Improving State Economic Development Policies

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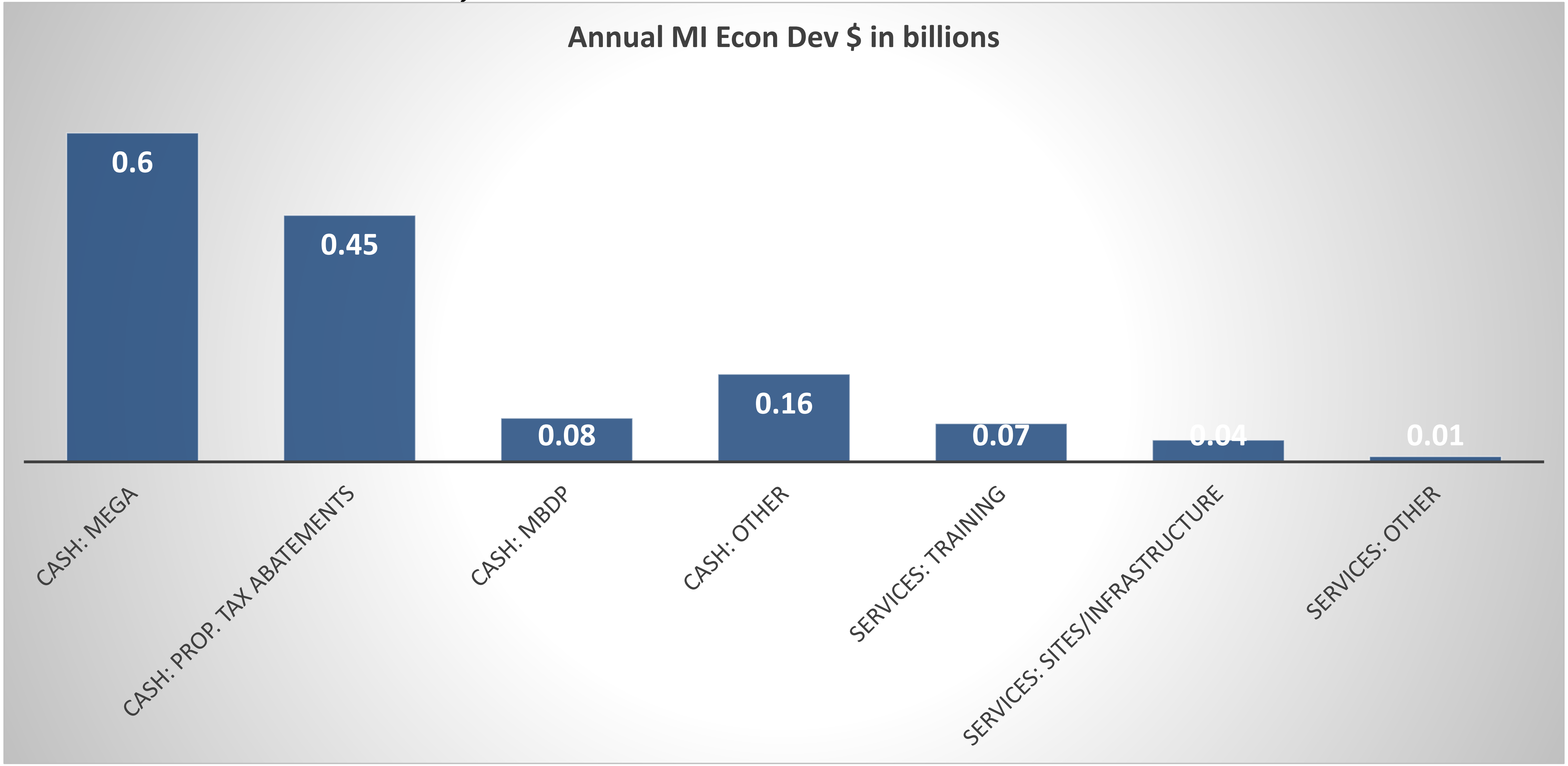
Based in part on Bartik's 2019 book, *Making Sense of Incentives*,

Available for free download at https://www.upjohn.org/research-highlights/making-sense-incentives-taming-business-incentives-promote-prosperity

What is “economic development”? What is state economic development policy?

- **Economic development** is improving per-capita earnings, which is affected by everything a state does.
- **Economic development policy** usually refers to policies that target particular firms or industries to encourage job growth.
- Of **$50 billion/year** that state/locals in U.S. devote to economic development policies, about **$47 billion** is cash incentives (tax breaks/cash grants) to firms, about $3 billion is customized services such as customized job training, business advice such as manufacturing extensions services, infrastructure such as access roads, or site development services such as brownfield redevelopment or business parks.

