at Washington College sums up the thinking of most economists. There are “little grounds to support tax cuts and incentives—especially when they occur at the expense of public investment—as the best means to expand employment and spur growth.” [1]

Billions of dollars a year are “spent” by states, counties, and cities on economic development incentives in various forms (e.g. tax abatements, tax reductions, direct grants, infrastructure investment, etc.) Government officials and private sector applicants argue that these tax expenditures pay for themselves in additional revenue created by new or expanded businesses and job creation.

Over the last 30 years, hundreds of public and private sector analyses have evaluated the impact and value of economic development incentives. [2] Their conclusions vary widely; most often because of variations in the way they approach the analysis.

Any study of the value of economic development incentives must first decide what to count as costs and benefits. Most analyses, remarkably, count only benefits. A report by the Massachusetts Budget and Policy Center concludes that a series of studies suggesting that corporate tax incentives lead to job growth “appears to be fundamentally flawed, as it simply assumes that the Commonwealth does not have to pay for corporate tax incentives.” [3]

More sophisticated studies include the negative, as well as the positive side, of the equation. That means taking into account a number of different costs.

1. Additional public and private costs generated by a large new business. For example, increased congestion, higher overall labor costs, environmental deterioration, new infrastructure costs, and additional public service costs such as police and fire protection.
2. Loss of tax revenue resulting from the negative impact of the new business on existing businesses.

This is particular true for incentives to businesses that only sell their product or services to the local community (e.g. retail). Having a Wal-Mart or a Home Depot move into the area does not increase overall spending on groceries or light bulbs. It redirects spending for those items that would otherwise go to other local businesses.

Retail incentives are almost always a net revenue loser. (See the New Rules Retail Sector for a list of studies and local initiatives in this area).

Incentives to sports arenas have a similar negative net impact, although some might argue that there may be an important qualitative benefits attached to such incentives (e.g. being a "major league" city).

### 3. Budget cuts that result from spending on economic development incentives.

This is especially important to consider when, as is the case today, overall budgets are tight or being cut. Which brings up another important feature of tax incentives. Direct appropriations - everything from education, to transportation, to maintaining state office buildings - must be approved each and every year. Tax expenditures, on the other hand, carry over automatically, with no need for annual approval and without regard to existing fiscal conditions.

The national trend in the 1990s was to reduce business taxes and create or expand incentives for business investment. At that time, state tax receipts were growing at about 6 percent a year. By 2000, however, state forecasters were already predicting that tax revenues would barely keep pace with inflation as delayed tax cuts began to take full effect.[4] Today those incentives are still draining money from local and state treasuries even while core budgets are being cut.

As one observer notes, "Rather than requiring a vote in favor of continuation, a tax expenditure continues until a vote in favor of eliminating it occurs." [5] And such a vote requires political courage, for it is viewed as a tax increase. It is far easier to cut direct expenditures than it is to cut tax expenditures.

### 4. Reduced economic development because of cuts in public services.

Ironically, economic development incentives can lead to less economic development if they lead to cuts in public services. Studies have consistently found that spending on public services - especially education and infrastructure - has a positive effect on economic development.[6]

A review of existing literature on incentives conducted for the Louisiana Department of Economic Development in 2003 concluded tax incentive programs "often have no measurable impact on growth, and even when they do, it is likely that they are not cost-effective...most economists in the field would recommend economic development policy based on sufficient and appropriate infrastructure investment and service provision, and a balanced, predictable and fair tax system." [7]

### 5. Benefits that would have occurred without the incentives.

Often the benefits credited to tax incentives would have occurred anyway. A number of studies focusing on the role of tax credits in job creation have found that 55-70 percent of the tax credits granted to employers are payments for workers who would have been hired without the subsidy.[8] One analysis mockingly concluded, "incentives have very little effect on actual growth, but they have a substantial positive effect on announced growth." Studies of Enterprise Zones, the new darling of advocates of

government involvement in economic development, indicate that most of the incentives are used by existing businesses that would have expanded anyway.[9]

[1] Robert G. Lynch, *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*, Economic Policy Institute, March 2004.

[2] A recent report by the Massachusetts Budget and Policy Center summarizes the findings of the leading studies. *Tax Expenditures and Economic Development*, Massachusetts Budget and Policy Center, April 27, 2004.