



Michael Hicks, Director of the Center for Business and Economic Research, and Professor of Economics at Ball State University

State and local tax incentives have little effect on business relocation

A Civic Caucus Focus on Competitiveness Interview

August 9, 2013

Present

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Summary

According to Michael Hicks, director of the Center for Business and Economic Research and professor of economics at Ball State University, Minnesota's grades are average or above for eight of nine categories in the 2013 edition of an annual scorecard of factors important to location decisions by logistics and manufacturing firms. However, in the ninth category-tax climate-Minnesota received a grade of "F."

The scorecard includes 50 variables lumped into nine different categories, with every state being graded in each category. The scorecard gave Minnesota the following grades in those categories: "A" for human capital and for productivity and innovation; "B" for manufacturing industry health, logistics industry health and expected liability gap; "C" for worker benefit costs, for global reach and for sector diversification; "F" for tax climate.

Hicks says local governments need flexibility to find the right mix of services and amenities vs. taxes that will attract residents. He states what he calls Hicks's law: In the short run, households move to jobs; in the long run, jobs move to people. He says the most successful communities have responded

to what households are looking for. Research shows, he says, that tax incentives offered by state and local governments have little effect on business relocation, especially for manufacturers. He calls manufacturing businesses "footloose," because their success does not depend on local demand, so they can choose to locate almost anywhere.

Background

Michael J. Hicks is director of the Center for Business and Economic Research and professor of economics in the Miller College of Business at Ball State University in Muncie, Indiana. He came to Ball State following stints at the Air Force Institute of Technology's Graduate School of Engineering and Management and research centers at Marshall University and the University of Tennessee.

Hicks's research has focused on issues affecting local and state economics. While he studies such diverse issues as local telecommunication deregulation, state tax incentives and local government consolidation, he is best known for his research on Wal-Mart's effect on local economies. He has authored one book on Wal-Mart and papers on the subject in the Eastern Economics Journal, Atlantic Economics Journal, Economic Development Journal, Regional Economic Development, Journal of Private Enterprise, and Review of Regional Studies.

Hicks has received research and teaching awards from Tennessee, Marshall, AFIT and Ball State, and his research has been highlighted in such media outlets as the Wall Street Journal, New York Times, and Washington Post. His weekly column on economics and current events is distributed through newspapers, including the Indianapolis Business Journal, the South Bend Tribune, and The Star Press.

Hicks earned doctoral and master's degrees in economics from the University of Tennessee and a bachelor's degree in economics from Virginia Military Institute. He is a retired infantry lieutenant colonel in the U.S. Army Reserves, having served in combat and peacekeeping operations in North Africa, Southwest Asia, Korea and Japan.

Discussion

Ball State University publishes an annual scorecard grading all 50 states on factors important to location decisions by logistics and manufacturing firms. Michael Hicks, director of the Center for Business and Economic Research and professor of economics at Ball State University, explained that some of the center's research results in an annual manufacturing scorecard. The 2013 Manufacturing + Logistics National Report is the sixth such scorecard published jointly by the center and by Conexus Indiana, a public policy group aligned with manufacturing and logistics in the state.

He described the scorecard as a national report of state-level variables. In 2008, Conexus asked him to develop an index of measures that might influence siting decisions for manufacturing. He noted that manufacturing firms are "footloose," because they don't rely on local demand.

The report lumps about 50 variables into nine categories. Each state receives a letter grade (A through F) in each category. The grades are assigned using a strict bell curve, meaning there are as many A grades as F grades, Bs and Ds balance off, and the rest, the highest number, fall into the C

grade. He described the categories and how they are measured and reported Minnesota's grade on each of them:

- **Manufacturing industry health.** Manufacturing location depends on local factors other than local demand: quality and availability of the labor force, transportation infrastructure, non-wage labor costs, access to innovative technologies and the cost of doing business. Three variables are included in the measure of manufacturing industry health: the share of total income earned by manufacturing employees in each state, the wage premium paid to manufacturing workers relative to other employees, and the share of manufacturing employment per capita. Minnesota's grade: B.
- **Logistics industry health.** Logistics involves not only the capacity to move goods, but also to store inventory and manage the distribution and processing of manufactured goods. Logistics firms' location decisions depend upon many of the same factors as manufacturing firms, but also include existing or planned transportation networks of roads, railroads, waterways and airports. Four variables are included in the measure of logistics industry health: the share of total state income earned by the logistics industry, the share of logistics employment per capita, commodity flows data by both rail and road, and infrastructure spending as the per capita expenditure on highway construction. Minnesota's grade: B.
- **Human capital.** The quality and availability of labor are the most important factors to businesses and their location decisions, especially quality of educational background. Four variables are included in the measurement of human capital: rankings of educational attainment at the high school and collegiate level, the first-year retention rate of adults in community and technical colleges, the number of associate degrees awarded annually on a per capita basis and the share of adults enrolled in adult basic education. Minnesota's grade: A.
- **Tax climate.** Business taxes, individual income taxes (both on workers and small business), sales taxes, unemployment insurance taxes and property taxes all play a role in assessing a region's potential for employer location. Hicks pointed out that states must pay for public goods, so higher taxes may not be a problem if a state has other factors that manufacturers like. Data on corporate taxes, income taxes, sales and use taxes, property taxes and unemployment insurance tax data are used to measure the tax climate. Minnesota's grade: F.
- **Worker benefit costs.** Non-wage labor costs represent an increasingly important part of total business costs and are affected by state and local laws, worker demographics, worker health and performance of firms and industry. Data on health care premiums, long-term health care costs, workers' compensation costs per worker and fringe benefits of all kinds as a share of worker costs are used to measure benefit costs. Minnesota's grade: C.
- **Expected liability gap.** Many states have failed to provide a direct funding stream to repay infrastructure bonds or to fully fund pension plans. These unfunded liabilities represent an expected state fiscal liability gap, which is a good indicator of the direction of future taxes and public services. Data on unfunded liability per capita and as a percentage of GDP, average benefits, and bond rankings are used to measure the expected liability gap. Hicks said if the

grade is C or higher, the state does not have a sufficient liability claim to generate concern for businesses. He pointed out that a state like Illinois is not nearly in as dire straits as a city like Chicago. Minnesota's grade: B.

- **Global reach.** The level of international trade, both in exports and imports, is a robust measure of a region's competitiveness in the production, movement and distribution of consumer goods. How well manufacturers make goods with a global market appeal is an important predictor of the health of state manufacturing and logistics sectors into the future. Hicks noted that trade negotiations and junkets are probably minimally effective in increasing exports, because officials are usually trying to bring foreign companies to their state. The following variables are used to measure global reach: per capita exported commodities and manufacturing goods and the growth of manufacturing exports, the amount of manufacturing income received annually from foreign-owned firms in a state, the level of adaptability of the state's exporters to changing demand, as well as the reach of foreign direct investment. Minnesota's grade: C.
- **Productivity and innovation.** The value of manufactured goods per worker, i.e., productivity, as well as firm access to inventions and innovations is critical to the long-term performance of a firm and an industry as a whole. The presence of local talent in these areas, through access to university laboratories and nonprofit research activities, plays an important role in location decisions by manufacturers. Manufacturing productivity growth, industry research and development expenditures per capita, and the per capita number of patents issued annually are the variables used to measure productivity and innovation. Minnesota's grade: A.
- **Sector diversification.** States that concentrate their manufacturing activity in a single sector typically suffer higher volatility in employment and incomes over a business cycle. One potential benefit of low levels of economic diversification is that the resulting industry clusters, such as automobiles in Detroit, often emerge in highly specialized regions. Each state's diversification of manufacturing activity is calculated using a complex index. Then states are ranked from the most diverse (# 1) to the least (# 50). An A grade means average concentration, with grades getting lower for higher concentration. Minnesota's grade: C.

The concepts of foundational competitiveness and investment attractiveness are good ways to think about competitiveness. An interviewer asked Hicks to comment on the way the Civic Caucus is thinking about competitiveness, that is, using foundational competitiveness and investment attractiveness to frame our conversations going forward. (See the Civic Caucus June 7, 2013, [interview with Mark Haveman](#) for an in-depth discussion of these concepts.)

Hicks said that's a fairly good way to think about it. He noted that Paul Krugman and other economists have said that regions don't compete with each other, businesses do, and that trade is the antithesis of competition. Hicks said it's a far more nuanced debate involving foundational competitiveness: how good are our people, the skills they bring to the workforce, our housing stock, our recreational opportunities and our schools?

Local governments need flexibility to find the right mix of services and amenities vs. taxes that will attract residents. Hicks stated that households choose locations that match a set of amenities

they care about: schools, recreation, environment and climate. They balance that with the tax rates they'll pay. "They could find places with lower tax rates and fewer services," he said. "The challenge is to find the right mix that will attract residents. It's a local government challenge."