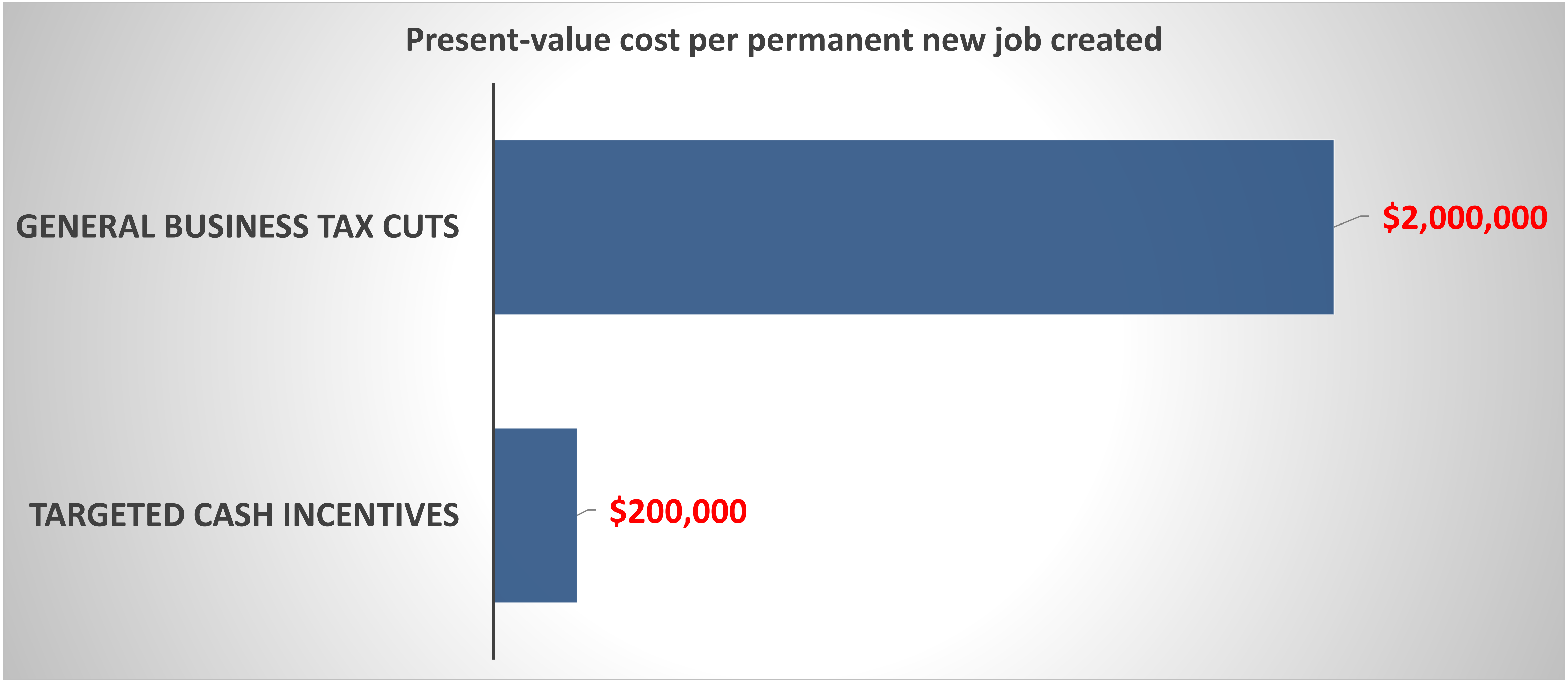
Of Michigan's $1.4 Billion in Economic Development Programs, About $1.3 billion Goes to Cash Incentives, $0.1 Billion to Customized Services



