Reflections on State Tax Incentives

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Tax incentives are components of the tax code designed to encourage certain behaviors, such as job creation or investment in specific geographic areas. Tax credits including jobs tax credits, investment tax credits and training credits, tax deductions, tax holidays, tax free zones and property tax abatement are common types of incentives used by federal, state and local governments.

Jobs tax credits (JTC) – also called employment tax credits or job creation tax credits – are tax credits available to businesses that increase employment. About 23 states in the U.S. offer job creation tax credits. The structure of these credits differs among states. Some states link the credit to wages to target higher paying jobs, specific industries, or offer higher credits to businesses creating jobs in distressed areas.

These credits are offered to attract or retain firms. There is some sort of negotiation and approval process. The credits offered by the Indiana Economic Development Corporation would fall in this category.

Three of the seminal issues surrounding state tax credits are: (1) whether jobs tax credits create jobs that would have been created in their absence; (2) the expected tax expenditure on JTC programs; and (3) whether higher credit amounts influence job creation in distressed areas.

RESEARCH ON STATUTORY TAX CREDITS

The primary issue with incentives is whether tax incentives create jobs (investment, etc.) that would not have been created in their absence. Is the incentive really altering a firm’s decision to hire workers at the margin?

Statistical analysis of state tax incentives to date has been ad hoc in nature and limited to a few states where researchers have either gathered or had access to the appropriate data. The analysis in Faulk (2002) uses data from the state of Georgia for firms taking or eligible to take (but not taking) Georgia’s JTC. Georgia’s JTC is available...
for the creation of new full-time jobs in manufacturing and distribution, warehousing, goods processing, tourism, research and development, and information processing. The maximum credit is half of a firm’s tax liability. The credit can be taken for five years if the jobs are maintained. Unused credit can be carried forward for up to ten years. The minimum number of jobs that must be created (5 to 25) to qualify for the credit and the credit amount ($750 to $3,500) per job varies by location: firms creating jobs in distressed counties have to create fewer jobs and receive a higher credit. This credit is similar to North Carolina’s Lee Employment Tax Credit. South Carolina’s credit is also similar. These similarities provide some evidence of the copycat effect among states has been documented in the literature.

The analysis of Georgia’s JTC shows that companies taking the JTC created 23 percent to 28 percent more jobs than eligible firms not taking the JTC over a three-year period. That is 1,800 to 2,200 (total over three years) more jobs and an associated tax expenditure of $2,300 to $2,600 per job – $5 million total. This estimate is an upper bound, meaning that these numbers represent the maximum number of jobs attributable to the credit. About 75 percent of the jobs created would have been created without the credit. This credit creates a relatively small number of jobs and a relatively small tax expenditure.

The findings for Georgia are consistent with analysis of other states. In their analysis of Ohio’s job creation tax credit, Gabe and Kraybill (2002) find that this credit had little impact on actual job growth. In their analysis of state investment tax credits Chirinko and Wilson (2008) find that these incentives have a positive but small effect.

One reason that the tax expenditure is relatively low for jobs tax credits is that the participation rate for these types of tax credits is quite low. According to estimates in Faulk (2001), for example, the participation rate for Georgia’s JTC is 19 percent for the 1993-1995 period. This means that 19 percent of eligible firms took the credit. The low participation rate suggests that there are information problems and/or that the costs of taking the credit are larger than the benefit. One reason the participation rate is low (or the costs of taking the credit is greater than the benefit) is that a large portion of companies have no state income tax liability and therefore would not benefit from taking the credit. Around 44 percent of corporations filing Indiana returns had no tax liability in 2001 (Faulk and Landers 2004). In Georgia about 75 percent to 88 percent of “C” corporations have no corporate income tax liability in a given year. (It is about 65 percent in North Carolina). The low participation rate suggests that there are large numbers of firms that are not influenced by these credits. Faulk (2008) provides analysis of a variety of factors that affect the use of business tax credits including tax liability, targeting, credit ceilings and refundability.

Georgia’s JTC is structured so that jobs created in distressed areas (determined by the tier designation of the county where the business is located like the North Carolina credit) receive a higher credit and have a lower jobs creation threshold. The original intent of this credit structure was to encourage and reward the creation of jobs in distressed areas because distressed areas benefit more from the creation of a job. There is general consensus in the literature that incentives should promote employment in distressed areas. In this case, the credit is a form of government intervention in response to a market failure. If incentives do work, creating jobs in nondistressed areas may have undesirable secondary consequences from the firm’s perspective, making tight labor markets even tighter and putting upward pressure on wages, which ultimately could decrease firm locations and expansions.

