Thoughts on State Taxes, Incentives and Economic Development

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I have been teaching, researching, writing and consulting on state tax policy and economic development for over 20 years. I thought it would be most useful to the legislators gathered here today to distill what I have learned into what I see as the most important things to keep in mind when assessing state economic development policy and the role of taxes and incentives in generating growth.

1. Success in pursuing economic development is best measured not by job counting but by the growth in median earnings of a state's workers, or other measures that reflect the improvement in economic well-being of a broad swath of the state's population. A policy that grows jobs but lowers wages should not be considered a success.

2. Wage growth requires growth in productivity of the workforce. States have a very important role to play in enhancing productivity because of their responsibilities for public education and skills training.

3. In the long term, research shows, the most important factors affecting state growth are the rate of new firm formation and innovation, and the level of education of the workforce. In fact, the single most important thing that a state can do to increase the prosperity of its residents is to invest in quality public education, all the way from early childhood through graduate study and research institutions.

4. State policies should be evaluated in terms of their ability to support technological innovation and new firm formation. An emphasis on small firms misses the point – the vast majority are not innovative, and will not grow much. It is *new* firms that are the engines of growth. In the area of tax policy, income taxes are friendly to innovation and new firms because they are low or nonexistent during the early stages of a firm's life and become a significant cost only when and if the firm becomes profitable. They reduce risk to the entrepreneur, whereas property and sales taxes are part of fixed costs that can imperil a firm struggling to become profitable.

5. Tax incentives are likely to remain a part of state policy, but incentives should at least be reformed to make them more cost-effective. This should begin with a recognition that they are expensive and of limited effectiveness. For the average firm, state and local taxes paid by business amount to just 1.8 percent of total costs. Thus tax breaks provide very little leverage over the economic decisions of firms; other cost factors predominate. As a result, tax cuts and incentives mostly subsidize firms for doing what they would have done anyway.

6. It should be no surprise then that scholarly research on the effect of taxes on location decisions of firms provides no consensus. Many find no effect, and those that do often come to contradictory conclusions about which taxes matter and which ones don't. Among the studies finding some effect, the influence of taxes is generally small. Even the limited effectiveness found by some researchers is called into question when you consider that states must balance their budgets. The cuts in services required to finance tax breaks can reduce or even eliminate any gain from the small amount of new economic activity generated.

7. Don't waste money incentivizing local market activity. Retail, local services, housing, utilities: these are activities that feed on the income generated by the basic or export sector of the economy (manufacturing, wholesale, R&D, corporate headquarters). They grow as the basic sector grows, and they can't serve the local market from somewhere else. Don't facilitate local governments competing with one another for such activities.

8. Don't front-load incentives or tax breaks; this rewards "take the money and run" behavior and increases the odds that the firm will have moved on before the increased tax base actually generates taxes. Instead, reward longevity. This means designing incentives that reduce annual costs, or that convert loans to grants as job creation or other goals are met over the years.

9. Set limits and live by them. A cap on the total amount available for a particular incentive or set of incentives forces the state to evaluate alternative projects, prioritize them, and to consider their economic impact and cost. Such caps also reduce revenue losses and harm to essential public services. Caps on awards expressed as maximum dollars per job or percent of project costs help ensure that you aren't creating subsidy dependence by incentivizing activities that don't make economic sense in your state, and ensure that the private investors have a substantial stake.

10. Sunset and evaluate. An evaluation that does not coincide with a sunset is unlikely to be taken seriously. A sunset without any evaluation will not lead to more effective use of public funds.

11. Remember: Tax breaks and incentives do not pay for themselves; they are expensive, and they reduce the state's ability to fund the essential services – particularly education and infrastructure – that provide the real foundations for long term growth and prosperity.

Thank you for the opportunity to submit this testimony. I would welcome your questions and comments: pfisher@iowapolicyproject.org