Presentation on “Who Benefits from Incentives? The Effects of State Policies”

at the 2023 Roundtable on Evaluating Economic Development Tax Incentives

Roundtable sponsored by National Conference of State Legislatures,

With support by Pew Charitable Trusts

Presenter: Timothy J. Bartik

Senior Economist

Upjohn Institute for Employment Research

Date of presentation: October 24, 2023

 I want to briefly describe the main forces driving income distribution effects of state and local economic development policies. This presentation is based on [my econometric model of how the benefits and costs of these policies are distributed across different income quintiles in a state economy](https://www.upjohn.org/about/news-events/new-bartik-benefit-cost-model-business-incentives-provides-realistic-evaluation-incentive-benefits#:~:text=The%20Bartik%20Benefit%2DCost%20Model,local%20governments%20with%20more%20revenue.). However, you don’t have to use my model to quantitatively evaluate incentive programs in order for the model to be useful (although it is free to use!) Even if you don’t use the model for quantitative benefit-cost studies, some of the principles that I will outline can be used in descriptive analyses of a state incentive program. We can use these principles to ask: is the state adopting practices that are likely to increase or decrease the “progressivity” of the benefits from its economic development efforts, that is, the extent to which benefits go to lower income groups?

The model, which some of you have seen before, allows a user to enter in data on any incentive project, and in particular to enter in information on the incentives provided by year, the number of jobs, the location of the project, and various other project characteristics. The model then determines the probability that this incentive will tip the project location decision and thus the expected number of jobs induced. The expected jobs induced, together with the costs of the incentives, then have consequences for various types of income. The model’s income distribution results thus depend on how various types of income tend to be distributed by income group. And this is something that public policy can affect in how it designs economic development incentive programs.

To illustrate how policy can affect income distribution effects of incentives, consider a hypothetical incentive program in my home state of Michigan. The program provides an incentive of $5,000 per job for 15 years, starting in year 2 of the project, and continuing through year 16. The project is at an “average” place in Michigan with a typical number of available non-employed workers, and has a multiplier of 2. The project is somewhat arbitrarily scaled at 10,000 jobs.

For today’s brief presentation, I am simply going to focus on overall benefits, and benefits for the lowest income quintile, households in the lowest income quintile. This lowest income quintile at baseline gets only 5% of total income, rather than the 20% it would get if all households got the same income.

What we report is the present value of the income effects of this incentive program, over an 80-year period. Income flows in each year are expressed in present value terms by discounting them to the present at a 3 percent real interest rate or discount rate, which is commonly in benefit-cost analyses.

In the baseline simulation, the main benefits of the incentives are “labor market benefits”, that occur due to job creation driving up employment rates and real wage rates. The lowest income quintile gets more than 10% of these benefits, and therefore these benefits tend to help equalize the income distribution.

The incentives and job creation also drive up property values, which is a benefit, but not one that many low-income households receive.

We also have to pay for these incentives. The gross present value of the incentives is $511 million. There are some offsets, but there are still $475 million in incentive costs to pay for. These costs tend to be paid disproportionately by the lowest income quintile, because most state and local taxes are relatively regressive, so tax increases are relatively harmful to the lowest income quintile. Also, cuts in state and local spending tend to hurt the lowest income quintile.

In addition, these spending cuts have some indirect effects, in particular the model allows K-12 spending cuts to affect future earnings, 30 or 40 years later, of children in K-12 when those cuts occur. These earnings losses particularly hurt the lowest income quintile, partly because the lowest income quintile has somewhat more children per capita, and partly because the evidence suggests similar dollar earnings losses from K-12 spending cuts for different income groups.

On net, in this particular case, although the incentive program overall has net benefits, the lowest income group loses. The losses in paying for incentives, and in education cutbacks, exceed the labor market benefits and scantly property value benefits.

But the relative magnitude of these benefits can change dramatically if more of the jobs go to the local non-employed. For example, the evidence suggests that if the project occurs in a local labor market that is economically distressed – that is, it has a higher rate of non-employment -- then labor market benefits will be considerably higher. Property value benefits will be slightly lower because in-migration is less. And incentive cost effects, both directly on higher taxes and lower public spending, and indirectly via lower earnings because of education cutbacks, will be somewhat less.

