“"The Role of Business Taxes, Tax Incentives and Other State Policies in Economic Development"

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Mr. Chair, and Members of the Committee: Thank you for inviting me to testify today.

My name is Tim Bartik, and I am a senior economist at the Upjohn Institute for Employment Research. The Upjohn Institute is a non-profit and non-partisan research organization that, focuses on providing research on how to improve the performance of the U.S. labor market. I have been at the Upjohn Institute since 1989. My research, going back to the 1980s, has mostly focused on how to increase the benefits of state and local economic development policies, and how to strengthen local labor markets. This includes research on business tax incentives, as well as research on preschool education and place-based college scholarships. I co-direct the Upjohn Institute’s major research initiative on place-based policies in the United States, which are policies that seek to create broadly-shared prosperity in local places, particularly economically distressed places.

My purpose today is to report what economic research says about what are the most cost-effective ways for a state like New Mexico to deliver what I will call “economic development benefits”.

By “economic development benefits”, what I mean is bringing about broadly shared local earnings prosperity, that is an increase in real per capita earnings for a wide variety of groups in New Mexico. In other words, economic development benefits are increases in either the percentage of state residents with jobs, or the percentage with good jobs, and ideally both.

So defined, “economic development benefits” obviously are affected by more than state and local business tax incentives. Anything that either increases the number of jobs, or the number of good jobs, or increases the ability of residents to access jobs or access better jobs would be relevant. Economic development benefits for state residents also occur due to the many economic development programs that provide businesses with customized business services, for example customized job training provided by community colleges, or business advice programs such as small business development centers. Economic development benefits can also occur due to infrastructure that supports job creation, such as access roads and industrial parks. And economic development is crucially affected by child care, education, and job training programs that help more residents be able to access jobs and access better jobs. And finally, economic development benefits are affected by the overall business tax structure, not just business tax incentives.

So, what are the top research findings on economic development that are relevant for state policymakers?

First, economic development programs differ enormously in the cost per job created, with the highest costs for untargeted business tax breaks, and the lower costs for customized services to business.

Across the board business tax cuts have the highest costs per job created. The present value of the costs per one permanent job created – that is the value today of the stream of foregone tax revenue from a business tax cut – is over one-half million dollars. This $519, 000 assumes that the business tax cut is financed by an increase in household taxes, which has some negative effects on job creation, but not enough to offset the effects of the business tax cut.[[1]](#footnote-1)

More targeted business tax incentives would be less costly, at less than half the costs, at around $196,000 per job created.

Infrastructure investments, if well run, can create jobs at about $98,000 per job created. And customized job training and business advice programs, such as manufacturing extension programs or small business development centers, can create jobs at a cost of $29,000 to $32,000 per job created.[[2]](#footnote-2)

Why this pattern? Well, across the board business tax cuts tend to be costly because they are untargeted. They go to many businesses that are not even considering new investment or new job creation in the state. In addition, across the board business tax cuts also tend to go to so-called “non-export-base businesses”, by which economists mean businesses that sell their goods and services within the state. These locally-oriented firms have their job creation decisions mainly driven by the demand of state residents for goods and services, and not by business taxes.

Business tax incentives do a bit better because they are targeted. They are generally targeted at “export-base businesses”, by which regional economists include businesses that “export” their goods and services to residents and businesses in other U.S. states – this term “export base” does not require that the export be to another country, merely to another state. These firms are more footloose and easier to affect with business taxes and have multiplier effects on job creation decisions in suppliers and retailers. In addition, business tax incentives do tend to be targeted at firms that are considering specific job creation or investment decisions, and the employment levels of such firms are more easily affected by tax changes.

Business infrastructure and customized business service programs can be more cost-effective than business tax incentives because if run well, they can provide many businesses, and particularly small and medium-sized businesses, with services that have a significantly higher value to the businesses that what it costs the public sector to provide. For example, business advice that helps a smaller business be able to pivot to a new and growing market can be cheap to provide yet have significant job creation effects. Customized job training can help firms be better able to find the productive workers they need, which is fundamental to business competitiveness. And infrastructure can be crucial to making a business site productive, for example via better access to markets, supplies, and workers.

