Tax Incentives:
Costly for States, Drag on the Nation

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Tax incentives are intended to spur economic growth that would not have otherwise occurred. More specifically, these narrowly targeted tax breaks are usually offered in an attempt to convince businesses to relocate, hire, and/or invest within a state's borders.

But state and local tax incentives come at an enormous cost. While a comprehensive accounting of these programs is impossible, the best available estimates suggest that states and localities are devoting some $50 billion to tax incentives every year.[i] Unfortunately, despite the enormous expenditures being made on these programs, the evidence suggests that tax incentives are of little benefit to the states and localities that offer them, and that they are actually a drag on national economic growth.

Tax Incentives Face Many Pitfalls

The academic literature indicates that states are significantly limited in their ability to influence business behavior through tax incentives, and that spurring true economic growth through the use of incentives is even more difficult.[ii] Despite the hopes of lawmakers and their constituents, there are simply too many ways in which tax incentives can fail to live up to their stated goals.[iii]

1. **Windfall benefits:** Tax incentives are rarely the deciding factor in whether a business chooses to hire or invest within a state's borders. State and local taxes are only a small part of the cost of doing business—about 1.8 percent on average.[iv] Even large tax reductions are therefore of limited impact to a firm's balance sheet. Based on the "consensus" estimates in the academic literature about the responsiveness of business decisions to taxes, as many as 9 out of 10 hiring and investment decisions subsidized with tax incentives would have occurred even if the incentive did not exist.[v] These large and mostly unavoidable windfall benefits significantly reduce the cost-effectiveness of virtually every tax incentive.

2. **Runaway benefits:** Given the interconnected nature of the U.S. economy, it is impossible to design a tax incentive so that its benefits remain entirely in-state. Even in the rare cases where tax incentives are the deciding factor in a business' decision to hire or invest, the incentive's benefits will quickly leak outside of a state's borders if, for example, the company purchases equipment manufactured

outside of the state. Similarly, current residents may see little benefit from an incentive if the incentivized company hires non-residents to fill its new job openings, especially since bringing in workers from outside the state creates new pressures on government services.[vi] Moreover, given that the federal government allows businesses to deduct many of their state and local tax payments, many tax incentives can actually trigger a federal tax increase for the companies receiving the incentive. Up to a third of the amount that states and localities spend on tax incentives can flow into the federal government's coffers in this way.[vii]

3. **Displacement, not growth:** One company's gain is often another company's loss. In the case of retail, as much as 90 percent of the apparent direct benefits of tax incentives are offset by losses among the subsidized retailer's local competitors.[viii] While this figure is likely to be lower for industries serving a more national market, states constantly run the risk of harming existing businesses within their borders when they attempt to give some companies a competitive edge through the use of tax incentives. Local tax incentives are particularly troublesome in this regard, as job or investment growth that one locality might consider "new" is often simply "poached" from another locality in the same state.[ix]

4. **Neglected alternatives:** The $50 billion in state and local tax incentives offered every year must be paid for somehow, and oftentimes that means reductions in the public services that businesses use every day. The net economic impact of a tax incentive depends critically on how those funds would have otherwise been used. If offering more tax incentives requires spending less on public education, congestion-relieving infrastructure projects, workforce development, police and fire protection, or high technology initiatives at public universities, the overall impact on a state's economy could actually be negative. While the long-term economic benefits of education and infrastructure investments may not be as flashy as incentive-backed ribbon-cutting ceremonies, these investments are even more fundamental to any successful economy.

5. **The wrong signal:** While small tax incentives are unlikely to affect business behavior, large tax incentives can harm a state or locality's reputation. Business owners sometimes interpret the presence of lucrative incentives as a signal that a location may have other serious weaknesses, or that the government is mismanaged or desperate.[x]

A National Perspective

From the perspective of individual states and localities, the evidence regarding the ineffectiveness of tax incentives is fairly clear. Even clearer, however, is the folly of these incentives when viewed from a national perspective. State tax incentives are often described as a zero-sum game in the aggregate, but as the below discussion indicates, the reality is probably even more grim.

1. **Zero-sum game:** To the extent that state and local tax incentives affect business behavior at all, they are much more likely to reshuffle investment between geographic areas than they are to spur genuinely new economic activity.[xi] But while luring a company away from its current location may be of benefit to the state in which the company relocates, it is clearly of no help to the national economy. In recent years, businesses have become increasingly adept at playing states and localities off of each other in order to extract the most lucrative tax incentive packages possible. This competition sometimes becomes so intense that states have found themselves offering incentives not to spur new growth, but simply to retain the businesses already located within their borders.[xii]

2. **Inefficient business decisions:** From the perspective of economic efficiency, any tax incentive that actually manages to affect a business' location decision is likely to be a drag on the national

economy. This is because when incentives affect behavior, they do so by encouraging businesses to locate in areas that would not otherwise be optimal—including areas that are located farther away from important markets or infrastructure, or from the best possible employee talent pool. As a result, incentives can cause businesses to consume more energy or infrastructure resources than they otherwise would, and can contribute to excessive sprawl, traffic congestion, pollution, and other negative outcomes. Moreover, in cases where incentives cause a company to abandon a previous facility where public investments have already been made to accommodate it, those investments may be wasted at the old location and must be duplicated at the new one.

