Best Practices for the Design and Evaluation of State Tax Incentive Programs for Economic Development

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Executive Summary

States seek to promote economic development through a range of tax and non-tax incentives, both of which have proliferated in the high-stakes bidding war over increasingly-mobile jobs and capital investment. The rising revenue costs to the states, coupled with fundamental concerns regarding the ability of incentives to affect the path of economic development, has led to enhanced oversight to better ensure accountability in the use of state resources. While there are ongoing steps to improve accountability and evaluation practices, current practice by the states is still woefully inadequate.

One of the fundamental challenges associated with evaluating incentive programs is that in practice it is impossible to determine whether or not the incentive was decisive in creating new economic activity. Critics rightly claim that (i) there is simply too little evidence that incentives induce significant new economic activity which means that incentives are not likely to be self-financing and (ii) research on the effects of taxes on economic activity generally finds very small behavioral responses on the part of firms and individuals. As a result, incentives are not likely to have much of an effect on economic development.

Assuming that states will choose to continue to use incentives to attract new development opportunities, the practical issue becomes utilizing incentives in such a way that they can limit any harm while at the same time potentially yielding benefits for state residents and the economy. The goal of this report is to present a discussion of the various issues that must be considered in the ongoing conversation about state-level economic development incentives.

The first section focuses on factors that should be considered in the design of incentives, starting with well-defined policy goals and objectives. The use of tax incentives should be viewed by the state as a strategic decision and subject to rigorous analysis of the rate of return on investment (ROI). We discuss the three broad components of a strategic plan for the use of tax incentives: a strengths-weaknesses-opportunities-threats (SWOT) analysis, a strategic action plan that includes well-defined goals and objectives, and an evaluation framework. We then outline the following general characteristics of good incentive programs:

- **EFFICIENT**. A good incentive will provide a well-defined *return on investment* to the state of Alabama.
- **TRANSPARENT**. Incentives should be *transparent* so that benefits to taxpayers and costs to the state are clear.
- **CERTAIN**. Policy *certainty* is important in terms of the magnitude and timing of tax relief for business taxpayers and the realization of tax losses that impact the state budget.
- **PROSPECTIVE**. The state should avoid *retroactive policy changes* that may penalize firms for previous investment decisions.
- **SIMPLE**. Incentives should be *easy to administer and easy to comply with*.
- **TARGETED**. Incentives should be *targeted* and provided on a *discretionary* basis in order to promote economic activity that might not otherwise take place.
- **PROTECT PUBLIC FUNDS**. *Fiscal exposure* to the state should be minimized through such constraints as annual financial caps or time limits on the use of credits.
- **LEVERAGE**. Some incentives produce a *leveraging* effect, drawing in additional resources from local government resources, private sector resources, or federal resources.
- **ACCOUNTABILITY**. *Performance-based incentives* should be built into the program.
- **EVALUATION**. Incentives should include a built-in framework for *evaluation*, which should seek to identify the extent to which incentives induced new economic activity rather than rewarding existing economic activity.
- **OWNERSHIP**. A state agency or agency partnership must *own* the incentive program to ensure proper administration and to conduct or support a thorough program evaluation.

Next we discuss the costs and benefits associated with different types of tax incentives, which are attractive since they can provide direct financial relief to firms and they operate to a large extent on the current tax system which can reduce administration and compliance costs. But they can be costly in terms of forgone revenue, so the potential for reduced service provision cannot be ignored and must also be considered when designing and evaluating a tax incentive. Additionally, the tax system was not necessarily designed to support the administration of a tax incentive, so any program will entail costs above and beyond those otherwise incurred to manage the tax system. Complexity and fairness should be evaluated alongside other direct and indirect impacts of an incentive program.

We discuss the various merits of several forms of tax incentives, including credits, deductions, abatements, exemptions, and rebates. We also consider several issues related to the monetization of

tax incentives. Additionally, we evaluate the choice of the appropriate tax structure within which to enact an incentive, whether that be through the corporate income, personal income, sales, or property tax.

Subsequent sections focus on how to measure tax and economic impacts from tax incentives. The direct tax expenditures resulting from a tax incentive will depend on (i) the benefit structure of the incentive program on a per-use basis; (ii) the timing of incentive realization or use; and (iii) the take-up rate or extent of utilization of the incentive by business. Each will need to be determined in order to estimate short-run and long-run revenue consequences. In terms of economic impact, we consider the *direct effects* of new payroll expenditures associated with the creation of new jobs, the *indirect effects* of new non-payroll expenditures such as construction costs, equipment acquisitions, and the purchase of supplies and services, and the *multiplier effects* as the firm's expenditures become someone else's income, and that income gets spent in the state economy.

This discussion helps draw out the difference between *gross* economic impacts and *net* economic impacts which are exceedingly difficult to distinguish in practice. It is not appropriate to assume that the full economic impact associated with recipient firms is entirely due to a particular incentive if (a) some of the firm's activity would have occurred even without the incentive or (b) some of the activity would have taken place among other firms or in other areas. The best studies will acknowledge these issues and make adjustments or assumptions that allow the estimation of net impacts that are truly driven by the incentive.

Finally, we address alternative economic development strategies, including other forms of incentives, state tax policy more generally, and the use of direct state budget expenditures. We evaluate the benefits of more targeted tax incentives as compared with alternative strategies such as financial incentives or direct expenditures on durable infrastructure or human capital. Additionally, less-targeted tax relief could create a more neutral, non-distortionary tax system that is more fertile for a variety of types of economic development activity.

We recognize that despite the many concerns regarding tax incentives, their use by state and local governments will continue. Accordingly, our general conclusion is that incentives must be well structured, with carefully defined goals and measurable outcomes that can support the evaluation process. A combination of conceptual considerations, statistical modeling, sound data, and good judgement can go a long way toward improving the structure of tax incentives. We also urge

policymakers to place emphasis on tax incentives that can promote the growth of high-quality infrastructure capital, private capital, and human capital. These are the most important foundations for regional economic growth and can offer sustained benefits to the private sector and to individual workers and their families.

Introduction

Promoting economic development has long been a core function of state governments. Broad state investments like education finance and the provision of transportation infrastructure provide an essential foundation that enables private sector economic activity to flourish. Educated workers support the competitiveness of in-state entrepreneurs and businesses while a sound transportation network facilitates in-state and interstate commerce. Absent public sector support, both of these ingredients to economic development would be underprovided and growth would suffer.

States also try to play a more direct role in promoting economic development through a range of tax and non-tax economic development incentives. Tax incentives for job creation and capital investment are pervasive across the country, including programs like Alabama's *Jobs Act*.[1] Financial incentives, including mechanisms to support entrepreneurs and venture capital, are also prevalent. These incentives have proliferated to a bewildering scale as the states have engaged in the high-stakes bidding war over increasingly-mobile jobs and capital investment. A recent report has identified 1,800 different incentive programs across the American states (C2ER, 2013). As the number of incentives has grown, so have their costs. For example, Gorin (2008) notes that Tennessee provided Nissan with incentives amounting to only $8,000 per job in 1980, while Kentucky gave Toyota incentives totaling $50,000 per job in 1987. A national watchdog group monitoring state incentive programs finds that the top 11 tech company megadeals for data centers recently cost the states $1.95 million per job (Mattera, Tarczynska, and LeRoy, 2016). While this is certainly an extreme example, it is indicative of the aggressiveness of interstate competition for jobs and capital.

The rising costs to the states, coupled with fundamental concerns regarding the ability of incentives to affect the path of economic development, has led to enhanced oversight to better ensure accountability in the use of state resources.[2] The concerns regarding incentives have in fact been brewing for a considerable period of time. A provocative paper was released in 1994—*Congress Should End the Economic War Among the States*—challenging Congress to limit the use of incentives that were costly, counterproductive, and potentially unconstitutional through their interference with interstate trade (Burstein and Rolnick, 1994). Peters and Fisher released their critique in 2004, "The Failures of

[1] See http://www.madeinalabama.com/assets/2015/07/DCOM-0150-2015-Alabama-Jobs-Incentive-Package-2-.pdf.