Second, on the benefits of job creation side, the key thing that I would hope state policymakers would realize is that in the average local labor market, at most 20% of the new jobs created actually end up going to increasing the employment rate of local residents. The remainder of the new jobs end up going to in-migrants. In distressed local labor markets, the percent of new jobs going to local residents increases to 40% -- that is, the benefits for state residents on average are double for helping create jobs in a distressed area.[[3]](#footnote-3)   
  
Why so low a percentage of the jobs going to local residents? One might think, surely firms on average do more local hiring than 20% -- they’re not hiring 80% in-migrants? Well, when new jobs are created, they can be immediately filled in 3 ways: (1) hiring already-employed local residents; (2) hiring unemployed local residents; (3) hiring in-migrants. But if the jobs are filled by hiring already-employed local residents, this creates a job vacancy, which is filled in the same 3 ways. And so on. These job vacancy chains are only terminated when every new job ultimately results in either a job for a local resident who otherwise would be non-employed, or a job for an in-migrant. And in the typical local labor market, there aren’t enough non-employed local residents with the right networks or job skills to fill most of the vacancies created along these vacancy chains, so 80% of the new jobs ultimately go to in-migrants. In contrast, if the local employment rate is low, with a high proportion of non-employed residents, a higher percentage of new jobs will end up going to those local residents who were non-employed.

As this discussion suggests, there might be ways to affect how jobs are filled, in addition to the obvious possibility of targeting job creation more at distressed places. For example, if we have job training institutions and job placement institutions that are large enough and good enough to help more unemployed or unemployed residents access jobs, then more of the jobs will tend to go to local residents.

One thing this discussion also implies is that although the benefits of job creation are considerable, from the viewpoint of state policymakers, they are much less than the increased earnings of the jobs. Thus, when we compare the benefits per job with the cost per job, we discover that across the board business tax cuts do not have a positive benefit cost ratio if the only benefits we count are the increased earnings per capita. In other words, households taxing themselves more to pay for business tax cuts costs households more in increased taxes than it generates in increased earnings per capita from higher employment rates for state residents – probably around 58 cents on the dollar.[[4]](#footnote-4) Or, to put it another way, if there is surplus revenue to invest in household tax reductions or general business tax reductions, households on average would gain more from the household tax reductions, even after accounting for the extra job creation from the business tax reductions.

In contrast, the average business tax incentive does pay off, although not by much, at an increase of 1.52 dollars in increased earnings per capita and other economic benefits per dollar of business tax incentives. The balance of benefits and costs here is close enough that the details of how business tax incentives are designed can matter greatly – more poorly designed incentives may have costs greater than benefits, and better designed incentives may do much better than this 1.52 ratio. I will come back to these design issues later on.

The third research finding that I want to emphasize is that in the modern skills-based economy, the “economic development benefits” of investing in high-quality skills programs – in terms of the increase in per capita earnings of state residents – is often higher than for business tax incentives. High-quality programs that expand the skills and labor supply of state residents will directly increase the earnings per capita of state residents. Some of these residents will leave the state, but a sufficient percentage will remain to boost the state’s per capita labor supply and skills. Based on economic research, these increased skills will have spillover benefits for the state economy, including for those whose skills do not improve. When my co-workers have greater skills, my employer is better able to introduce more productive new technologies, which enhances the competitiveness of my employer, enabling my employer to pay higher wages and to expand. When suppliers to my employer have workers with better skills, this also increases the competitiveness of my employer, which also will have spillover benefits for my wages.

If one does calculations for high-quality skills development programs of the present value of the resulting increase in per capita earnings of state residents, one gets ratios of the present value of the earnings boost, to the costs of the skills program, that far exceed the 1.52 benefit cost ratio for the average business tax incentive program. These ratios of present value of earnings benefits to skills program costs are: community college workforce education, 8.15; universal pre-K, 5.16; public school spending increases, 4.67; child care for low-income children, birth to age 4, 3.01; place-based college scholarship programs such as the Kalamazoo Promise, 2.73.

Based on these findings, what recommendations do I have for state economic development policies, and particularly for policies related to business tax incentives?