Analysis of Georgia’s JTC program suggests that the higher credit amount for jobs created in distressed areas is not a significant determinant of a firm taking the credit. This
suggests that the credit is not effective at encouraging job creation in distressed areas. Gabe and Kraybill (1998) show a similar result for Ohio’s Job Creation Tax Credit. The Ohio credit is structured as a percentage of income taxes withheld from workers. To our knowledge the only study that shows that geographic targeting works for this type of credit is the Sohn and Knapp’s (2005) analysis of Maryland’s Job Creation Tax Credit. They show that the Maryland credit does concentrate jobs in urban areas for certain industries. The credit was designed to target urban areas to mitigate sprawl.

While these jobs tax credits may not be effective in creating jobs in targeted areas or otherwise, they may serve as a way to signal a positive business climate, and the higher credit amount in distressed areas may signal that policymakers are aware of the challenges in these areas.

**RESEARCH ON DISCRETIONARY TAX CREDITS**

All states employ at least one – and often many – tax credits that are applied at the discretion of economic development authorities. These tax credits are more frequently criticized simply because there is a human, not merely statutory, element to their application. Also, these programs more often target specific industries than do statutory tax credits (which tend to be more focused on regions than industries). The research questions surrounding discretionary tax credits mirrors those of statutory tax credits. Simply, did the credit actually incentivize the firms’ location or expansion decision?

Any review of discretionary tax incentive studies must begin with a 1997 Federal Reserve Bank review of research findings that examined more than 90 studies that evaluated the role of fiscal policy in economic growth (Wasylenko 1997). More recent studies include research by Anderson and Wassmer (2000), who examined local tax incentives in urban areas, focusing on the Detroit area. Both of these studies identify difficulties in matching targeted industries with actual local human capital availability. They also report little empirical support to conclude that these tax incentives yielded net benefits to communities.

The most recent policy debate – which has also enjoyed significant research evaluation – is the Michigan Economic Growth Authority (MEGA) incentives that have been in place since 1995. These studies include a book written in 2005 (LaFaive and Hicks 2005) and an academic study that followed (Hicks and LaFaive 2010). Also, studies by the Upjohn Institute (Bartik and Erickeck 2010) and Anderson, Bolema and Rosan (2010) reviewed the program. The Upjohn Institute study used a simulation model to estimate impacts of the program, reporting modest job creation, at costs in the $4,000 per job range. The Anderson, Bolema and Rosan study used a different simulation model to estimate impacts, finding no net job creation.

The studies by Hicks and LaFaive approached the problem by analyzing historical data on employment and earnings and tax incentives provided by the MEGA program. Data limitations permitted these authors to examine only two of the four targeted industries (manufacturing and warehousing/wholesale). The other eligible entities (headquarters and high technology firms) were too poorly defined to match to existing secondary data on economic activity. The Hicks and LaFaive models included techniques that accounted for existing trends, local and annual factors that could bias the findings and were also tested on other industries to assess the sensitivity of the model to the MEGA incentives. In particular, the model tested whether the MEGA incentives increased construction earnings, because most of the recipient firms also built new plants or equipment. Hicks and LaFaive reported no discernable impact on employment or earnings in manufacturing or wholesale as a consequence of the MEGA credits. They did find that the incentives...
boosted construction employment at an annual cost of roughly $124,000.

All three of the study approaches to MEGA have limitations. The Upjohn Institute and Anderson, Bolema and Rosaen studies, which had very different findings, both required very strict assumptions about how big the effects might be. While these assumptions were drawn from other scholarly studies of tax effects on incentives, none were particular to Michigan. Further, any change in the assumptions would change the results to a degree which would change the conclusion about the direction of the impact.

The Hicks and LaFaive study had a different problem known as endogeneity. This problem occurs when the randomness of the tax credit is in question. The particular worry is that the credits might be targeted to counties that are losing manufacturing jobs at the highest rate. This would cause the statistical model to misidentify the jobs and earnings effects. While the study went to great lengths to correct this problem through what is formally referred to as an ‘identification strategy,’ and was successfully vetted through a peer review process, some doubt will always remain.

The different findings, which are sensitive to assumptions and underlying characteristics of the program, make a clear interpretation by policymakers a difficult task. More high quality research on the matter is an important tool for furthering good public policy and understanding of discretionary tax incentives.

**CONCLUSIONS AND EXTENSIONS**

In a time when all states offer some form of tax incentives, the argument that state government requires some incentives is seductive. Analysis on types of tax incentives continues to provide mixed results, with some modest success stories and horrendously expensive failures. A better understanding of the actual impact of tax incentives here in Indiana and better understanding of how the effects may be influenced by program specific-
tives would move the debate about economic development incentives in Indiana from its historically partisan arena toward a more information-driven policy process.
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