[2] See, for example, Pew Center on the States (2012) and The Pew Charitable Trusts (2015).

Economic Development Incentives," questioning whether incentives were a cost-effective means of promoting growth.

Despite these mounting concerns, the utilization of incentives has escalated. And while there are ongoing steps to improve accountability and evaluation practices, current practice by the states is still woefully inadequate. The Pew Center on the States (2012, p. 1) notes: "But no state regularly and rigorously tests whether those investments are working and ensures lawmakers consider this information when deciding whether to use them, how much to spend, and who should get them." This is disappointing in light of the $4 billion budgeted in support of state economic development agencies in fiscal year 2016 alone (Francis, July 2016). But this is just the tip of the iceberg since it does not account for tax expenditures or other incentive programs that operate outside the economic development agency's budget.

If the costs are so high and the concerns so great, why do states continue to use incentives? The answer is that advocates view them as necessary in the face of interstate competition and effective in attracting mobile capital and jobs. The stylized case is a manufacturing firm that has announced its intent to build a new facility and create new jobs but has not settled on a specific location. In response to the firm's announcement, states place their bids and the chase begins. Ultimately the firm finds a new location, builds its plant, and employs workers. Incentives are then deemed the decisive factor by the proponents of their use. Of course, in practice it is impossible to determine whether or not the incentive was decisive—this is one of the fundamental challenges associated with evaluating incentive programs. From a national perspective, this is a zero-sum game since the company intended to locate somewhere. In fact, it is a *negative* sum game to the extent that resources are used to incentivize an activity that would have taken place anyway.

Critics rightly claim that there is simply too little evidence that incentives induce significant new economic activity which means that incentives are not likely to be self-financing.[3] Tax incentives that entail large revenue costs on a per-job basis cannot reasonably yield complete revenue recovery or a revenue surplus from economic growth. Even if there are other policy objectives, likely helping the unemployed or distressed regions, tax incentives can be a very costly means of achieving policy goals. The reason is that research on the effects of taxes on economic activity generally finds very small

[3] See, for example, Peters and Fisher (2002 and 2004).

behavioral responses on the part of firms and individuals.[4] As a result, incentives are not likely to have much of an effect on economic development. In addition, tax and other incentives create costs for the states. In the case of tax incentives, the forgone revenue must be made up by budget cuts and/or higher taxes on incumbent economic activity. Such actions would serve to offset the expansionary effects arising from the tax incentive itself.[5] We discuss these and related issues in greater detail in the sections that follow.

The reality is that incentives are not going to be forbidden by Congress or eliminated by the state of Alabama. So the practical issue becomes utilizing incentives in such a way that they can limit any harm while at the same time potentially yielding benefits for state residents and the economy. The goal of this report is to present a discussion of the various issues that must be considered in the ongoing conversation about state-level economic development incentives.

In the sections that follow, we draw upon research and experience to provide a framework for the design and evaluation of tax incentives. The first section focuses on factors that should be considered in the design of incentives, starting with well-defined policy goals and objectives. Goals and objectives will provide metrics that can support rigorous analysis of program effectiveness and return on investment. Some of the basic considerations presented can be used as qualitative design criteria as well as guideposts for the evaluation of specific tax incentives. Next is a careful evaluation of the costs and benefits associated with different types of tax incentives. The various structural features of the business tax system represent the policy instruments of tax incentives that will need to be aligned with policy targets such as private capital investment. Subsequent sections focus on how to measure tax and economic impacts from tax incentives, both *ex ante* and *ex post*. This discussion will make it clear that evaluating incentives is a complicated, data intensive process, and may produce findings that underwhelm those who are looking for clarity. Finally, we address alternative economic development strategies, including other forms of incentives, state tax policy more generally, and the use of direct state budget expenditures.

Our general conclusion is that incentives must be well structured, with carefully defined goals and measurable outcomes that can support the evaluation process. A combination of conceptual

[4] Wasylenko (1997) provides a review; Gorin (2008) provides a concise synopsis.

[5] Supporters of tax incentives often argue that they are giving up revenue that the state has never seen. While this may be the case in some instances, any *new* economic activity—firms, workers and households—will require public services from state and local government. An incentive granted for new economic activity limits government's capacity to provide these services.

considerations, statistical modeling, sound data, and good judgement can go a long way toward improving the structure of tax incentives. We also urge policymakers to place emphasis on tax incentives that can promote the growth of high-quality infrastructure capital, private capital, and human capital. These are the most important foundations for regional economic growth and can offer sustained benefits to the private sector and to individual workers and their families in Alabama. Before incentive policy is implemented, alternative investment strategies using the broad tools of the state budget should also be considered and evaluated.

Factors to Consider in the Design and Evaluation of Tax Incentives

Start with Strategy

The use of tax incentives should be viewed by the state as a strategic decision and subject to rigorous analysis of the rate of return on investment (ROI). This is consistent with the state's dual obligations of promoting the well-being of residents of Alabama while at the same time being a good custodian of state tax receipts. There are three broad components of a strategic plan for the use of tax incentives:[6]

- Strengths-weaknesses-opportunities-threats (SWOT) analysis
- Strategic action plan
- Evaluation framework

The foundation for policy development should be a traditional SWOT analysis. Tax incentives policy must be grounded in reality and practicality, be built on Alabama's unique comparative advantages, and offer a clear path for improved economic development outcomes.

The next step is development of a strategic plan that includes well-defined goals and objectives that, to the extent possible, lend themselves to measurement for purposes of efficiency, transparency, evaluation and accountability. In practice, many goals are lofty, aspirational, and do not directly lend themselves to direct measurement. For example, a general goal would be to improve the quality of life for residents of Alabama. A goal like this could be measured by a host of different metrics, thus complicating efforts to engage in rigorous program evaluation. More specific goals might include job creation, urban revitalization, tax base expansion and promotion of private sector capital investment to

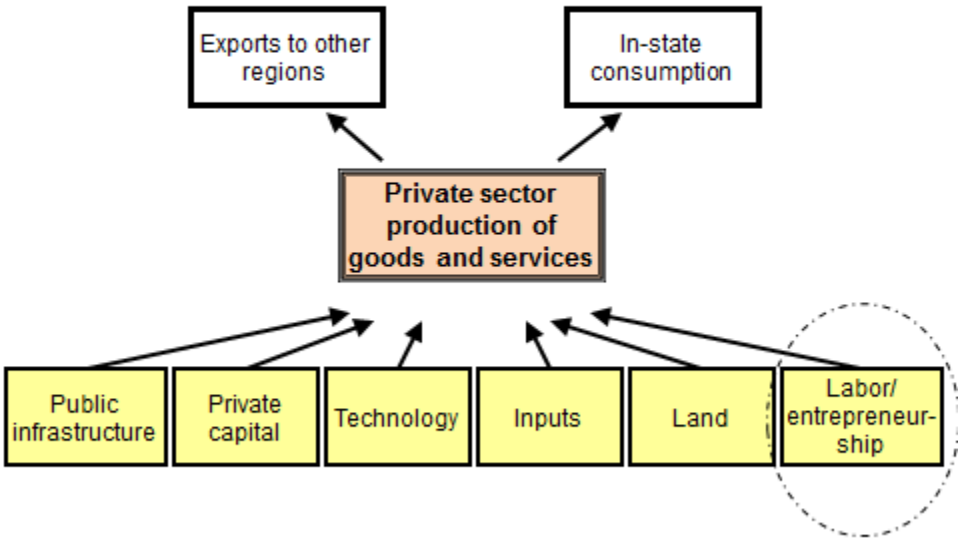
[6] There are numerous variations of this planning framework. For a similar approach applied to state economic development strategy, see U.S. Economic Development Administration (2016).

improve the state's competitiveness. Each of these goals is in principle subject to direct measurement and ROI analysis as part of the specific evaluation framework that must be outlined as part of the original policy.