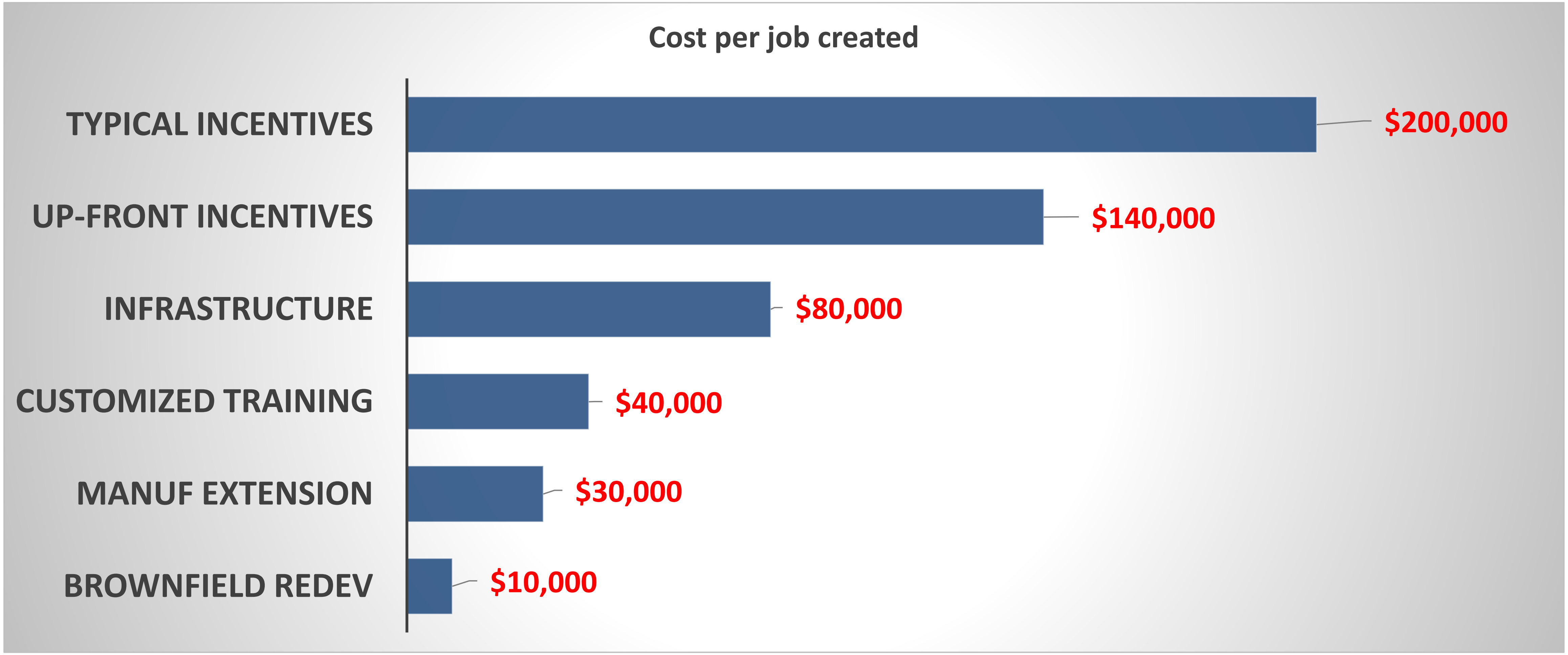
Why might targeting export-base firms, especially firms making location/expansion decisions, create more jobs/$ than general business tax cuts?

- Location/expansion of "export-base" firms (sell outside state) has multiplier effects (usually 1.5 to 2.0; sometimes 3 or more).
- Tax cuts for non-export base firms have little local job effects, as limited by local demand.
- Only one-fifth of firms are export-base, so 80% of general business tax cuts will not do much to boost jobs.
- Even among export-base firms, many are not in market position to expand.
- So in theory, targeting export-base firms considering location/expansion can create jobs at perhaps 1/10th cost of general business tax cuts.

So although there might be other reasons to lower general business taxes (e.g., reducing local prices), general business tax cuts have high present value cost per job created, compared to cash incentives, although both are costly



Cash incentives so costly because at least 75% of the time, jobs would have been created anyway. Cash more effective if upfront. But customized services even more cost-effective, as provide services firm may not be as able to get on their own.



Political and economic issues with cash incentives vs. customized services

- Cash is easier to hand out and is valuable to all firms
- Services must be high-quality and targeted at firms that can use services (e.g., often small businesses)
- Unlimited demand for cash incentives, and no natural limit to supply, and easy to pass on to successors, and sometimes hidden as part of tax system: puts state in weak position to say “No”.
- Cash incentives to large firms are very visible to public, and are politically popular: government is “doing something” to create jobs
- In contrast, customized services have natural limit to size, tend to be paid upfront, & are subject to appropriations process. Smaller businesses that use these services have less political clout.
- If cash incentives to be used, state is well-served as having strong legal rules on size of incentives (per job, as % of payroll, as % of investment) that prevents excessive incentives, and overall budget for incentives. (Overall budget not enough as states often break limits for large projects.)

