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Tax Credits for Job Creation and Retention: What Can We Learn from the States?

During the current recession, the economy has lost about 3.6 million jobs. In January, the nation's unemployment rate hit 7.6%, and forecasters expect further job losses and higher unemployment rates in the months ahead. In order to boost the economy and stem job losses, Congress has just approved a substantial fiscal stimulus package, and further measures may well be introduced in the future. One measure not included in the package is a temporary federal tax credit for businesses that create jobs in the United States. But such a provision was part of the original plan proposed by the Obama transition team before the president took office and is often cited as a potential addition to the federal government's arsenal of tax incentives.

While the federal government does not have direct experience with such a credit, many states do. In fact, 22 states currently have broad, statewide job creation tax credits (JCTCs) and about another dozen have narrow JCTCs targeting specific industries or specific geographic zones. In this *Economic Letter*, we describe how these state credits are structured, in terms of size and function. We also consider what issues and lessons arise from state experiences with these and similar credits that might be relevant to the public debate over a possible federal credit.

The structure of state job creation tax credits

As mentioned above, 22 states have a broad JCTC with little or no restriction on eligible industries. The details of these credits vary widely, but their basic structures are similar.

All the JCTCs currently in place are intended to subsidize *net* job creation by businesses. That is, only new jobs that expand a business's total payroll employment typically qualify. (Ohio and Indiana have both JCTCs and separate job retention tax credits (JRTCs). We return to these JRTCs in the next section.) With many state JCTCs, a company can only claim the credit if the number and/or wages of the new jobs are above specified thresholds and meet certain requirements, such as providing health insurance. In addition, states often offer multiple credit rates, which increase with the number or wages of new jobs.

JCTCs generally are credits against a state's corporate income tax and use one of three basic structures. In most states, the credit per new job is a percentage of that job's annual wages or total compensation. In a number of other states, the credit per new job is a percentage of the state income tax withholdings associated with that job. The credit per new job in a few other states, as well as the federal JCTC proposed by President Obama during the transition, is a fixed dollar amount (for example, $1000 in Virginia). The president proposed a $3000 federal credit.

Another important question is whether a JCTC is refundable, meaning that a business can receive a payment from the state even if it has no tax liability. President Obama proposed a refundable credit. Refundability is an important consideration in gauging a credit's fiscal cost and its effectiveness as a countercyclical policy tool because the fraction of companies that do not have positive net taxable income rises sharply in downturns, exactly when a government might want to subsidize job creation. Very few JCTC states offer refundability, though many do allow companies to carry forward the credit several years, that is, to allow companies to use the credit in future years if they have a positive precredit tax liability.

Finally, state JCTCs differ with regard to whether the new-job credit is available only in the year in which the job was created or in future years as well, provided that the job is maintained. Such a multiyear credit is intended to encourage future job retention in addition to current job creation.

The structure of job retention tax credits

In providing tax incentives to support employment, retaining jobs can be as important as creating new jobs. For example, a recent study by Christina Romer, chair of the Council of Economic Advisers,

and Jared Bernstein of the Office of Vice President Biden, stated that a "key goal" of the Obama administration's fiscal stimulus program is to "save or create at least 3 million jobs by the end of 2010" (Romer and Bernstein 2009).

Given the importance of job retention, it is worth briefly discussing the Ohio and Indiana JRTCs. The stated aim of those two programs is to provide incentives to corporations to retain jobs that the corporations otherwise would not be able to retain. In other words, the JRTCs aim to provide a subsidy proportional to the difference between a corporation's actual level of employment (or payroll) and some counterfactual level representing what the corporation would have absent the credit.