Policy Targets

Well-defined goals will facilitate the identification of policy targets (e.g. private sector jobs) and the identification and design of specific policy instruments (e.g. wage-based corporate tax credits to promote employment creation). A stylized portrayal of policy targets is shown in Figure 1 to provide context. A state economy combines a variety of inputs, from labor to capital equipment, in order to produce a range of goods and services, some of which are exported out of state and others of which are consumed by state residents. It is important to recognize that exports draw in *new* purchasing power to the state and are the potential source of new jobs, income and tax base creation. Sales to in-state consumers—especially retail sales and services—will generally compete with other producers in the state. Incentives to foster provision of retail sales and services will displace existing economic activity and limit net economic development gains. The real engine of economic growth is the in-state production of goods and services that are ultimately sold to out-of-state consumers.

Figure 1: Factors Affecting an Economy's Performance



Primary policy targets often include the following:

- Public infrastructure: traditional investments like the transportation network and modern investments like broadband communications; investments in industrial parks and site development that leverage public dollars in order to attract private sector investment. Infrastructure investments have lasting impacts on a region's productive capacity.
- Private physical capital: investments in plant, capital equipment and computer and information technology. New capital investments typically enhance productivity and lead to the creation of new jobs; firms with greater capital intensity tend to require utilization of more highly skilled workers who in turn earn higher incomes. Financial capital is necessary to acquire fixed assets and provide working capital on a day-to-day basis. Modern private capital can improve the competitiveness of the state economy.
- Technology: the nature of the firm's production process which is generally embodied in private capital investments. Fostering growth in technology—through new capital investments and research and development—will help sustain and create good quality jobs.
- Inputs: the raw materials and intermediate inputs that are used in combination with capital equipment and workers to produce a good or service. Market forces typically provide firms with the resources and inputs they need to produce. However, in some instances it may prove fruitful to incentivize a supply chain in order to support lower-cost production processes for in-state producers. Similarly, promotion of *agglomeration economies*—spillover benefits like lower costs that come about from firms and workers locating in close proximity to one another—can lower costs of production.[7]
- Land: an essential component of the production process, but only provides indirect benefits to state residents other than landholders. Acquisition can be incentivized in any of a number of ways, including tax incentives, grants and loans.
- Labor and entrepreneurship: highlighted in Figure 1 since these are arguably the most important inputs to production in the sense that employment directly benefits workers and families and thus eases pressures on state and local government budgets. Labor can be targeted by firm-based tax incentives with the goal of increasing the number of people employed or raising incomes. Tax incentives can also be used to promote investments in worker human capital that enhances productivity on the job and earnings and helps foster entrepreneurship.

[7] Glaeser (2010) discusses several different facets of agglomeration economies.

Policy targets should be chosen based on their ability to impact economic development goals. In general, alternative policy targets and policy tools need to be evaluated to determine which provides the greatest ROI. For example, if the goal is to increase employment, then incentives for land acquisition represent a poor target since land only indirectly leads to employment creation. For distressed regions, a jobs-based tax incentive may be most appropriate since it directly targets the policy goal. Wage-based or training credits, on the other hand, may be appropriate when the goal is to improve job quality rather than increase the level of employment. Incentives that can enhance the private capital stock and technology will indirectly lead to the creation of better quality jobs and promote the competitiveness of firms and the economy.

Targeting may also focus on industries and industry clusters based on the unique comparative advantages and strategy chosen by the state. In 2013, about half of the states used some form of industry targeting in their approach to economic development (C2ER, 2013). Industry clusters are also commonly used in order to exploit possible supply chain and agglomeration linkages. In these latter instances, fostering the growth of one firm can lead to costs savings for other firms in the regional economy and thus spillover growth.

Incentives: Cost Reduction or Boost to Competitiveness?

It is important to consider how incentives might impact the productivity and competitiveness of the state economy.[8] Do incentives simply lower business costs or do they lead to fundamental improvements in the ability of the state to compete in an interstate and international marketplace? Typical incentives for land acquisition, job creation, and access to financial capital simply serve to lower the costs of doing business. Low costs are of obvious importance in a competitive market environment. For decades, the southern states have been aggressive in the use of this low-cost-of-business economic development strategy, promoting low-cost land, low taxes (often with generous incentives) and low-cost labor. This served the region well as economic activity migrated from higher-cost locations elsewhere in the U.S. to the southern states, including Alabama. But low costs do not necessarily improve the fundamental productivity of firms, workers or the regional economy. Moreover, the low-cost strategy

[8] The perspective that follows is similar to the argument made in *Advanced Manufacturing in the American South: An Economic Analysis Supporting Regional Development*, prepared by Waldman and Murray for the Southern Governors' Association, available at https://www.mapi.net/system/files/attachments/files/Advanced_Manufacturing_American_South_0_1.pdf.

may mean that the state is compelled to compete against other low-cost workers around the world, including those in developing countries.

The rapid emergence of low-cost production sites outside the U.S., coupled with advances in technology, has led to the loss of manufacturing jobs throughout the region. The *world is flat*, to use the name of a popular and influential book on the globalization of markets (Friedman, 2005). And this flat world makes it ever harder to compete solely on the basis of low costs. At one time, Alabama competed against its regional neighbors and others to attract jobs and capital to the state. Today, Alabama competes in a global marketplace.

An alternative development strategy that is built on *promoting value added in production processes* may offer a more secure, stable, and progressive path of economic development for the state. Low costs remain important when the emphasis falls on promoting value added. But the balance is tilted toward the use of incentives that can cultivate the growth of productive assets that stick in the state and promote the competitiveness of the economy.

At a fundamental level, economic growth arises from growth in the factors of production like those illustrated in Figure 1. Productivity growth comes from sound investments in human capital, as well as high-quality private sector capital and public infrastructure. If Alabama can enhance investments in these forms of capital, it can create a stronger foundation for the creation of private sector value added. When the focus falls on value added and improvements in productivity, economic development is no longer simply a zero-sum game across the states. The key is the recruitment and retention of firms that are committed to competitiveness and the use of state dollars to invest in productive assets to nurture private business sector growth.

Economic Development and Quality of Life

The production function framework presented here is driven by the perspective that exports are the major driver for state economic *growth*: selling more goods and services means greater utilization of inputs sourced in the state. As important as this perspective is, it does not directly capture the quality of life dimension of economic *development*. Jobs are important, but so are earnings and fringe benefits like health insurance. Parks, recreation areas, museums, professional sports facilities, and historic resources are examples of assets that improve quality of life for state residents. These same assets can improve the attractiveness of a region as a place to locate, do business and visit. State residents must be willing to pay to for these quality of life assets.

Incentives to promote quality of life must be carefully developed and subjected to evaluation just like other incentive programs. There are two issues associated with cultivation of quality of life assets that warrant attention here. First, some can displace other economic activity in a regional economy. A good example would be a professional sports facility which may reallocate economic activity both across regions and across sectors of the economy. People who travel to enjoy professional sports will shift *where* they spend their incomes, thus shifting the location of sales, employment, and tax bases. (If out-of-state residents are attracted to the facility, this is analogous to traditional exports, and can provide a boost to the economy.) In general, those who go to professional sports facilities change *how* they spend their incomes as well: more is spent on admissions, lodging, and food but less is spent elsewhere in the economy. This reallocation of economic activity creates winners and losers across regions and sectors and may lead to no net gain in economic activity.

