

Tax Incentives

Bad Economics and Bad Policy

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27 July 2016

For the

Multistate Tax Commission

What's a tax incentive?

- “A **tax incentive** is an aspect of a country's [tax code](#) designed to [incentivize](#), or encourage a particular economic activity.” (Wikipedia)
- **“Tax Incentives for Economic Development: What are tax incentives for economic development?** The Federal Government has often used the tax system to partner with the private sector for economic development initiatives. A variety of tax expenditures aim to lure or keep companies and sectors within the United States. In addition, a more coherent set of incentives supports private investments in specific communities.” (Tax Policy Center, the Urban Institute and the Brookings Institution)
- “**tax incentive:** Deduction, exclusion, or exemption from tax liability, offered as an enticement to engage in a specified activity (such as investment in capital goods) for a certain period.”
(www.businessdictionary.com)

What's a tax incentive?

Governmental Accounting Standards Board (GASB):

GASB Home >> **PROJECTS**

PROJECT PAGES

Tax Abatement Disclosures

Project Description: The objective of this project is to determine what disclosure guidance for governments that have granted tax abatements, if any, is essential to financial statement users. For purposes of this project, tax abatements are a reduction of or exemption from taxes, offered under an agreement between a government and a specific taxpayer, typically for the purpose of spurring economic development. ~~The project will not consider guidance for programs that reduce the tax liabilities of broad classes of taxpayers or are not the product of individual agreements with each taxpayer. The project also will not consider issues related to recognition.~~

Status:

Added to Current Agenda: December 2013

Exposure Draft approved in October 2014

What's a tax incentive?

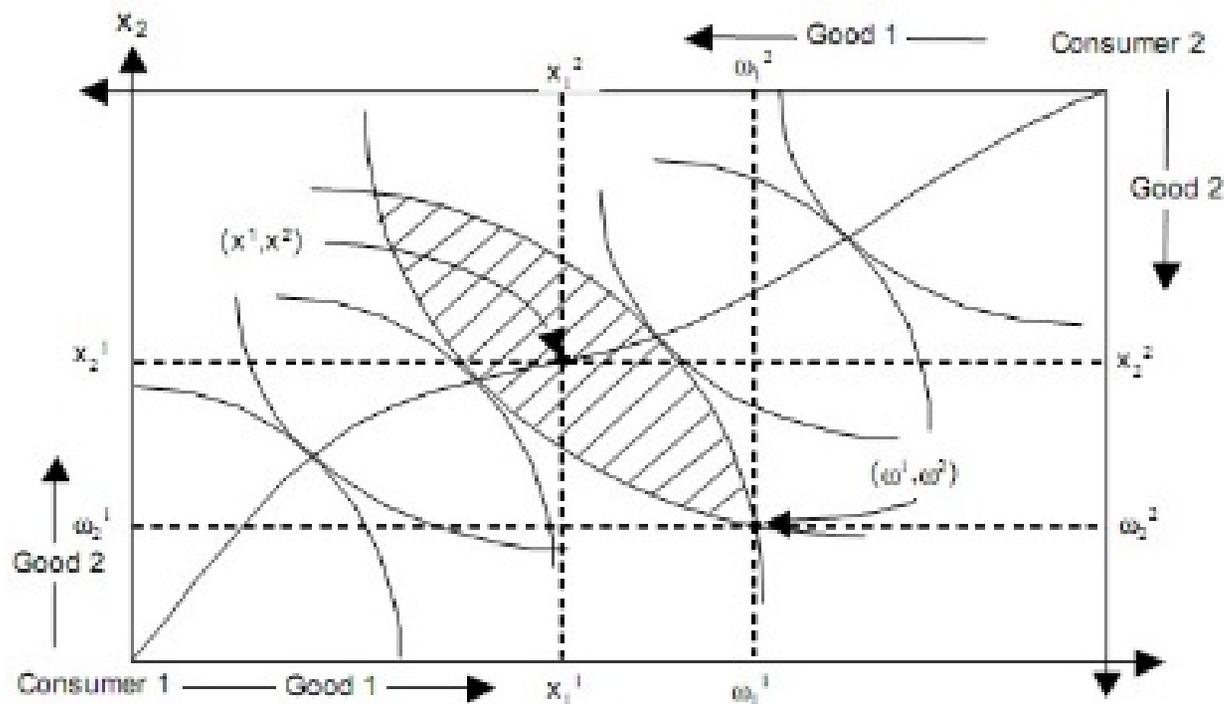
- Government subsidies that are available to specified or selected but not all private sector businesses
 - Whether through
 - Tax credits
 - Tax deductions
 - Tax rebates
- Functionally equivalent
 - Grants
 - Any other form of expenditure

Tax incentives are

BAD

ECONOMICS

When should government not get involved?



The first fundamental theorem of welfare economics

“If preferences are locally non-satiated, and if (x^*, y^*, p) is a price equilibrium with transfers, then the allocation (x^*, y^*) is Pareto optimal. In particular, any Walrasian equilibrium allocation is Pareto optimal.”

Microeconomic Theory, Andreu Mas-Colell, Michael D. Whinston and Jerry R. Green, page 549

The Little Bo Peep Theorem:

“Leave them alone and they’ll come home, wagging their tails behind them.”

Under “ordinary” circumstances, government can’t improve on the uncoordinated actions of private actors

What are “ordinary” circumstances?

