Economic Incentives 101
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Introduction

Economic incentives play an important role for states and localities in developing their position for capital investment and job creation. Economic Incentives are components of a government’s toolkit designed to address various business needs in a competitive environment through promoting job creation, job retention, and capital investment. Different incentive models have been designed to add value for specific locations, creating a higher level of competition in the marketplace for investment. One component under economic incentives is tax incentive programs. Tax Incentive Programs influence business location decisions by improving the relative profitability of businesses investing at a particular site. Tax incentive programs affect competition, which makes communities more efficient in their effort toward improving their economic conditions.

Research that addresses capital investment outlines a clear theme: tax incentives influence capital investment. In this report, we outline the basics of tax incentives in economic development that influence business location decisions.

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1 See Economic Development Incentives Portal
Historical Background

Historically, states under the most economic stress were the first to create tax incentive programs. State governments have offered economic incentives since 1791. For instance, particular southern states sought to lure industry to their communities through tax incentives, low interest loans, and subsidized plants and land. In another example, New Jersey offered an out-of-state company a tax exemption to build an industrial park in-state. Other milestones in the tax incentive evolution that play major roles in economic development include:

- The Morrill Act (1862) provided each state Federal land to be sold, stipulating that the proceeds be used to fund public colleges focused on agriculture and mechanical arts. There were sixty-nine colleges funded from the act, some of which include Cornell University, Massachusetts Institute of Technology, and Oklahoma State University.
- Modern state economic bureaus were founded in Alabama, North Carolina, Florida, and Maine, established between 1923 and 1927.
- After World War II, many states tried to preserve economic bureaus devoted to encouraging industrial relocation.
- By late the 1970s and early 1980s, economic development agencies began to function with special interest toward commercial and industrial-site planning.

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2 See The Rise of the Entrepreneurial State, 17
3 See The Morrill Act
4 See The Rise of the Entrepreneurial State, 17
5 See The Rise of the Entrepreneurial State, 17
6 See State and Local Incentive Competition for New Investment, 21
Purpose of Tax Incentives

Tax incentives assist states and localities in the development of incentive models. The sole purpose of tax incentives is to influence business location decisions by improving the profitability of investing in a particular site. By program design, tax incentives benefit businesses by offsetting business cost and government by providing new jobs and thus increasing the tax base. An incentive program helps maximize the income from a business locating into a certain community.

Tax incentives are modeled with the purpose of maximizing income for new business. For example, Kentucky developed tax incentive programs to:

- **Address Cost Disadvantages**—reduce business costs for startup, expanding, or relocating businesses.
- **Revitalize Distressed Local Economies**—more generous incentives offered to businesses that choose to locate in communities with high unemployment and poverty rates.
- **Encourage Beneficial Behavior**—lowering environmental emissions or creating a new product.
- **Targeted Industrial Policy**—attracting industries with strong economic growth trends.

Overall, one sees the commitments toward achieving economic goals from both parties; however, governments have the greater challenge in offering something that otherwise would not have been attractive.

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7 See State and Local Incentive Competition for New Investment, 2
8 See Review of Kentucky’s Economic Development Incentives, 2
How Incentives Work

Incentive programs must be designed to ensure a community an increase in the rate of return on investment. From a business perspective, a company must assess the value of a tax incentive by analyzing the potential cost of locating at a particular site. When incentives include job training grants, loans, and jobs tax credits, costs in capital and operation are affected. Governments have the responsibility to understand how far businesses will go to take advantage of incentives because the incentive must go to the applicant who maximizes its full potential.

Governments must consider commitments that address return on investment in incentive program design:

- **Assessment of Need**
  - Some businesses apply for incentive programs without proving how strong their investment intentions are without incentives. Rarely do these businesses produce the net benefits and incentive program intentions governments would like to see in program yield.

- **Screening Process**
  - If screened, governments can learn if investors have received incentives from other jurisdictions. Governments must maximize an investor’s full potential of economic impact, especially in the long-term. When governments know the investor’s history pertaining to incentive program utilization, governments can make more informed decisions about state and local economic future.

- **Expected Job Creation.**
  - Performance contracts set provisions toward guaranteeing the full potential of incentives. As an example, there are stipulations preventing businesses from hiring workers to satisfy program qualifications, then laying off workers once incentive funds have been received.