The second issue is placing a value on the quality of life asset itself, which may be important but highly problematic in practice. The evidence shows that professional sports facilities are generally not a sound investment from a strict financial ROI perspective for local governments.[9] But they may offer marquee effects for the community if they attract other types of economic activity to the area. In addition, there may be value to residents that goes above and beyond directly-incurred expenditures, including the pride created for those who never choose to go to a game. Benefits like this may help explain why communities make what appear to be bad financial investment decisions when supporting professional sports franchises.

Historic preservation offers another example. When preservation is a standalone activity—as with the rehabilitation of a historic monument—a decision must be made regarding the value of preservation so as to guide the investment of resources. Such an assessment may consider benefits of preservation for both current and future generations. In some instances, preservation may be coupled with community revitalization goals that entail the development of retail trade and service opportunities for residents and dampen sprawl pressures on surrounding urban areas. Once again, the value of preservation itself must be identified, as well as the value of a revitalized community. As with a sports facility, the emergence of new shopping opportunities may displace other economic activity, limiting net gains in economic development. Any displacement should be explicitly recognized in order to evaluate an incentive's effectiveness in promoting historic preservation and community revitalization.

[9] Coates and Humphreys (2003, p. 335) note that "…economists have no evidence of positive economic impact of professional sports teams and facilities on urban economies."

Characteristics of a Good Incentive Program

Policy goals and carefully chosen policy targets can help promote the effectiveness of tax incentives. This strategic approach can be complemented by the consideration of key characteristics of a good incentive program, some of which have surfaced in the discussion above. These characteristics are especially important in light of the difficulties associated with quantitative evaluations of the effectiveness of tax incentives—basic qualitative design considerations can potentially improve the effectiveness of incentives even if outcomes are difficult or impossible to measure.

- **EFFICIENT**. A good incentive will provide a well-defined *return on investment* to the state of Alabama. A good incentive program will also lead to lasting *investments* in Alabama that will lead to clear economic development gains for the state and its residents. Examples include the recruitment and retention of private capital investment, along with investments in public infrastructure capital and human capital. Tax incentives should focus on economic activity that is *exported* from the state to maximize the net gains associated with the incentive.
- **TRANSPARENT**. Incentives should be *transparent* so that benefits to taxpayers and costs to the state are clear.
- **CERTAIN**. Policy *certainty* is important in terms of the magnitude and timing of tax relief for business taxpayers and the realization of tax losses that impact the state budget.
- **PROSPECTIVE**. The state should avoid *retroactive policy changes* that may penalize firms for previous investment decisions.
- **SIMPLE**. Incentives should be *easy to administer and easy to comply with*. The use of incentives will necessarily entail costs, but to the extent possible these costs should be minimized. Using existing policy tools and the existing system of tax administration can help reduce costs for the state and for business. Evaluation responsibilities and costs will be an essential feature of a good tax incentive.
- **TARGETED**. Incentives should be *targeted* and provided on a *discretionary* basis in order to promote economic activity that might not otherwise take place. Providing incentives on a discretionary basis requires screening of possible recipients. It is not uncommon for states to use agency discretion or competition to determine incentive assistance (C2ER, 2013). Targeting implies that tax incentives should not be structured as entitlements available to all taxpayers. Broad statutory relief through the tax system would be a preferred policy approach, eliminating the need for costly-to-administer incentive programs.

- **PROTECT PUBLIC FUNDS**. *Fiscal exposure* to the state can be minimized through annual programmatic expenditure or funding commitment caps; time caps, which limit the period for which an incentive may be used; and constraints on how much of the incentive may be used by a firm (for example, limiting the amount of taxable income that can be offset by a tax credit or limiting the size of the credit itself).
- **LEVERAGE**. Some incentives produce a *leveraging* effect, drawing in additional resources from parties other than the state. This might include local government resources, private sector resources, or federal resources. Leveraging allows an incentive to have a larger impact than would otherwise be the case.
- **ACCOUNTABILITY**. *Performance-based incentives* should be built into the program. The alternative is prospective provision of incentives and then the imposition of claw-back penalties for non-performance. For example, employment-based credits should be provided only upon the demonstrated creation of jobs rather than prior to job creation.
- **EVALUATION**. Incentives should be implemented with a built-in mechanism or framework for *evaluation*. This will require the commitment of resources on the part of the state as well as businesses that receive the benefits of the incentive. To the extent possible, evaluations should seek to identify the extent to which incentives induced new economic activity rather than rewarding existing economic activity. *Accountability in the use of public funds* arises through reporting, monitoring and evaluation of the incentive program. Over one-half of the tax incentive programs offered by state governments around the country have data collection and evaluation systems in place (C2ER, 2013). However, as discussed below, there are ongoing concerns regarding the effectiveness of these evaluations (Pew Center on the States, 2012).
- **OWNERSHIP**. A state agency or agency partnership must *own* the incentive program to ensure proper administration and to conduct or support a thorough program evaluation.

Factors like this can be used to design and evaluate incentives generally. Other factors and rules of thumb can also be important. For example, some incentives may foster supply chain development; some industries will have larger multiplier effects; and some firms will tend to buy extensively from in-state suppliers while others will purchase intermediate inputs largely from out-of-state vendors. Fringe benefits and job training opportunities for workers are also important. Simple rules of thumb like taxes forgone per job created allow for comparisons across incentive programs. To the extent possible, these

factors should be considered in the design stage, when making decisions on whether to extend tax incentives to a firm and when conducting evaluations.

Costs and Benefits of Tax Incentives

Tax incentives are intended to reduce the burden of one or more taxes while at the same time catalyzing new economic activity that would not otherwise have taken place. To place tax incentives in broader context, consider the Tax Foundation's tax component of its business climate index, which gave Alabama a ranking of 32nd in its most recent report (Walczak, Drenkard, and Henchman, 2016). The state's 6.5 percent flat corporate income tax rate placed it at the 14th position among the states. The flat and relatively modest rate in comparison with other states makes the corporate income tax relatively attractive. The personal income tax has a progressive rate structure with a top rate that is lower than all but five other states, and was ranked 22nd. The sales tax, on the other hand, received a poor ranking of 48th in part because of the high combined state and local tax rate and also because of the broad taxation of business inputs and the exclusion of many consumer purchases from the base.

Tax incentives can be costly in terms of forgone revenue. For example, a recent study in Connecticut shows that the state could have reduced its statutory corporate tax rate by 1.9 percentage points in 2012 had there been no state corporate income tax credits (Luna and Murray, 2016). In general, it is important to evaluate broad tax relief to business as an alternative economic development strategy. For example, revenue-neutral sales tax base changes would be one such option for Alabama to consider. This would entail broadening the base to include more consumer purchases while expanding the range of exemptions available to all business taxpayers. Lower effective burdens on business would help promote economic development.

Forgone revenue may alternatively be viewed in terms of the reduced capacity to fund government services. Some government services are redistributive in nature, but still deemed desirable by voters. Other services enhance quality of life for residents and may make Alabama a more attractive place to live and do business. Finally, some services—notably investments in education and infrastructure—are important means to grow the state economy. The potential for reduced service provision cannot be ignored and must also be evaluated when designing a tax incentive. Fund allocations for different tax instruments may also affect the ability to support public service delivery. Local property taxes, for

example, are often earmarked for education finance. So any form of property tax relief has implications for school funding.

Just over one-half of the responding states reported using incentives that offered tax-related benefits to industry in 2013 (C2ER, 2013), with significant growth taking place in support of larger firms since 1999. Tax incentives are attractive since they can provide direct financial relief to firms and they operate to a large extent on the current tax system which can reduce administration and compliance costs. However, the tax system was not necessarily designed to support the administration of a tax incentive, so any program will entail costs above and beyond those otherwise incurred to manage the tax system. Complexities create costs for both taxpayers and tax administrators. This problem may be compounded by the presence of multiple incentive programs with different goals and structures.