State governments need to allow flexibility to the local governments. "We should allow for the most federalist taxation system, so local governments have more control over what they spend relative to higher levels of government," he said. The evidence suggests that the fiscal backlash around the country is not aimed at high tax rates, but at high spending with a low quality of public services.

He stated what he called Hicks's law: In the short run, households move to jobs; in the long run, jobs move to people.

The communities that have done best have responded to what households are looking for. In response to a question, Hicks discussed exogenous and endogenous amenities. Exogenous amenities are things that are in a location naturally: lakes, mountains, climate, etc. They provide allure to people. But migration has been slowing steadily for the last generation or so. Some demographers argue that a lot of the benefits of climate, for example, have run their course. Hicks said the exogenous factors will matter far less.

The endogenous amenities are those driven by the spending patterns of humans. Migration is now more local. The communities that have done best have responded to what households are looking for. People tend to value schools enormously, recreational amenities and safety. They're willing to forego other things to live where they get better education. That manifests itself in household location decisions. "The amenity aspect is really driving location decisions," Hicks said.

Manufacturing is less likely to locate in an urban city. An interviewer asked Hicks how cities in the urban core make themselves competitive for manufacturing. He responded, "One place where manufacturing is less likely to locate is an urban city, unless you can drive down the land costs. It's unlikely that many of the old factories will be resurrected into manufacturing. I'm not sure manufacturing is the solution to urban problems. Many workers stuck in the cities and unable to get out probably don't have the human capital that manufacturers are looking for. Manufacturing is not an urban renaissance tool."

Many factors in the manufacturing scorecard are just as relevant to other businesses. An interviewer asked if any of conclusions of the manufacturing scorecard study have validity to the service sector. "Absolutely," Hicks replied. "We live in an economy dominated by local consumption of goods. Most factors that manufacturing cares about also apply to the service industry. When other businesses are making location decisions, many of the factors in the manufacturing scorecard are just as relevant to them."

Tax incentives have little effect on business relocation. An interviewer asked how much of the investment that cities put into convincing businesses to relocate in their city makes sense. Hicks responded that before the 1970s, very little of this went on. The efforts to scout businesses from other locations came from the South. "This has morphed into huge efforts at tax incentives and state governments trying to chase down businesses. Research says there is little effect of these tax incentives." Instead, the research suggests four things:

(1) Many state incentives are really just part of the tax system and everybody gets them. These non-discretionary credits seem to work better than those offered through a political process to firms.

(2) Firms who receive discretionary credits appear to offer a more optimistic assessment of job creation than those who lose out on the bidding for these credits. This means the credits are likely going to the wrong businesses.

(3) There is little evidence that these credits play a large role in economic growth. Most studies find some effect, but the cost per job is often astonishing. (He coauthored a study which found only construction job impacts in Michigan's largest program, at a cost of over \$120,000 per job.) Studies that find costs are more reasonable (a few thousand dollars per job) do not report significant economic effects otherwise. Tax incentives just do not have a robust track record.

(4) Discretionary tax credits are really a symptom of a poor tax climate and credits simply shift the cost of government to existing, and presumably successful, businesses.

"As long as voters are going to reward the talk of commercial development by our leaders, they're going to think that incentives matter," Hicks continued. "I believe there'll be a backlash on some of that. I think we tell our elected officials that we want jobs, but what we really want is for our community to be better. The most successful places in the country don't engage in business attraction."

Economies with large amounts of research and development (R & D) tend to be near universities. Responding to a question about how the study reflects the R & D sector of the economy, Hicks noted that businesses that pay for R & D do so exclusively in pursuit of a profit. "They pursue R & D not to better the economy, but to better their bottom line," he said. An R & D economy is good, because those workers are paid better, have higher human capital and are healthier. R & D is the source of economic growth, Hicks continued. It's a cost, but it's a cost balanced by demand. He observed that places that have big parts of their economies in R & D tend to be near universities that drive R & D.

Conclusion

Hicks complimented the Civic Caucus for grappling with what the policy decisions will be over the coming years. What do we do to make our lives and our economies better? How intertwined are those things? What is it that would cause more people to wish to live here or satisfy people already paying taxes here? How do you balance that against higher tax rates to do those things? How do business and commerce play into that?

He's hopeful that the Great Recession will cause us to focus on questions like these: How effective are tax incentives? How important are the schools? How should we treat debt? How do we derive efficiency?

"The scorecard is an opportunity to look at footloose businesses like manufacturing, that can go most anywhere in the country," he concluded, "and try to see what's driving them."