- **Program Evaluation**
  - Guidelines of programs should call for evaluations in awarding incentives and for evaluating programs. Evaluation monitors incentive impact and comforts public opinion about incentive programs. The recipient of the incentive program should not evaluate the program it administers.\(^9\)

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\(^9\) See State and Local Incentive Competition for New Investment, 25
\(^{10}\) See Economic Development Incentive Programs: Some Best Practices, 2-3
Incentives are good for Economic Development

Incentives expand local employment opportunities and provide a competitive edge toward business attraction in locations that otherwise wouldn’t be competitive. Traditionally, businesses seek to maximize full profit potential in site selection. To realize full profit potential, businesses evaluate alternative sites based on product demand and the cost of production. The argument from states and localities is that incentive programs reduce the cost structure of operation and meeting product demand, thereby inducing attractive alternative locations.11

Local economies benefit most from incentives due to results in employment expansion, personal income expansion, community income expansion, and expansion of community output (business revenues or sales). Once a new business facility has landed and become operational, money will be spent directly on certain items, including (1) payroll; (2) service contracts with local vendors; and (3) local purchases of supplies and equipment. After the new business has made such expenditures, it sets in motion a series of spending flows that affect many areas of a local economy. For example, purchasing of goods and services from local suppliers supports hiring of workers at those businesses and enables those businesses to make additional purchases from suppliers. In this cycle, employees of local businesses begin to earn salaries and wages that will be spent on local goods and services from other businesses. The ripple effects of the activity are evident on three different levels:

- **Direct effects**—initial changes in employment, income, or output that trigger the first round of spending (i.e. the value of a firm’s initial change in payroll or production).
- **Indirect effects**—changes in employment, income, or output in subsequent rounds of re-spending that arise through purchase from local supplier industries (inter-industry purchases).
- **Induced effects**—when payrolls increase and workers in affected industry sectors spend more on local goods and services (household spending effect).12

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11 See State and Local Incentive Competition for New Investment, 7
12 See Analyzing the Benefits and Cost of Economic Development Projects, 2
Given the benefits incentive programs have on commerce, governments also see a great benefit by maintaining or expanding the tax revenue base from new spending, thereby offering improved services or updated services to residents.

Incentive programs favor economic development because they allow disadvantaged communities to level the playing field for business recruitment. Incentive programs are an investment of public finances for community benefit, rather than a subsidy of private business activities.\textsuperscript{13}

Emerging Trends

1. Money matters but services and responsiveness matter more. In the era of social media, texts, and instant messaging, saving time and “instant service” is as important as dollars. A state can make up for lack of dollars by great service.
2. Calibration and fine tuning of incentives toward specific state goals and strategies will become increasingly important.
3. Workforce and talent incentives have a greater influence than tax incentives due to the long term nature of the workforce issue.

\textsuperscript{13} See Analyzing the Benefits and Cost of Economic Development Projects, 1
Criticisms of Incentives

The most common criticism of incentive programs is that they are too generous. Lavish incentives can negatively impact a government’s revenue base, requiring additional spending on public services (such as education and healthcare) to support new business. Problems arise when incentive programs strain local infrastructure but fail to produce the jobs or revenue they promised.14

Another criticism arises when lawmakers assume that historically profitable incentives will continue to generate revenue in the future, overlooking changes in the economy which affect the program. Failing to recognize economic trends put governments in a position to lose critical revenue due to outdated incentive programs.15

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14 See State and Local Incentive Competition for New Investment, 7
15 See Frequently Asked Questions About Economic Development Tax Incentives, 3
Urban/Rural Conflict on Tax Incentives

The conflict between urban and rural communities on tax incentives is not an “us vs. them” relationship; instead, the relationship is better described as a conflict about what communities serve a better purpose in using tax incentives. Generally, incentive-induced employment growth in a local labor market has potential positive long-term effects. Furthermore, employment growth in metro communities contribute toward more permanent drops in unemployment due to a more accessible labor force.  

However, rural and poor communities have a greater need for incentive-induced employment growth. Business development inside rural, poor communities provides positive shocks (sudden growth) to local labor demand. Additionally, incentive packages that include financing toward workforce training will also provide positive shocks to the local economy.  