Fairness is also a prominent concern among the voting public. High-profile targeted tax incentives are often perceived as unfair, especially if they reduce corporate or business income taxes leaving the remaining tax burden to be shifted more heavily onto residents and consumers through personal income and sales taxes. It is important to remember that business taxes are inevitably borne by individuals, either through lower wages, higher prices, or lower returns to capital (which impacts many low- and middle-income workers with diversified retirement savings accounts, not just the wealthier owners of capital investments). Targeted tax incentives can enjoy broader support if they can be shown to improve wages or produce other benefits for an area.

Types of Tax Incentives

To be effective, a tax incentive must be able to alter a firm's return on investment in Alabama with some degree of certainty. This means creating a tax loss to the state that should be viewed as an investment in future economic development. Tax incentive relief can come in any of a number of forms:

- Tax credits: incentives that are applied against the firm's tax liability. If a firm has no tax liability, then the incentive offers no relief. Relief can be provided through credit carrybacks or carryforwards or through refundable tax credits. Carrybacks and carryforwards may create uncertainties for firms and the state on the timing and magnitude of relief. In 2013, for example, Connecticut had $2.5 billion in unclaimed corporate income tax credits that were being carried forward, a figure that was about four times the level of corporate income tax collections (Luna and

Murray, 2016). Refundable credits, on the other hand, can be structured to provide certainty on the value and timing of incentive realization.

- Tax deductions: incentives that reduce the costs of doing business through an allowable deduction from taxable profits. Tax deductions may offer no relief to taxpayers if there is no tax liability incurred. As such, deductions are typically less effective than credits. They also provide greater financial benefits to companies facing higher tax rates, which makes them potentially less fair.
- Tax abatement: direct reduction in tax liability. Abatements typically arise in the context of specific incentive packages for specific firms. Abatements will be more effective for taxes where there is a liability regardless of profitability, such as for sales and property taxes.
- Tax exemption: economic activity is not subject to taxation. Exemptions are generally based on statute and remove an entire class of economic activity from taxation. For example, certain business inputs are exempt from the state and local sales tax in Alabama.
- Tax rebate: a portion of taxes paid is returned to the taxpayer. Rebates are typically provided on an *ex post* basis, i.e. after business decisions have been made. As such, they offer a poor mechanism for incentivizing new economic activity.

Tax credits, with some means of ensuring taxpayer relief, are the most effective of these policy instruments in terms of broadly having the capacity to affect firm-level tax liabilities. The more liquid the tax relief, the greater the savings to the firm and thus the greater the likelihood of an incentive impact on business decision making. Refundable credits can provide relatively certain tax savings to business and tax costs to the state. Monetizing and enabling transferability of tax credits (i.e., when a recipient can essentially sell a stream of future payments in exchange for an up-front lump sum payment) offers an alternative means of creating liquidity for incentive recipients, though some uncertainty regarding monetized value and the timing of relief will still exist because of the secondary "market" for these tax credits.

Monetization of credits is a rather peculiar form of tax relief. Firms incur costs in marketing and selling credits, and they are typically sold at discounted value in the secondary market. This creates a different form of business investment strategy on the part of the recipient firm that may distract it from its core business line. Brokers have emerged across the states to facilitate these transactions. These costs all arise from the peculiar nature of the credit scheme and could be avoided through a simpler refundable credit program. Moreover, this form of credit monetization diminishes the transparency of the incentive program and may compromise the program in the eyes of the public, who will see credit

benefits that seemingly flow to firms that have little or nothing to do with state economic development.[10]

The basis of incentivized activity— for example, employment or capital investment—should be determined through the broad strategic planning process outlined above. If the goal is employment creation, then the tax credit should be directly targeted to employment creation on a realization rather than prospective basis. A general tax credit is undesirable since it is not tied to any particular activity of the firm and there is no assurance that employment creation will follow. A jobs credit would encourage job creation generally. A wage-based credit, on the other hand, would encourage firms to hire better-paid workers, achieving the job creation objective as well as a job quality objective. A job training credit may encourage hiring while promoting investments in the human capital of Alabama workers.

The value of the incentive will also have to be determined, based in part on the need to provide meaningful relief in order to induce any new activity. As noted above, available research indicates that the business response to variations in taxes and tax incentives is modest. As a result, relatively large incentives may be required in practice to alter business behavior. Decisions will also have to be made as to whether different regions, for example, receive differential incentives. Depressed regions may require larger incentives to help overcome other obstacles to business development in such places.

The basis for an incentive might also be tied to a firm's historical experience in order to induce new economic activity. For example, if the policy goal is to increase productivity through R&D activity, it may be desirable to use historical R&D expenditures as a benchmark and then provide a tax incentive for R&D expenditures above this historical benchmark. This can add to the administrative and compliance costs of the incentive program and may or may not produce effective results.

Different Tax Instruments

While businesses pay a wide variety of taxes, the largest burdens arise under the corporate income, personal income, sales, and property taxes. Each of these tax instruments can be used to support tax incentives. Because of the importance of these taxes to business decision making, the broad structure of the taxes should first be evaluated to determine whether or not there are structural features that either impede or encourage economic activity as noted above. Structural reform, discussed below, is an alternative means of adjusting the tax system to encourage economic development.

[10] Zimmerman (2015) discusses transferability in the context of historic preservation programs.

The corporate income tax applies only to businesses established in the formal corporate form; pass-through entities like limited liability corporations and sole proprietorships pay tax at the individual level through the personal income tax. Depending on the policy goal, it may be desirable to provide incentives to both corporate and non-corporate businesses. This would require the use of both tax instruments to support policy.

Use of the corporate income tax as a policy tool can be effective in targeting relief to specific types of economic activity deemed attractive by the state. The detailed line items of the corporate return will facilitate this targeting. For example, Alabama is among a large number of states that have increased the sales factor weight in the corporate income tax apportionment formula in order to encourage the location of firms that sell their goods disproportionately out of state.

In principle, tax credits can be differentiated based on targets ranging from R&D expenditures to capital investment to employment. More nuanced targets may also prove possible using existing tax forms and reports or through incentive supplements to traditional reporting mechanisms. This breadth of targeting is not *directly* available under the sales or property taxes because of the nature of the reporting process for these other tax instruments; supplemental forms, schedules and reports could be used to support targeting for these other tax instruments.

Unlike the sales and property taxes, businesses do not pay corporate income tax unless they are organized as a corporation and realize a profit. Many new firms as well as firms with significant expansions may be non-corporate, and/or may have deductions from business receipts that do not yield a profit. As noted above, refundable tax credits offer the most generous means of addressing this problem.

The ideal sales tax would tax all final consumption by consumers in Alabama while at the same time exempting all business inputs from tax. In practice, this is not the case. Most states, including Alabama, exempt a wide array of consumer purchases from tax, especially services. On the other hand, the sales tax falls on a wide range of (primarily tangible) business inputs. Taxation of business inputs leads to two problems. First, the *source-based* taxation of production activity means that firms conducting business in Alabama will pay a high sales tax rate on purchased inputs, driving up the costs of doing business in the state. Given the high state and local rate structure in the state, this is problematic. One estimate indicates that businesses in Alabama pay 27 percent of total sales tax collections in the state (Ring, 1999). The second problem is that the sales tax will *pyramid* across the production chain as tax is levied

on intermediate inputs that have already been subjected to taxation. This further increases the costs of purchased inputs and leads to variations in the final amount of tax that is embedded in price. It also creates winners among firms that produce more of their own inputs rather than purchasing them in the (taxed) market. This can create incentives for vertical integration within the supply chain.