3. **Weakened economic foundation:** As indicated above, the presence of tax incentives can lead to cuts in state and local services that are central to the success of the American economy. If states' decisions to spend scarce public resources on tax incentives lead to a less educated citizenry or a deterioration in infrastructure quality, the results will be felt throughout the country. A tax incentive civil war is a costly distraction from the country's economic fundamentals.

Recommendations

Given their extremely limited economic benefits, states and localities should sharply reduce their reliance on tax incentives and should work with neighboring states and the federal government to accomplish this goal. Even the best designed tax incentives suffer from the problems of windfall benefits, out-of-state benefits, and the other pitfalls identified above. To the extent that states and localities insist on continuing to offer incentives, those programs should be redesigned in order to reduce their susceptibility to these common pitfalls, and they should be closely scrutinized in order to weed out or reform the least effective programs. [xiii]

1. **Curtail use of tax incentives:** Despite their ineffectiveness, unilaterally cutting back on the use of tax incentives can be politically challenging if it creates the impression that elected officials are not doing everything in their power to help their state compete in the national economy. Accordingly, states should seek out opportunities to partner with their neighbors in amicably ending the worst aspects of the tax incentive arms race. Business leaders in the bi-state Kansas City community recently called on their elected officials to do just this, urging that Missouri and Kansas lawmakers work together to end the practice of luring businesses back-and-forth across the state line with expensive incentive packages.[xiv] A more comprehensive version of this sort of agreement would require that states lobby the federal government to get involved, possibly by cutting back on grants in aid to states that do not revise their tax incentive programs to target job creation that it truly new, rather than just "new to the state."[xv]

2. **Improve tax incentive design:** Given that tax incentives are unlikely to disappear any time soon, lawmakers should ensure their incentives are designed so as to minimize their vulnerability to the pitfalls identified above. Accomplishing this goal means requiring that the jobs created with tax incentive dollars come with a living wage and benefits so that the employees of subsidized companies do not have to rely on government programs like food stamps and Medicaid to survive. Moreover, the incentives should be targeted toward the localities and regions most in need of an economic boost, and toward areas where adequate transit options exist so that lower-income workers without vehicles can benefit from any new jobs created. All tax incentives should also include a "clawback" provision, or money-back guarantee, where the government recoups the incentive payment if the business fails to live up to its job creation or investment promises.[xvi] Finally, most tax incentives should include a cap on their overall size to ensure that the program doesn't grow far beyond the amount that lawmakers intended.[xvii]

3. **Put remaining incentives under the microscope:** Given all the potential pitfalls facing tax incentives, even a comparatively well-designed incentive program can yield disappointing results. Because of this, it's important to monitor the effects of all incentives on an ongoing basis in order to identify particularly ineffective programs. Accomplishing this goal requires disclosing basic data about the impact of the incentive, including which companies benefited, how many jobs they added, how well those jobs paid, and any other related outcomes.[xviii] But lawmakers should also go beyond basic transparency by mandating systematic and rigorous reviews that attempt to control for problems like windfall benefits and displacement in determining whether the incentive has been of any benefit to the state's economy. A number of states have recently made meaningful progress in reviewing some of their tax incentives in this manner, but every state still has significant room for improvement.[xix]

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[i] Peters, Alan and Peter Fisher. "The Failures of Economic Development Incentives." *Journal of the American Planning Association*. Vol. 70, No. 1. Winter 2004.

[ii] Brief of Amici Curiae Economics and Public Policy Professors in Support of Respondents. *Daimler-Chrysler Corp. v. Cuno.* Supreme Court Nos. 04-1704, 04-1724.

[iii] This discussion draws partly on observations made in: Pew Center on the States. "Evidence Counts: Evaluating State Tax Incentives for Jobs and Growth." April 2012. *Available at*: http://www.pewstates.org/research/reports/evidence-counts-85899378806. Harris, Paul R. and Ronald D. Berkebile. "A Financial Analyst's Toolkit." *Government Finance Review*. June 2008. *Available at*: http://www.pewstates.org/research/reports/evidence-counts-85899378806

[iv] Fisher, Peter et al. "Selling Snake Oil to the States." Joint report by Good Jobs First and the Iowa Policy Project. November 2012. *Available at*: http://www.goodjobsfirst.org/snakeoiltothestates

[v] Peters, Alan and Peter Fisher. "The Failures of Economic Development Incentives." *Journal of the American Planning Association*. Vol. 70, No. 1. Winter 2004. At 32.