This dramatically changes both overall net benefits, and the relative benefits for the bottom income quintile. Overall net benefits triple. And the lowest income quintile moves from losing income overall, to gaining benefits that are almost 8% of total benefits (47/599=7.8%). So, the incentive program targeted at a distressed local labor market helps modestly move the income distribution towards more equality, while also having much higher net benefits overall.

Therefore, even without using my model, we should always be asking: what is being done in these programs to increase the proportion of jobs from this program that go to the non-employed? Is the program targeted at areas where many of the non-employed live? If not, are there any features of the program that might tend to increase hiring of the non-employed, for example by tying business tax incentives to customize job training programs, or even requiring that local training programs be used as a “first source” for hiring?

The magnitude of benefits also depends upon whether or not local housing supply can expand to deal with any population influx without huge price increases. Suppose that we increase the housing price effects of added population from the Michigan estimated average to the California estimated average, which is about twice as great. In this case, property values go up more, which increases benefits for local property owners. But few of those benefits go to the lowest income quintile. The increased prices and resulting nominal wage increases mean local costs are higher, and this ends up destroying some local jobs. This higher cost effect partially offsets the induced jobs, so labor market benefits are lower. Because of lower labor market effects, budget cuts are somewhat larger, so losses in those two categories are higher. In addition, one of the “other effects” in that category are higher local prices for local residents on fixed incomes, so the higher local price increases also increase those costs. On net, we end up with an incentive project that has net losses, rather than net gains, and its net losses are particularly high for the lowest income quintile. And all of this is solely because the local housing supply does not respond adequately to the new jobs and population.

Therefore, even without using my model, we should be asking: are my state’s economic development efforts to attract jobs being complemented by housing supply efforts to help accommodate the people attracted by those jobs? If they are not, then the incentive program is likely to have some negative gentrification effects that not only hurt the lowest income quintile, but also hurt the overall state economy.

To take a third example, a key issue is how incentive programs are being paid for. Economic development incentive programs are not a free lunch. They must be paid for. And how they are paid for has economic effects.

For example, suppose instead of the baseline assumption -- half the incentive program being paid for by tax increases, and half by spending cuts – that instead we assume that all of the program is paid for by public spending cuts. The result is that education spending will be cut much more, which has larger adverse effects overall and for the lowest income quintile. As a result of these larger earnings losses due to education cutbacks, labor market benefits and property values benefits are also reduced somewhat, and the overall fiscal costs of the program are somewhat larger because state and local tax revenue is depressed somewhat by the lower earnings from the education cutbacks.

As a result, net benefits again turn negative, in this case very negative. And almost half of these negative effects are on the lowest income group, due to its loss of earnings benefits from K-12 spending.

Therefore, even if we don’t use my model, we should always ask: where did the funding for this program come from, in the sense of what would have happened without this program, and did it lead to cutbacks in programs that might have had considerable economic benefits? Is there any way that policymakers can structure funding for this program so that it does not squeeze out other areas of the state budget that might be important to the state economy? For example, as [Pew has pointed out in reports](https://siteselection.com/issues/2021/nov/how-states-can-avoid-costly-pitfalls-while-rebuilding-their-economies.cfm) over the years, states might want to control incentives via incentive budget caps, to prevent adverse effects on needed programs. One could even consider tying incentive budgets to be some percent of state business tax revenue, which would mean that increasing incentive budgets would require financing by higher average business tax rates – which is not contradictory, it is not a crazy policy for a state to tax businesses more on average, but lower net business taxes after incentives for businesses that choose to invest and create jobs in the state.

In conclusion, I invite you to explore this model to see how various features of incentive programs alter benefits for different income groups. Even if you do not use the model to quantitatively evaluate your state’s incentive programs, this benefit cost model gives some useful insights to keep in mind. In particular, in deciding on the income distribution effects of incentive programs, we should always keep in mind three things: (1) who gets the jobs; (2) are too many of the benefits capitalized into property values, and (3) who is paying for this incentive program?