As noted above, tax instruments should be subject to structural evaluation to determine strengths and weaknesses prior to the introduction of incentives. The sales tax is a case in point: broader exemptions for input purchases would improve the structure of the tax and encourage production activities in the state. This policy should not be viewed as an incentive *per se*. Instead, it is simply one element of a good tax system.

Sales tax incentives can be used to encourage certain types of activity that may promote economic development. Given the existing base and reporting apparatus, incentives would be confined primarily to the acquisition of tangible business inputs. For example, construction materials could be afforded a credit (or simply exempted) to encourage capital investment in the state. Similarly, credits or exemptions could be provided for certain types of capital equipment deemed to have important effects on economic development such as information technology acquisitions.

In summary, the sales tax is a potentially good policy instrument for promoting certain capital purchases. Incentives would build on an established system of administration and compliance. Because sales taxes are paid regardless of firm profitability, incentives can provide both certainty and transparency in terms of tax relief.

The property tax represents another form of source-based taxation through the burdens that fall on land and capital improvements in Alabama. Like the sales tax, property taxes accrue regardless of firm profitability, so tax relief will provide direct savings to firms. The ability to use the property tax as an incentive is enabled by the state. Enabling policy should be predicated on the capacity of local governments to engage in strategic planning and conduct meaningful evaluations of the effectiveness of any incentives. Poor decision making by local communities can lead to long-term base erosion that compromises the capacity to fund public services.

In contrast to income and sales taxes, there is no detailed line-item form for reporting and paying property tax. Providing general property tax incentives is thus a rather blunt instrument that could encourage land or capital acquisition; there is no direct assurance of employment impacts arising from a property tax incentive. Tax incentives can, however, be structured to incentivize more specific forms of

business activity. For example, property tax credits might be tied to general capital investments or specific forms of capital investment that help improve the productivity and competitiveness of businesses. Similarly, a property tax incentive could be tied to job creation generally or to the creation of high-paying jobs. Property tax incentives can provide transparent and certain tax savings to firms, largely using the existing structural apparatus for the tax's administration and compliance. This enhances the simplicity of the incentive.

Tax Expenditures and Economic and Budget Impacts

The use of tax incentives gives rise to direct tax expenditures—forgone revenue—that are intended to spur business activity and in turn promote growth in tax revenues. The magnitude of direct tax expenditures is important since it determines the magnitude of tax incentive benefits to firms and current and future revenue sacrificed to promote growth. Estimating tax expenditures is exceedingly difficult but essential.

Tax incentives will induce new economic activity, but some incentives will go to firms that would have invested or created jobs even without a subsidy. Ideally, the screening process would have eliminated the latter type of firms from consideration, but this is not generally feasible. Truly induced economic activity will create *new* ripple effects across the Alabama economy, giving rise to additional jobs and income, and expanding tax bases, through the supply chain and multiplier process. Economic impact analysis (EIA) is the most-commonly employed tool for estimating the effects associated with new economic activity in the state. Typical EIA evaluates *gross impacts* arising from new economic activity. This can overstate the net benefits of tax incentives through two channels. The first is the inclusion of firms whose behavior (e.g. investment or employment) did not in fact change in response to the incentive. This is the "but for" issue: would the economic activity have taken place without the incentive? The second is *crowding effects*. For example, new business activity may drive up labor costs that discourage growth on the part of other firms; tax incentives that spur local retail trade and service activity may crowd out other businesses located in the same region of the state. In sum, it is not appropriate to assume that the full economic impact generated by recipient firms is entirely due to a particular incentive if (a) some of the firm's activity would have occurred even without the incentive or (b) some of the activity would have taken place among other firms or in other areas. The best EIA

studies will acknowledge these issues and make adjustments or assumptions that allow the estimation of net impacts that are truly driven by the incentive.

In principle, tools like EIA allow for identification of economic and tax impacts that arise from the use of tax incentives. This allows for evaluation of return on investment of state tax dollars and identification of net economic and revenue impacts for the state. These evaluations should be mandated and mechanisms for data collection and analysis should be explicitly identified in the enabling legislation for any incentive.[11]

Most impact studies do not evaluate how public service costs might change in response to incentives. If incentives have no net effect on private sector activity, there is only a revenue loss that must be made up elsewhere in the budget. On the other hand, if the tax incentive does spur new economic activity, then there will be new service delivery requirements. Meeting these needs can be problematic when some of the associated revenue is forgone through the tax incentive. While net fiscal burdens are seldom evaluated, they warrant consideration in the design and evaluation of tax incentive programs.

Tax Expenditures: Forgone Current and Future Tax Revenues

The direct tax expenditures resulting from a tax incentive will depend on (i) the benefit structure of the incentive program on a per-use basis; (ii) the timing of incentive realization or use; and (iii) the take-up rate or extent of utilization of the incentive by business. Each will need to be determined in order to estimate short-run and long-run revenue consequences.

The structural characteristics of the incentive will determine the potential revenue losses to the state and the potential tax savings to business on a per-use basis. This should be known with relative certainty: the strategic planning and design process should yield considerable clarity on the value of the incentive to the firm since the intent is to alter firm behavior. A simple example would be a single year, $1,000 refundable tax credit for each job created. Taxpayers can be assured of receiving the benefits of this incentive in the year of job creation while the state can be certain of revenue losses in the same year due to the refundable nature of the tax incentive.

Uncertainty can easily arise in the context of other structures. For example, if the same tax credit program was nonrefundable, then there would be uncertainty as to how much benefit would accrue to

[11] Exceptionally clear resources on incentive evaluation include The Pew Charitable Trusts (2015) and Pew Center on the States (2012).

the firm and how much revenue loss would be seen by the state. The state will simply not know the profit position of each firm receiving the credit and whether the credit can in fact be applied against a tax liability. Tax return information can provide potentially important insights on this question, but this can require considerable effort on the part of a revenue department.

To complicate matters further, consider an initial year nonrefundable credit for job creation with a 10 year carryforward. Firms will have some uncertainty regarding whether profits will be earned and how large they will be, which will in turn affect the scope and timing of tax savings. The state will be subject to greater uncertainty still on the timing of incentive realization and thus the timing of the tax expenditure. This uncertainty can hamper effective budgeting both within and across fiscal years. The transfer or monetization of tax credits reduces some of the uncertainty for the firms, but does not reduce the uncertainty for the state. Fiscal year caps on realization can reduce the state's fiscal exposure to this uncertainty. But the same caps limit the effectiveness of the incentive to business in terms of potentially realized tax savings.

The take-up rate on the incentive will influence the overall revenue losses incurred by the state. The extent of utilization will depend on the generosity of the incentive and how firms then respond. There is a vast literature that examines the effects of state and local taxes on various measures of business activity.[12] A critically important conclusion from this body of research is that while taxes do matter, the responses tend to be small or *inelastic*. This means that induced economic activity will tend to be small in size. A direct implication is that tax reductions are not likely to be self-financing through the dynamics of the economic development process. This is an important element of realism that needs to be at the center of the debate over the use of tax incentives.

The most sophisticated approach to estimating take-up rates would be to utilize a formal economic model of the Alabama economy. In general, these are multi-equation statistical frameworks that capture the relationships between state taxes and various facets of business activity like employment creation and capital investment. The benefit structure of the tax incentive will determine the scope of tax reduction for the firm. These tax savings then lead to changes in business activity. A well-developed model will implicitly include the behavior of in-state firms, as well as out-of-state firms that have historically chosen to do business in Alabama; all of this business activity is embedded in historical

[12] Surveys of the literature include Bartik (1991) and Wasylenko (1997); Wasylenko (2015) provides an update. Bruce, Liu and Murray (2015) find little evidence that state taxes affect in-state entrepreneurship. Gale, Krupkin and Reuben (2015) show that state taxes have little impact on firm formation and employment.

economic data. This means that the model can potentially estimate take-up rates that account for new business activity that comes from out of state.