First, any resources devoted to incentives should not come at the expense of reducing funding for more cost-effective job creation programs, or for high-quality skills development programs that have high benefit-cost ratios. We should make sure that we have adequately funded business advice programs for small and medium sized businesses, and customized job training programs, and infrastructure programs before turning to handing out cash via incentives We should also make sure that we have adequately invested in early childhood programs, K-12 education, community college and four-year college programs, and job training, before devoting significant resources to business tax incentives or business tax incentives. The rationale: these alternative approaches to increasing the per capita earnings of state residents have higher benefit-cost ratios, and are more cost-effective than business tax incentives, even if business tax incentives can work.

Second, to help ensure that business tax incentives do not reduce spending on programs with greater economic development benefits per dollar of resources, business tax incentives should be subject to an enforceable budget cap.

Implementing a reasonably-sized budget cap for business tax incentives is facilitated by making business tax incentives more upfront. This avoids the temptation of passing on incentives’ budget costs to future Governors and legislators. In addition, making incentives more upfront – say payable over no more than 5 years or so, is likely to make incentives more cost-effective. Firms heavily discount the future in making business location and expansion decisions, so the incentive paid out in year 15 plays little role in landing a given investment today – but it may cost the state a lot of money 15 years from now. Research suggests that making an incentive totally upfront, rather than paying it over time, may increase its benefit-cost ratio by about one third, from 1.52 to 2.13.

Of course, if incentives are more upfront, there is the question of what to do if the firm then leaves? The answer is having clawbacks in all incentive contracts, which allow the incentives to be recovered by the government if the jobs do not last for at least for some reasonable period of time. And states have to be willing to enforce such clawback provisions.

Two interesting state incentive programs are those of Virginia and California. Virgnia provides a one-time job creation credit of a little over $20,000 per job. The credit is allocated when the jobs are created but is not paid out unless the jobs are still there 4 years later. This pays the credit reasonably upfront yet avoids the need to recover the funds from the firm if the jobs only last a short time.

California has an interesting tax credit program called California Competes. Under this program, the state has a competition three times a year to allocate a given budgeted amount of tax credits. In the first round of the competition, firms must propose their requested tax credit, anticipated payroll creation, and investment levels over a five-year period. Each proposal is given a score based on the ratio of tax credits to the sum of payroll creation and investment level. The state sets a threshold such that only proposals with ratios that fall below the threshold move to round 2. The threshold ensures a very competitive group of proposals move forward. The threshold is set low enough so that on average only half of the proposals that get through round 1 will be funded in round 2. In the next round, the state considers other criteria in deciding which firms get the credit, for example the degree to which the firm’s expansion would help promote innovation in the state, and the state’s judgement about whether the credit is needed.

This credit is interesting for several reasons, including that it clearly has a budget constraint. Furthermore, the credits mostly are paid out within a five-year period, so compared to many state business tax incentive programs, it is relatively upfront. Finally, the screening procedure encourages firms to make more modest credit requests, in order to get their proposed project into the second round.

Third, state economic development programs should do more targeting to distressed places. The rationale, as I stated before, is that the benefits of generating job opportunities in distressed places are likely to be considerably higher. For example, the benefits in terms of higher earnings per capita of job creation in distressed places are at least twice as great as for the average non-distressed place.

States have historically found it difficult to target distressed places. Targeting is always politically challenging. In addition, there are some practical difficulties. For example, North Carolina used to have a job creation credit that was much higher in more distressed rural counties than in the rest of the state. But in the end, fewer total tax credit dollars went to these distressed rural counties than in more economically prosperous counties, because the rural counties didn’t have enough projects that could use these credits.

In a report I did for Pew Charitable Trusts[[5]](#footnote-5), I proposed that states make targeting more likely to have broad sustained bipartisan support and be enforceable by making economic development block grants to all areas of the state, but to provide grants in proportion to how many jobs each local labor market was short of full employment. These economic development block grants could be used for a variety of purposes related to economic development, not only incentive payments, but also including business advice programs, customized job training, business incubators, and business parks. Including all areas of the state makes the program more politically feasible, and the tie to how many jobs the area is short of full employment is more politically defensible than some other targeting formulas. It is similar to how many states target school aid funds, by providing more funds for students who are eligible for a free or reduced-price lunch. In addition, the provision by formula block grants ensures that more total dollars per capita will go to the distressed places that would most benefit from more jobs. The report I have for Pew includes data for all 50 states, including New Mexico.