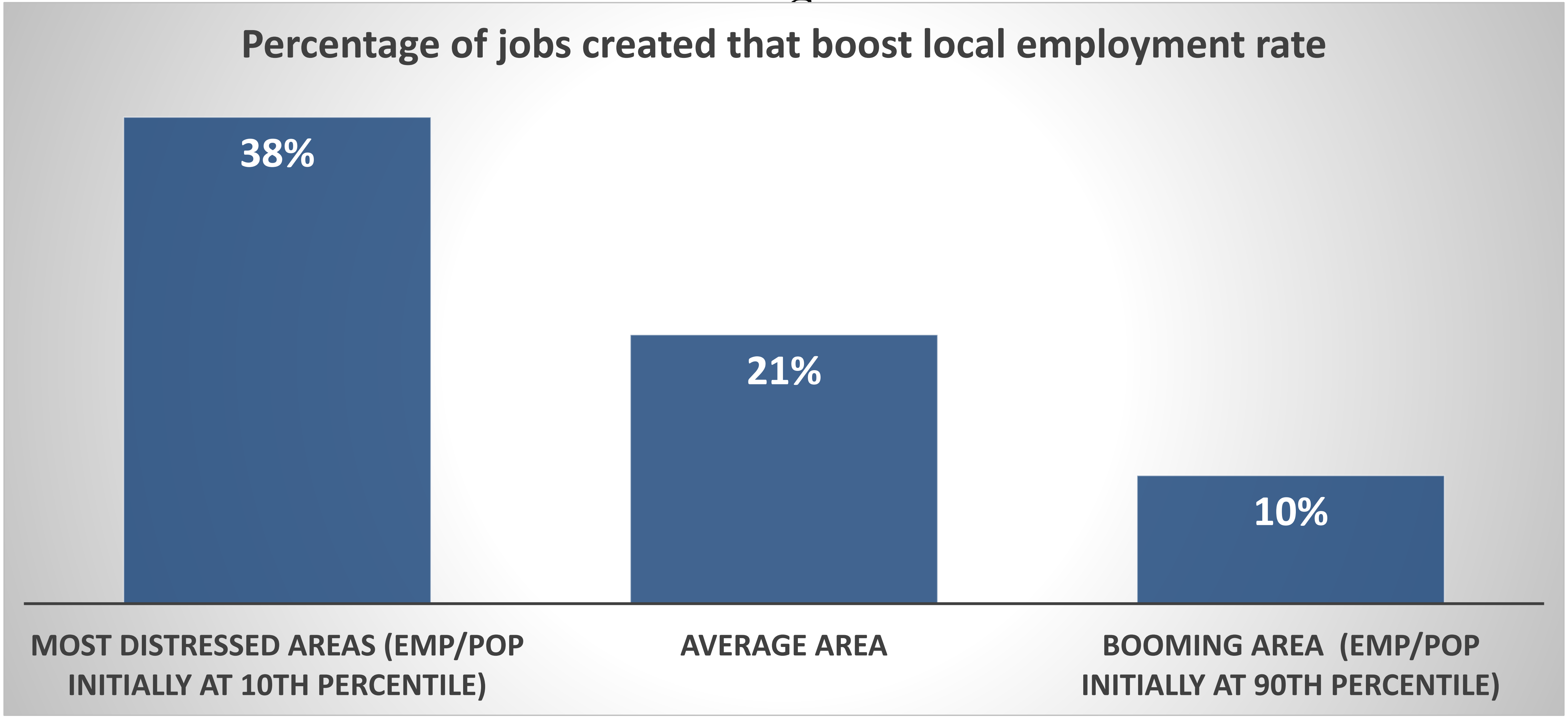
Job growth is a means to an end: higher employment rates for local residents

- Main benefit of creating jobs via economic development is **higher earnings per capita**
- Main way that job creation increases earnings per capita is by **increasing employment rates** (employment to population ratios), which both directly increases earnings per capita, and puts upward pressure on wages.
- On average, **only 20%** of jobs created increase employment rates of state residents; rest go to in-migrants
- Why 20% local/80% in-migrants: jobs created are filled by 3 groups: (1) employed residents; (2) non-employed residents; (3) in-migrants. First way leads to local job vacancies, which are filled in same 3 ways. These **job vacancy chains ultimately are only terminated by hiring of non-employed residents, or hiring of in-migrants**.
- Policy can affect local share by affecting hiring patterns anywhere along vacancy chain.

How can policy increase local hiring of non-employed?

- **Target economic development programs at more distressed local labor markets** (multi-county areas that contain commuting flows such as metro areas or rural commuting zones). In local labor markets that are at 10th percentile with low employment rates, local share is 38%; in 90th percentile, 10%.
- **Target firms that are more likely to do local hiring** of non-employed. These tend to be firms with many **"mid jobs":** jobs that pay OK, but have modest credential requirements (manuf, business services). Low-wage, low-credential jobs don't boost local employment rates much except in very distressed local labor markets; high-wage high-credential jobs don't help local residents much except in high employment rate local areas.
- **Increase incented firm's local hiring through sticks or carrots**: local hiring requirements, first-source hiring agreements, customized training.
- Increase local hiring more generally through **stronger local workforce programs**.

Due to more benefits for local residents, benefit-cost ratio for economic development programs can be twice as great in distressed areas, half as great in booming areas



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Policy Recommendations

- Cut back on cash incentives, rely more on customized services
- Limit cash incentives by rules for $ per job (or as % of payroll or investment), & by budget caps
- Make cash incentives more upfront (<5 years), w/ clawbacks
- Target econ dev at distressed areas
- Target export-base firms with high multipliers
- Encourage local hiring of the non-employed