Economic models, while rigorous and helpful to the policy process, are also difficult and costly to develop. They require extensive economic and statistical knowledge, coupled with a good understanding of the state economy and the state's fiscal structure. Data limitations may preclude or limit the ability to precisely estimate how specific tax incentives affect firm activity.

A similar but less sophisticated application would use information on the structure of the incentive to determine how it would affect business costs. Evidence from the empirical research literature could then be used to estimate the extent to which the incentive might change business behavior. This is similar in spirit to the modeling approach described above, but the application takes place without the formal structural model of the economy.

An alternative approach builds on available experience and data, but requires an analyst's judgement in the end. There may have been experience with similar incentive programs in the past that can inform current policy on take-up rates and other matters. Rigorous evaluations of previous programs would offer the most support. The structural features of the incentive and available administrative data can also be helpful. For example, a tax incentive might be targeted to a specific industrial sector and designed to support the creation of 50 or more jobs per firm. Data from the state's unemployment insurance system could in principle be used to determine how many firms in the targeted industry had in fact created 50 or more jobs in recent years. These figures would not account for induced effects but could still provide a lower bound on the take-up rate of the incentive.

Net Impacts of Incentives

An effective tax incentive sets in motion a chain of events that ripples across the economy to promote economic development. A stylized version of the process takes the following form:

- The tax incentive recipient has new payroll expenditures associated with the creation of new jobs—these are referred to as *direct effects*. While some of the jobs may go to state residents, others may go to nonresident commuters and to in-migrants to the state. In-migration can occur as individuals seek employment with the firm receiving the incentive; alternatively, in-migration may take place as current workers leave their place of employment for a job with the firm, leaving a vacancy that must be filled.

- The incentivized firm incurs new non-payroll expenditures, potentially including construction costs, equipment acquisitions, computer and informational technology expenditures and the purchase of supplies and services (from lawn care to financial services). These new non-payroll expenditures are referred to as *indirect effects*. Some of this activity will be produced and acquired in state, creating additional benefits for the state economy. On the other hand, some of the activity will be produced by and/or acquired from out-of-state firms, creating economic development gains outside the state economy.
- As the direct payroll and indirect non-payroll expenditures work their way through the state economy, *multiplier effects* are created as the firm's expenditures become someone else's income, and that income gets spent. The process continues to ripple across the economy. The multiplier effects in principle influence every sector of the state economy. At each round of the spending process, leakages reduce the size of the ripple effects. The leakages may arise from several sources, most notably from out-of-state spending. Statewide multipliers tend to be in the neighborhood of 2 to 3.[13] This means, for example, that every dollar of direct payroll will lead to $1 to $2 of new income elsewhere in the economy. An important implication is that any form of spending by any sector of the economy will have ripple effects.

This discussion of direct, indirect, and multiplier effects helps draw out the distinction between gross economic impacts and net economics impacts. The difference arises from the two sources identified above. First, the incentive recipient may not in fact create *new* economic activity, but simply receive tax relief for activity that would have otherwise taken place. For these firms, there are no new direct or indirect effects arising from the incentive. Evaluations that include these impacts (and there are many examples) overstate the benefits of the tax incentive program. Unfortunately, there is no easy way to precisely estimate the share of the incentive that goes to firms that change their business activity in response to the incentive.

Second, there are a range of possible crowding effects that can dampen direct, indirect, and multiplier impacts on the economy. A clear example would be an incentive extended to a new retail trade

[13]Multipliers tend to be smaller for smaller and less diversified economic regions. The U.S. Department of Commerce provides RIMSII multipliers that are commonly used to conduct EIA. Employment multipliers for Alabama acquired for this report range from a high of 4.6 for paper manufacturing to a low of 1.3 for amusements, gambling and recreation (Table 2.5, Alabama type II multipliers). If one simply wanted to maximize ripple effects across the state economy, then spending should be reallocated to sectors with large multipliers. A useful resource guide on EIA is the companion handbook available at http://www.bea.gov/regional/pdf/rims/rimsii_user_guide.pdf.

establishment located in an established community with similar firms. Unless the region has new purchasing power from some source, the new retailer will simply crowd out the economic activity of its competitors. The fact that you can measure the employment and count the capital investment of the new retailer does not mean that there is a *net* new economic benefit created by the retailer. Again, a failure to account for this will lead to overstated economic impact estimates.

Crowding effects can take a number of different forms. Examples include:

- Reduced tax collections from the incentive lead to higher taxes on other firms in the economy, reducing their growth path.
- Increased labor demand on the part of the incentivized firm drives up labor costs which discourages employment creation by other firms.
- New economic activity congests public infrastructure like the transportation network, raising commuting and supply chain delivery costs, and reducing the attractiveness of the region for economic development.
- Large, visible companies create marquee effects that may diminish the interest of like firms in locating in the same region.
- More industrial activity puts pressure on available land and industrial parks, driving up land costs.

Together these two forces will dampen economic development gains associated with the tax incentive. This helps explain why two academic studies have found that large firm locations around the country—typically accompanied by generous incentive packages—have had surprisingly small net effects on regional economic growth.[14]

The best way to evaluate the net economic gains from a tax incentive is an *ex-post* econometric analysis that uses measures of incentive utilization (e.g. job creation by incentive recipients) to explain regional economic activity (e.g. growth in nonfarm employment). It is important to recognize that this approach does not require an analyst to distinguish between incentive recipients that induce new activity and those that do not. Similarly, there is no need to explicitly model potential crowding effects. Both of these influences will be embedded in the economic data. This is the general approach that is taken in academic research and in sound evaluations of state tax incentive programs. It is this literature that has produced evidence on the muted effects of taxes generally on business activity.

[14] See Fox and Murray (2004) and Patrick (2016).

An alternative but less precise approach is EIA, perhaps the most commonly used policy evaluation tool. Familiar modeling frameworks include Implan, Remi and RIMSII multipliers. Each of these models account for interrelationships within a regional economy and capture direct, indirect, and multiplier effects as described above. However, the models do not distinguish between new induced activity from the tax incentive and activity that would have taken place absent the incentive. If an analyst can make this distinction, then greater precision will be forthcoming, but this is not always possible. Moreover, these models have little if any capacity to account for crowding effects. As a result, economic impact analysis will provide upper bound estimates on the effectiveness the incentive and capture gross rather than net economic effects.

Impact analysis is still helpful but users must understand its inherent limitations. Considerable insights might be generated from scenario analysis built around an impact study. For example, one could assume that only 50 percent of the incentives utilized reflected newly-induced economic activity. Different assumptions can help bracket possible net effects on the economy to better inform policymakers.

A final consideration is the net fiscal effects of a tax incentive. One important perspective is the net revenue consequence for the state and a second is the net budget impact on the state, with the latter accounting for revenue losses from tax incentives, induced revenue effects from new economic activity and any changes in public service delivery costs. Tax incentives will generally not be self-financing, so there will be a net loss of tax revenue to the state. This result follows directly from research showing that taxes have a small role in affecting business activity. It may still be desirable to invest state tax dollars to promote the economic well-being of Alabama residents. But the revenue implications need to be well understood. Revenue losses must be addressed through some combination of tax increases elsewhere in the economy or cuts in service delivery. These policy responses can affect economic growth. Similarly, it is important to have some sense of how tax incentives affect the net budget position of the state, as adjustments to taxes and spending programs will also have impacts on economic development.

Alternative Strategies

If one considers tax incentives as an investment, then it is natural to consider alternative strategies that would be consistent with the state's strategic plan for economic development. One option would be to

use other economic development tools to promote growth in lieu of tax incentives. A second option would be to utilize broad tax and expenditure policies as reflected in the state budget to promote development.