The Rural Opportunity Initiative (ROI) in Tennessee is an example of a plan that addresses rural investment with incentives. Characteristics of rural communities are limited road access, lack of public infrastructure, and difficulty in matching labor skills to job requirements—all problems ROI addresses through tax incentives. The ROI program outlined below provides tax incentives for businesses locating or expanding in certain counties, allocated in a tier system based on the economic demand for that county:

- **Tier 1 Enhancement Counties**: $4,500 per job tax credit with a $500,000 capital investment in a 12 month period.
  - Job creation minimum of 25 full-time jobs in a 12 month period
  - Job tax credits may offset 50% of franchise and excise tax liability in 15 years carrying forward.
- **Tier 2 Enhancement Counties**: $4,500 per job tax credit with a $500,000 capital investment in a 12 month period.
  - Job creation minimum of 25 full-time jobs in a 3 year period
  - Job tax credits may offset 50% of franchise and excise tax liability in 15 years carrying forward
  - Additional job tax credits of $4,500 per job each year for 3 years to offset 100% of franchise and excise tax liability with no carry-forward
- **Tier 3 Enhancement Counties**: $4,500 per job tax credit with a $500,000 capital investment in a 12 month period.
  - Job creation minimum of 25 full-time jobs in a 5 year period.
  - Job tax credits may offset 50% of franchise and excise tax liability in 15 years carrying forward
  - Additional job tax credits of $4,500 per job each year for 5 years to offset 100% of franchise and excise tax liability with no carry-forward

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16 See State and Local Incentive Competition for New Investment, 12
17 See State and Local Incentive Competition for New Investment, 11, 12
18 See Rural Opportunity Initiative Enhanced Job Tax Credit
Which Tax Incentives are Most Beneficial? One Time Cash Payments vs. Periodic Performance-Based Incentives

The central challenge for governments providing tax incentive programs is understanding how to make the most informed decisions about which program best applies to a specific business; however, the decision of where businesses decide to locate relies solely on how they can maximize their income. Also, the most beneficial tax incentive programs to a government may not always be the most beneficial to business locations decisions.

The research on “one time cash payments vs periodic performance-based incentives” indicates that there is more benefit for a government to provide periodic performance-based incentives, due to the low degree of risk involved. For a government to decide which tax incentive programs to use to attract business investment depends on how risk prone or adverse a government is. The research opinions lean toward periodic performance-based incentives because of low governmental cost and program effectiveness.

The effectiveness of performance based incentives is also based on investment requirements on behalf of the relocating businesses, such as:

- **Corporate Tax Reduction**—tax incentives that reduce corporate income tax liability. The amount that businesses receive in tax credits is calculated as a percentage of the investment made by the participating business. Corporate Tax Reduction is essentially a matching tax incentive program.

- **Transparency**—programs are funded by taxpayer dollars and transparency is essential for building public support toward economic development initiatives.

- **Monitoring**—evaluation of companies receiving incentives is helpful for analyzing whether each incentive is delivering the intended result. If an incentive program is not meeting the prescribed criteria, then a state can take action and change the program or cancel it. If an incentive requires an outcome that cannot be regularly measured, then the incentive is not well designed.

- **Non-Entitlements**—Businesses that qualify for economic development incentive programs without proving they would not have invested in the expansion or location without the incentive, will rarely produce net benefits to the state or local economy.

Relocating businesses must be monitored or commit a degree of investment before the benefits of incentive programs can be realized. One time cash payments can be a strong incentive toward business attraction into a community due to the opportunities that maximize income; however, it is clear that risk is involved, and especially so with taxpayer funding.

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19 See State and Local Incentive Competition for New Investment, 18
20 See Review of Kentucky’s Economic Development Incentives, 25
21 See Review of Kentucky’s Economic Development Incentives, 109
22 See Review of Kentucky’s Economic Development Incentives, 109
23 See Economic Development Incentive Programs, 2
Sunset Functions and Business Planning

A sunset is the period of time when a tax incentive program expires. Sunsets play an important role in economic development, especially how businesses plan. First, screenings in tax incentive programs are a best practice for governments evaluating incentive applicants. Screening applicants help understand a business’ commitment to locating in a state, and whether they can plan around sunsets from a previous location. Second, a large function in tax incentive planning for governments rests on sunset stages, where they can predict a business’s investments to a community when incentives expire.