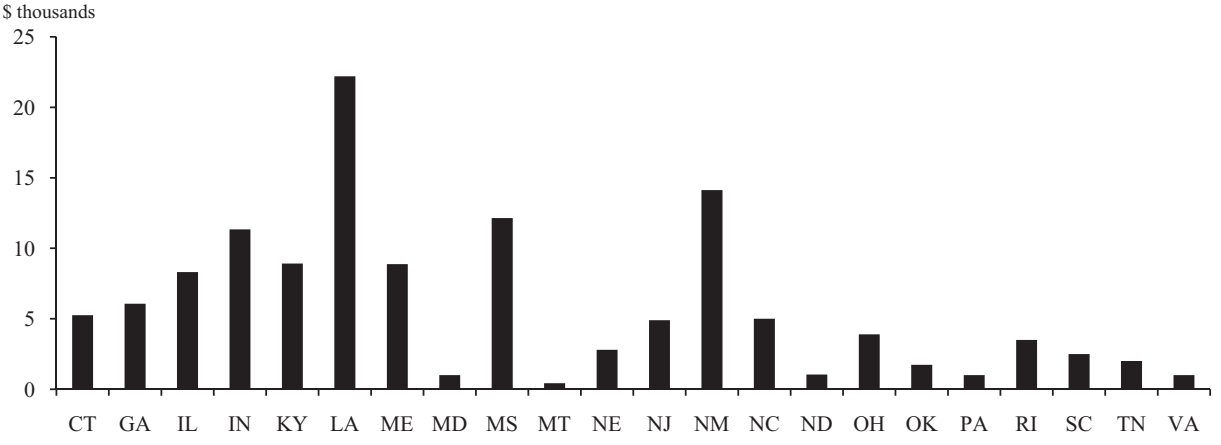
Of course, this begs the question of how such a counterfactual level could be calculated. In Ohio and Indiana, for a corporation to take the credit, it must first seek approval from the state and must demonstrate that the credit is a "major factor" in the corporation's decision to retain jobs. Clearly, there is no cut-and-dried statutory criteria for what might be a major factor. In practice, the states must evaluate credit applications on a case-by-case basis. The administrative and cost burdens of doing so are obvious concerns with JRTCs.

How large are state job creation tax credits?

As mentioned earlier, President Obama originally proposed a JCTC of $3,000 per new job created. How does the size of this credit compare to the JCTCs already in place in the states? Given that these states vary in the formulas they use to calculate credits, answering this question is not so straightforward. However, we can get a rough idea of credit size by making a few simplifying assumptions. Since the size of the credit in some states depends on the number and/or wages of net jobs created, we calculate the size of the credit in each state for a hypothetical business that hires new workers at that state's average manufacturing wage, based on data from the 2006 Annual Survey of Manufactures. We assume the business hires enough new workers to qualify for the credit. For states with a multiyear credit, we calculate the present discounted value of the full stream of credits. Three states have different credit rates for different areas of the state. In those cases, we use the median credit rate.

The results of our calculations are presented in Figure 1, which shows the credit sizes for the 22 JCTC states. The average credit is $5,820 per new job. The largest credits generally are those that can be taken in multiple years (conditional on the job being maintained). For example, the credit associated with a new job paying the average manufacturing pay in Louisiana ($50,270 in 2006) is $3,016 per year (6% credit rate) but it is available for up to 10 years. Thus, the present discounted value (assuming a 6% real interest rate) is $22,199. If one includes only credits that can be taken in the first year in which a job is created, such as the JCTC proposed by President Obama, then the average state credit drops to $2,331.

Figure 1
Estimated values of state job creation tax credits (per new job)



Source: Authors' calculations based on information from state tax departments and data on average manufacturing payroll per employee from the 2006 Annual Survey of Manufactures.

Some final considerations

A special concern for states, and a key motivation for enactment of these credits, is the need to compete with other states that may be attracting businesses and jobs away from their state. Thus, states must grapple not only with preventing employment losses or stagnation in downturns, but also with offering competitive tax environments even in good times. This likely explains why states generally do not enact JCTCs as temporary, recession-fighting measures, but rather as permanent additions to their tax structure. We have compiled information on when each JCTC state enacted credits, and there does not appear to be any evidence that states are more likely to enact these credits in downturns.

Unfortunately, there has been little economic research into how effective state JCTCs are in promoting net job creation. However, researchers have investigated the effectiveness of other state business tax credits, such as research and development credits (see Wilson, forthcoming) and investment credits (see Chirinko and Wilson 2008). This research has found that these tax credits appear to be quite effective at increasing business activity within the state, but the bulk of the increase appears to be due to the relocation of activity from other states. From a national standpoint, little net new activity is generated.

This suggests that, in periods of full employment, the effectiveness of a federal JCTC might depend importantly on the extent of international mobility of businesses and employment. However, given the current high level of unemployment and prospects for even further slack in U.S. labor markets, temporary federal tax credits for businesses adding or even retaining jobs may be a viable form of fiscal stimulus.

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