Economic Development Tools

Tax incentives are one of the primary sets of economic development tools used by the states to encourage economic development. Non-tax or financial incentives are the second set of broad tools used by the states. One categorization scheme for financial incentives is presented in Table 1, from Francis (2016). Note that some of these forms of assistance, especially tax exempt bonds, are often linked to tax incentive programs. The provision of tax incentives yields tax expenditures that affect the revenue side of the state budget, often with no explicit action being taken by a state legislature once the incentive policy has been enabled. On the other hand, grant and loan programs often represent direct state government expenditures and require support from the legislative and executive branches of the state.

A recent report finds that of the responding states, 35.6 percent used some form of general finance and lending program (C2ER, 2013). More specific forms of financial assistance are also provided by the states, including workforce training (10.4 percent), technology development and commercialization (9.0 percent), process innovation (8.7 percent), strategic business management (7.9 percent), new product development (7.4 percent), and export promotion (6.3 percent).

TABLE 1

Types of Financial Assistance for Economic Development

Type of assistance	Program	Mechanism
Loan programs	Capital A ccess	Creates insurance for losses from small business loans.
	Loan participation	Government directly lends a portion of a loan or purchases that portion from the lending bank.
	Loan guarantee	Government cosigns loan, guaranteeing a portion of the loan amount in the event of default.
	Collateral support	Government funds boost collateral for loans.
	Direct loans	Governments loan directly to companies.
Tax-exempt financing	Private activity bonds	Businesses participate in tax-exempt bond issues.
Investment programs	Direct investment	Government provides funds for direct investment in local companies.
	Fund of funds	Government provides funds for local private equity and venture capital funds.
	Certified Capital Companies	Incentive for insurance companies to invest in local private equity funds.
	Investor incentives	Incentives to individuals for local seed capital investing.

There are two broad justifications for financial incentives. The first is that they simply serve as another form of inducement to encourage business location and expansion by lowering costs. As a result, financial incentives should be scrutinized just like tax incentives. Second, financial assistance may be predicated on concerns over the effectiveness of private lenders in providing capital to new firms and especially small, risky ventures. New firms generally will have no formal track record in the marketplace and thus no demonstrable credit standing. Small firms, including entrepreneurial ventures, face the same problem. Complicating the problem for many entrepreneurs is a limited asset pool that can be put forth to stand up a business. Cash on hand, residential property, and credit cards may be the only resources at the disposal of an individual startup.

This distinction is important in practice. If financial incentives are used as a standard inducement tool, then their use can be guided by the strategic steps outlined in previous sections of this report. On the other hand, if they are to be used to fill a gap in the private sector provision of capital, the state must go further and decide if it wants—and has the capacity—to play the role of a banker. This could be done directly. For example, the state could capitalize a revolving loan fund through a one-time appropriation and then directly make loans. Questions naturally arise over the capacity to discern good from bad investment proposals, as well as political concerns over the objectivity of the lending process. Alternatively, the state could provide loan guarantees and serve the role of insurer for loans granted by the private sector.

A hybrid model is the Certified Capital Company (CAPCO). With CAPCO, state insurance premium tax credits—a tax incentive—are used to capitalize venture capital programs. Neither the state nor the insurance companies oversee investment decisions; this is done by a dedicated CAPCO entity. In principle this model sounds like a blended approach that can leverage public dollars using market participants. However, as we will discuss in much greater detail in a future report, these arrangements have their share of other problems that deserve additional scrutiny. In addition, economic impact studies of CAPCOs have not always done a good job of isolating the firms whose behavior was induced by access to credit from ongoing firm activity.

There is little research on the effectiveness of these financial incentive programs. As with tax incentives, mechanisms should be put in place to support ongoing evaluations. The same general principles of evaluation can and should be applied to financial incentive programs.

State Budget: Tax Structure and Expenditures

The state budget offers a variety of alternative options for investing state dollars in economic development, as has been alluded to above. Strengths of using the budget for this purpose include relying on the existing apparatus and policy tools of state government rather than creating a new incentive program; enhanced transparency with the public and taxpayers; and active legislative oversight and engagement to enact policy. On the other hand, using the budget may entail less precise targeting to specific policy targets, industries, and regions, and will typically have long-run rather than short-run implications for revenue and/or expenditure streams. Rate-of-return analysis can be used to evaluate competing investment strategies using budget dollars.

Analysis of the revenue structure should seek to identify elements of the tax system that represent impediments to business growth and expansion, while recognizing the need to fund public services, many of which directly affect the state's path of development. Two elements of the tax system may be problematic for business taxpayers: compliance costs and relatively high effective tax burdens. Tax structure complexity raises the costs of doing business and may create uncertainty as well. The corporate income tax in particular is a very complex instrument, especially for multistate taxpayers; it is more complex still when corporate incentives are embedded in the system necessitating differential reporting across states. The sales tax is complex by virtue of the nature of the base, with many consumer purchases being tax exempt and many business inputs subject to taxation. High tax rates relative to other states will tend to discourage economic activity. Alabama's high sales tax rate stands out as a potential source of distortion for the location of economic activity. The extensive array of business inputs subject to tax exacerbates the problem. The corporate income tax rate is higher than it needs to be because of the presence of corporate tax incentives that erode revenues.

Using tax policy to promote development can take two possible paths. The first is the classic route taken by incentives: targeted distortions that yield lower tax burdens for some taxpayers. In this instance, policy is altered to create some form of tax-induced competitive distortion that will attract economic activity. The second path is to broaden the tax base to support low tax rates for all taxpayers. This alternative route yields a more neutral, non-distortionary tax system across classes of business taxpayers. However, given the available evidence, the effects on economic development are likely to be modest. Auxier (2016) discusses how state tax commissions have addressed this tradeoff. Not surprisingly, some state tax commissions have chosen to recommend base broadening while others

have embraced the use of tax incentives. However, it is encouraging that most of these studies recommended more rigorous analysis of the effectiveness of tax incentives.

Direct budget expenditures might also be used as an explicit tool of economic development. Many state spending programs serve to support economic development, notably investments in infrastructure and human capital. An important strength associated with investments in these forms of capital is that the investment tends to stick in Alabama. A developed industrial site, a companion roadway, statewide highway infrastructure, and broadband are examples of infrastructure that makes the state economy more conducive to growth. Basic human capital investments are essential to the operation of democracy and a market economy. But the globalization of the economy requires more than this fundamental foundation to enable a state to compete effectively. Alabama, like other southern states, has long touted a low-cost labor force as an advantage. But the erosion of manufacturing jobs suggests that this is not an effective strategy for the future.

Tax incentives create a tax-induced reduction in business costs. As noted above, they do not change in any fundamental way the competitiveness of business investment and assets in Alabama. A *build it and they will come* strategy would place greater emphasis on investments in the state's productive assets, especially people, to improve economic development and the economic well-being of residents. This will mean a greater emphasis on creating value added in production processes rather than simply lowering costs through incentives.

Conclusion

Alabama, like most states across the country, actively uses tax incentives and other specific policies to promote economic development. However, there are serious concerns about the economic and fiscal returns to incentives, especially as their use and scope has grown. The state should rigorously evaluate its current incentive policy to determine how effective it is in meeting the state's goals and needs; new policies should be designed carefully and an evaluation apparatus and mandate should accompany adoption.

Policymakers should recognize that tax incentives are just one tool to promote economic development. More broadly, state tax and expenditure policy can have a material effect on the path of economic growth. Consideration should be given to the use of tax and expenditure policies as alternatives to tax

incentives. Alternatives can be evaluated based on strengths and weaknesses, including the relative return on investment. Together this information can be used to make better choices on the use of scarce public sector resources.

Resources

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