State and local governments that focus on understanding the cost and effectiveness of tax incentive programs build evaluation models and policies to keep tax incentive programs modern. The best practices for sunset planning are designing evaluation models. Evaluation models consist of joint committees, citizen’s commissions and legislative bodies that assemble to discuss the effectiveness of incentive programs and whether the programs should be extended, modified or allowed to expire. Some examples of states that have used evaluation models are:

- **Oregon**—Created a Joint Committee on Tax Credits to review expiring credits and propose changes on a six year cycle.
  - The committee requests hearings to review evidence and hear testimony from key stakeholders.
  - Committee recommendations are sent to the state Legislature for review and consideration toward modernizing incentive program policies.
  - In 2011, the Legislature allowed some little-used credits to expire while extending or redesigning others, and made modifications to energy incentives that would save the state $20 million over two years, all based on the Joint Committee recommendations
- **Washington**—A Joint Legislative Audit and Review Committee is responsible for reviewing tax incentives on a 10 year cycle.
  - The committee staff submits detailed evaluations with recommendation on whether to continue, modify, or end specific tax incentives.
  - A citizen’s commission considers the evaluations and holds public hearings to develop their own recommendations.
  - The committee and citizen’s commission together provide evidence and guidance to Legislative committees that vote on tax incentive issues.
  - In 2013, Washington ended an incentive meant to support beef processors after the committee staff concluded that the industry was no longer experiencing consequences of a disease outbreak that prompted creation of the incentive program.
- **Rhode Island**—A law in 2013 was approved to review tax incentives in the annual budget process.
  - As of 2014, incentives are evaluated by the state tax office every three years

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24 See Economic Development Incentive Programs, 2
25 See How to Inform Policy Choices, 1
26 See How to Inform Policy Choices, 1, 2
27 See How to Inform Policy Choices, 2
The Governor’s budget proposal includes recommendations on continuation, change, or ending tax incentive programs.

Gubernatorial recommendations are the subject of legislative hearings, providing lawmakers with opportunities to review tax office evaluation results and consider tax incentives alongside other state spending. 28
Safeguards for states and localities – Caps and Clawbacks

State and local governments understand the risk involved with tax incentive programs being potentially harmful to economic growth due to reductions in funding to education and infrastructure.

Caps

A common principle of an incentive program is that businesses are financed based on verified performance, meaning no tax dollars are paid until job creation or capital investment numbers are audited and confirmed. When governments decline to finance a business until job creation is confirmed, this is an example of an incentive cap.

- In Kentucky, businesses receiving incentives must meet criteria every year to continue to receive incentives. A sliding scale is used to evaluate performance. For instance, if a business is required to create 20 jobs, yet only creates 10, 50% of potential incentives would be the maximum incentive amount distributed for that year.
- In New York, periodic reviews are conducted to understand the purpose of the tax incentives, if the credit is still good policy, if the credit is still applicable to the credit’s original goals, and where state budget consequences stand.
- In Florida, evaluating incentive programs occur on a rotating three-year basis, as proposed. The evaluations determine economic benefits of job creation, increase/decrease in personal income, and impact on state gross domestic product resulting from each incentive program. Also, the state’s Department of Economic Opportunity must publish information on incentive programs awarded to businesses.
- In North Carolina, if a business receiving incentives does not maintain its contract to term, North Carolina can force the company to pay back all or a portion of the incentives received due to provisions related to clawbacks.

Clawbacks

Governments that make loans or grants to businesses with a contract for performance typically use “clawback” provisions. The clawback provision is used when a company doesn’t meet its requirements and must pay the state back for a portion of the incentive received.

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28 See How to Inform Policy Choices, 2
29 See Economic Development Incentives Portal
30 See Review of Kentucky’s Economic Development Incentives, 45
31 See New York State Business Tax Credits: Analysis and evaluation, 26, 27
32 See Tax Credit Trends: Expansion and Scrutiny, 8
33 See Review of Kentucky’s Economic Development Incentives, 45
34 See Review of Kentucky’s Economic Development Incentives, 46
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