One advantage of the block grant approach is that it allows economic development strategies to be regionally diverse. For most states, including New Mexico, there is really no such thing as a “state economy” – rather the state includes many regional economies. These regional economies are diverse in their economic strengths and weaknesses. This diversity means that each sub-state regional economy needs its own economic development strategies, not only in what industries to target, but in what business services and skills development programs are most needed to build on the region’s strengths and overcome the region’s weaknesses. Of course, distressed regions need the most state help, as these regions will tend to have the lowest per capita tax bases.

A final recommendation is that states should do more to link their economic development programs and workforce development programs. As I mentioned, a key issue is who gets the new jobs created by any economic development program. The proportion going to state residents will be higher in more distressed local labor markets. But the proportion also will be higher if the state is able to coordinate economic development programs with workforce programs. For example, if customized job training is a key part of the incentive package, it is likely that a higher proportion of new jobs created will go to more disadvantaged state residents who would be less likely to access these new jobs without this training assistance.

In conclusion, my main point is that we should be more focused in our economic development goals, but more flexible in our means to achieve those goals. Our economic development goals should not be simply to increase jobs and earnings, but rather the more focused goal of increasing per capita employment and per capita earnings of state residents, which is a narrower goal with much greater benefits for a variety of state residents. But once we define the goal as higher employment rates and higher earnings rates for state residents, we should recognize that there are many ways to achieve that narrower goal. That includes jobs creation programs, which should include customized services to business rather than only handing out cash via incentives. And it also increases skills development programs, which can complement job creation programs in achieving that elusive goal of broadly shared prosperity for state residents.

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1. Even if funds seem to come from other sources, such as from oil and gas-related surpluses, the relevant issue is what would be the alternative uses, or “opportunity costs”, if the policy had not been adopted. Thus, the impact of a business tax cut is the impact of that tax cut compared to some alternative uses of those funds, such as reducing household taxes. For purposes of this testimony, it seems plausible that simply distributing the funds to households via a tax cut would plausibly be an alternative use. It would be a separate issue if the proposal being analyzed would be to respond to surplus oil and gas related funds by cutting the state taxes or fees related to oil and gas. If that is the case, then the relevant alternative would distribute funds to stockholders in these oil and gas firms, who would mostly be outside the state. Because these stockholders are outside the state, changes in their tax payments would not directly affect the state economy. Under such an assumption of financing via higher payments from out-of-state oil and gas stockholders, the costs per job created figures would be lowered to: business tax cuts, $396K per job; incentives, $176K per job; infrastructure, $92K per job; customized training, $31K per job; business advice, $29K per job. The adjustments are less for the cheaper job creation options because they are so cheap that it doesn’t take much in added household taxes to pay for them. [↑](#footnote-ref-1)
2. The source for these figures is the research cited in [Bartik. (2020)](https://www.aeaweb.org/articles?id=10.1257/jep.34.3.99) and [Bartik (2018).](https://research.upjohn.org/up_technicalreports/35/) **.**These figures are present value costs, in August of 2023 dollars, for creating the equivalent of one permanent new job, with present values calculated at a 3% real discount rate. All figures assume a multiplier of 2 for direct job creation; the cost per job includes the extra multiplier jobs, the cost per direct job would be twice as great as given in the text. All calculations assume that the given policy is financed by an increase in household taxes. Household taxes are allowed to reduce jobs to some extent, which inflates the costs compared to what would occur if the policies were financed by the federal government or some other group outside the state economy, such as stockholders in oil and gas firms (see prior footnote). [↑](#footnote-ref-2)
3. Sources for this include research reviewed in [Bartik (2020)](https://www.aeaweb.org/articles?id=10.1257/jep.34.3.99) and new research in [Bartik (2023).](https://research.upjohn.org/up_workingpapers/339/) [↑](#footnote-ref-3)
4. The figures for benefit cost ratios for incentives and skills programs mostly come from sources described in [Bartik (2019](https://research.upjohn.org/up_press/258/)), which first presented these numbers. The general business tax cut result is based on applying a similar methodology as in Bartik (2019). [↑](#footnote-ref-4)
5. [Bartik (2022](https://research.upjohn.org/up_technicalreports/44/)). [↑](#footnote-ref-5)