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What Factors Influence the Effectiveness of Business Incentives?

Key policy and economic questions can inform evaluations of costs and benefits

Overview

Policymakers around the country use economic development incentives such as tax credits and exemptions to encourage companies to locate or expand in their state or community, with the ultimate goal of boosting the job prospects and income of local residents. These programs have a range of positive and negative effects on the economy and government budgets—impacts that should be examined to determine whether the policy is worth the cost.

This brief explores how four major factors influence the final outcome:

- ***Costs:*** Policymakers must account for an incentive's net budget cost and how it is paid for.
- ***Targets:*** The economic effects of an incentive depend in part on the characteristics of the companies that receive it, in particular whether the recipients are exporters, high-impact companies, or locally owned businesses.
- ***Design:*** Certain incentive designs can potentially deliver more benefits to companies for the same cost to government, increasing their effectiveness. The impacts can vary depending on when businesses receive the incentives and whether the program helps businesses overcome practical barriers to growth.
- ***Economic conditions:*** Thorough evaluations of incentives need to consider how effects can vary with the state of the economy, including whether the local economy is struggling and if housing supply can readily expand to accommodate additional population.

As policymakers and government officials evaluate their incentives, they should carefully consider how these factors influence their costs and benefits.

The analysis presented here is based on an economic model that estimates the various costs, benefits, and unintended consequences of incentives to determine the net impact on the economic well-being of local residents. While the model accounts for many economic and policy factors, this brief focuses on a set of key questions to explore the complex interplay among program design, business characteristics, and the underlying economy.

Costs

What is the incentive's net cost and how is it paid for?

When an incentive spurs new business activity, it can have budget implications that go beyond the initial cost of the program. On the positive side, increased economic activity results in additional tax revenue. But government spending will also grow as new job opportunities draw in additional population, boosting demand for government services such as transportation and public safety. The net budget cost—the incentive's initial cost, plus the increased spending needs, less the increased revenue—depends on the relative strength of these three effects, and a thorough analysis must account for these contrasting budget impacts.

In many cases the revenue and spending increases will largely offset each other and the program's net budget impact will be approximately equal to its initial cost. Because government budgets must be balanced in the long term, that cost must be paid for by increasing tax rates, cutting spending, or both. And each of these approaches can have negative economic consequences that offset some benefits of the incentive programs. Tax increases can have negative effects by reducing how much money people have available to spend and by discouraging business activity. Government spending cuts can result in fewer jobs and less economic activity, and reductions to long-term government investments can be damaging to future economic prosperity. For example, cuts to education can harm students' job prospects and wage potential for many years to come. And spending money on one incentive program means a state or city might have to forgo other potentially productive economic development strategies. A thorough analysis should account for these inherent budget tradeoffs.

Targets

Does the incentive target exporters?

Giving incentives to companies that sell their goods locally, such as retailers, will tend to harm other businesses in the community and undermine the program's potential economic benefits because sales and jobs at the new firm will come at the expense of existing companies. In contrast, incentives given to exporters—businesses such as manufacturers that primarily sell their products outside the state or community—are more likely to deliver local economic benefits because those firms bring in new dollars and jobs. Some companies may do both, selling a portion of their goods locally and exporting the rest. Evaluations should carefully consider how incentives given to one company will affect other local employers.

Does the incentive target high-impact companies?

When a company relocates or expands because of an incentive, the effects cascade through the economy. As the firm buys goods from other local businesses and new employees spend a portion of their wages locally, some additional jobs are created in a process called a multiplier effect. It is important for incentive evaluators to consider whether the recipient companies are likely to have high or low local multipliers. For example, businesses that pay higher wages or use more local suppliers will, all else being equal, tend to have a larger multiplier effect and thus a greater economic impact.

Are the recipient companies locally owned?

Incentives increase net revenue for the businesses that receive them, so if those companies are owned by residents of the jurisdiction offering the incentive, the additional business profits are retained locally as a benefit of the program. In contrast, if the business is not owned by local residents, any additional profits will flow to people outside the local economy. A comprehensive accounting of the benefits of incentives should consider how local ownership influences whether the added profits accrue inside or outside the city or state. In addition, because locally owned companies may be more likely to use nearby suppliers and spend their increased profits in the local economy, they may have modestly higher economic impacts.