[vi] Bartik, Timothy J. "Who Benefits from State and Local Economic Policies?" W.E. Upjohn Institute. 1991.

[vii] A more detailed discussion of the federal offset effect can be found in: ITEP. "How State Tax Changes Affect Your Federal Taxes: A Primer on the 'Federal Offset'." August 1, 2011. *Available at*: http://itep.org/itep_reports/2011/08/how-state-tax-changes-affect-your-federal-taxes-a-primer-on-the-federal-offset.php

[viii] Louisiana Economic Development. "Enterprise Zone Program 2009 Annual Report." Per RS 51: 1786. March 2010. *Available at*: http://www.louisianaeconomicdevelopment.com/documents/additional-resources/2009_Annual_Report_Enterprise_Zone.pdf

[ix] Mattera, Philip, et al. "Megadeals: The Largest Economic Development Subsidy Packages Ever Awarded by State and Local Governments in the United States." Good Jobs First. June 2013. *Available at*: http://www.goodjobsfirst.org/megadeals

[x] Therese McGuire of Northwestern University says that executives at 3M "viewed [tax incentives] as not only unfair but also a signal of a weak, if not desperate, government." *See* Therese J. McGuire. "State Fiscal Policies and State Economic Growth." Presentation for the Civic Federation and the Federal Reserve Bank of Chicago. April 4, 2013. Similarly, Drs. Alan Peters and Peter Fisher observe that "firms have shown themselves to be wary of basing location decisions on massive incentive offers. Very generous incentives may signal a profligate—and thus, in the longer term, expensive—local government." *See* Peters, Alan and Peter Fisher. "The Failures of Economic Development Incentives." *Journal of the American Planning Association*. Vol. 70, No. 1. Winter 2004.

[xi] LeRoy, Greg et al. "The Job-Creation Shell Game." Good Jobs First. January 2013. *Available at*: http://www.goodjobsfirst.org/shellgame. Wilson, Daniel J. "Beggar Thy Neighbor? The In-State vs. Out-of-State Impact of State R&D Tax Credits." Federal Reserve Bank of San Francisco Working Paper 08. 2005.

[xii] Bergen, Kathy. "Quinn signs Sears-CME tax breaks into law." *The Chicago Tribune*. December 16, 2011. *Available at*: http://articles.chicagotribune.com/2011-12-16/business/chi-quinn-signs-searscme-tax-breaks-into-law-20111216_1_cme-and-cboe-sears-cme-employee-income-taxes. McIllvaine, Leigh. "Diebold Pushes Ohio Down the 'PIT'." Clawback: A blog of Good Jobs First. April 24, 2012. *Available at*: http://clawback.org/2012/04/24/diebold-pushes-ohio-down-the-pit/.

[xiii] For more on these issues, *see*: ITEP. "Fighting Back: Accountable Economic Development Strategies." September 1, 2011. *Available at:* http://itep.org/itep_reports/2011/09/fighting-back-accountable-economic-development-strategies.php

[xiv] LeRoy, Greg. "K.C. Business Leaders Demand Cease-Fire on Wasteful Job Poaching." Clawback: A blog of Good Jobs First. April 15, 2011. *Available at*: http://clawback.org/2011/04/15/1746/

[xv] LeRoy, Greg et al. "The Job-Creation Shell Game." Good Jobs First. January 2013. *Available at*: http://www.goodjobsfirst.org/shellgame

[xvi] Good Jobs First. "Key Reforms: Clawbacks." *Available at*: http://www.goodjobsfirst.org/accountable-development/key-reforms-clawbacks

[xvii] Pew Center on the States. "Avoiding Blank Checks: Creating Fiscally Sound State Tax Incentives." December 2012. *Available at*: http://www.pewstates.org/research/reports/avoiding-blank-checks-85899433960

[xviii] Guidance on how to accomplish these goals is available in: Good Jobs First. "Model Legislation for Accountability in Economic Development." *Available at*: http://www.goodjobsfirst.org/sites/default/files/docs/pdf/GJF_model_complete.pdf

[xix] Pew Center on the States. "Evidence Counts: Evaluating State Tax Incentives for Jobs and Growth." April 2012. *Available at*: http://www.pewstates.org/research/reports/evidence-counts-85899378806. ITEP. "Five Steps Toward a Better Tax Expenditure Debate." October 1, 2012. *Available at*: http://itep.org/itep_reports/2012/10/five-steps-toward-a-better-tax-expenditure-debate.php