Design

When do businesses receive the incentives?

Businesses prefer to receive a dollar today rather than tomorrow because postponing the payment means it will be devalued by inflation, risk, and other factors and may cause a firm to defer or miss opportunities for investment and growth. Therefore, a front-loaded program is more valuable to the recipients, has more influence over their decisions to invest, and is more cost-effective than if the incentive were spread over many years. Although an incentive delivered far in advance of the business's investment can be wasted if the company does not follow through on its plans, incentive payments that coincide with agreed-upon job creation targets can provide a high value to businesses while protecting public resources. Evaluations should carefully consider how the timing of incentive payments affects their value to businesses.

Does the program help businesses overcome practical barriers to growth?

Unlike tax credits and other financial incentives whose value to companies roughly equals their costs to state or local governments, certain high-quality business services could provide a value that significantly exceeds their costs. For example, manufacturing extension programs offer smaller manufacturers advice on finding new markets and improving productivity, and customized job training programs work with businesses to ensure that they have access to a qualified workforce. Although many businesses invest in these services on their own, small and medium-sized firms often face uncertainty about the quality of the services, difficulty borrowing to pay for them, or the risk of losing trained workers, which can all prevent companies from making otherwise profitable investments. Therefore, when tailored to help small and midsize companies overcome these barriers, such services could have much larger positive impacts on business expansion and job creation than a financial incentive with the same cost. Evaluations should consider whether incentives are designed in a way that helps businesses overcome such barriers or that simply provides a financial inducement.

Economic conditions

Is the local economy struggling?

Incentives may have larger benefits when a local economy is struggling. When unemployment is high, there is an increased likelihood that new jobs will be filled from the large pool of unemployed local workers rather than by workers moving between communities, boosting local workers' earnings and increasing tax revenue. However, when unemployment is low, fewer local workers are available, and more of the new jobs will be filled by people moving from outside the area. Moreover, this increased population leads to higher government spending due to greater demand on local government services.

Can housing supply readily expand to absorb increased demand?

The economy is made of many interrelated parts, and changes in one area will affect others. For instance, growth in economic activity, employment, and population tends to increase property values. This effect will be more pronounced when housing supply is slow to respond to changes in demand, such as in areas where new construction is more restricted. Rising prices benefit property owners but also increase rental costs, including for local businesses, which can result in some job losses that partly offset the incentive's positive employment impacts. Evaluations should try to account for these types of indirect and unintended effects of incentives on the local economy.

Estimating the Costs and Benefits of Economic Development Incentives

This brief is based on a model developed by Timothy J. Bartik of the W.E. Upjohn Institute for Employment Research with support from The Pew Charitable Trusts. The model estimates the costs and benefits of financial incentives for business expansions and relocations that include significant capital investments. The net impact is summarized in terms of the net change in the incomes of local residents. If benefits outweigh costs, the result is an increase in total income for local residents.

The model relies on decades of economic research to estimate the impact of incentives on businesses' decisions to relocate or expand. These impacts can ripple through the local economy, boosting workers' income, consumer spending, and government revenue.

However, these benefits can be partly or entirely offset by various unintended effects. The model considers a variety of factors, including: that businesses often receive incentives for jobs they would have created regardless, that many of the jobs created by incentives will not go to the original local residents, and that other local businesses can be put at a disadvantage.

The model also considers the implications for government budgets. The total net budget cost is assumed to be paid for by increasing tax rates or reducing spending on other priorities, both of which have negative impacts on current and future economic development. To illustrate that some budget cuts can have long-term economic effects, the model estimates how reductions in education spending harm the wages of students far into the future.

For more information on the model, including many factors not discussed here, please see the full methodology paper, "**Who Benefits From Economic Development Incentives?**"

Conclusion

An economic development incentive that successfully causes a business to expand or relocate can benefit local residents by increasing their job prospects and ultimately their income. But incentives can have costs in the form of forgone revenue, increased demand on government services, and unintended negative effects throughout the economy. Whether the benefits outweigh these costs depends on many factors. Although it is not comprehensive, this brief outlines some of the important policy and economic factors that should be considered when evaluating new or existing incentives.

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