The first fundamental theorem requires

1. All goods are private.
2. There are no non-pecuniary externalities
3. There are no market imperfections

Under what circumstances is government useful?

1. When it arranges for provision of public good.
2. When it internalizes non-pecuniary externalities
3. When it eliminates market imperfections.

**4. ANY OTHER GOVERNMENT ACTIVITY IS
REDISTRIBUTION**

Do tax incentives

1. Provide public goods?

NO!

Beneficiaries are, by definition, isolated individual agents.

2. Internalize non-pecuniary externalities?

NO!

3. Remedy market imperfections?

NO!

They create market imperfections.

Tax incentives are

Pecuniary externalities

- Beneficiaries experience them as increases in income or reductions in cost
- Competitors experience them as reductions in income or increases in cost
- These are all market signals – **THERE IS NOTHING TO INTERNALIZE**

Tax incentives are

- Distortions imposed on the market economy
 - They privilege beneficiaries beyond market returns
 - They disadvantage all others despite market returns

- Distortions should be imposed on the market
 - Only when there are very good reasons to believe that the market has got things wrong
 - If the market has got things wrong, there are very good reasons to fear that “planners” of any sort won’t get things right

Tax incentives are

- Redistribution in favor of the beneficiaries
 - Have no obvious claim on our sympathies
 - Are almost surely selected arbitrarily
- As with all redistribution, welfare gains to beneficiaries must be weighed against welfare losses to “donors”
- Most, if not all, theories of redistribution favor those who are disadvantaged in consumption

An example

First Regular Session
Seventieth General Assembly
STATE OF COLORADO

INTRODUCED

T.L.S. NO. 15-0493.01 Kristen Forrester x4217

HOUSE BILL 15-1230

HOUSE SPONSORSHIP

Lee and Foote,

SENATE SPONSORSHIP

Heath,

House Committees
Business Affairs and Labor

Senate Committees

A BILL FOR AN ACT

101 **CONCERNING THE CREATION OF THE INNOVATIVE INDUSTRIES**
102 **WORKFORCE DEVELOPMENT PROGRAM.**

Redistribution to the unneedy

7 (I) INNOVATIVE INDUSTRIES HAVE HIGH PROJECTED GROWTH
8 RATES AND ARE A CRITICAL COMPONENT OF THE STATE'S ECONOMIC
1 DEVELOPMENT AND JOB CREATION;

2 (II) FINDING QUALIFIED EMPLOYEES CAN BE A CHALLENGE FOR
3 INNOVATIVE-INDUSTRY BUSINESSES;

13 (VI) INTERNSHIPS CREATE OPPORTUNITIES FOR BUSINESSES TO
14 FIND, TRAIN, ANDEVALUATEPOTENTIALLONG-TERMEMPLOYEESANDFOR
15 STUDENTS TO GET REAL-WORLD WORK EXPERIENCE WHILE EXPLORING
16 CAREER OPTIONS;

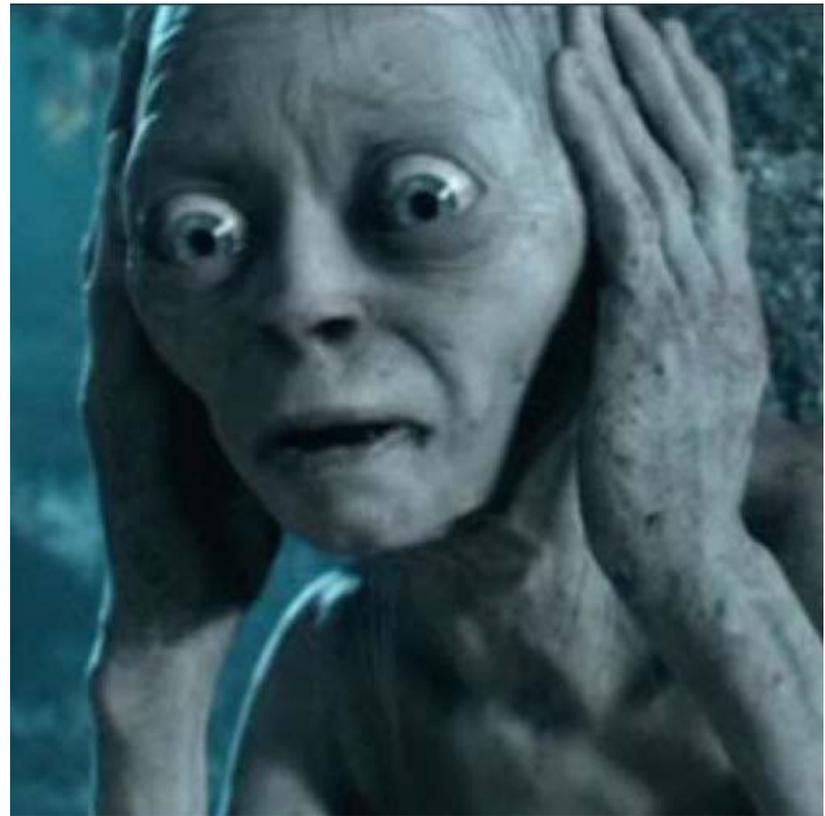
17 (VII) BY OFFERING INCENTIVES TO BUSINESSES TO CREATE
18 INTERNSHIPS, THE STATE WILL ENCOURAGE BUSINESSES TO CREATE MORE
19 OPPORTUNITIES FOR STUDENTS TO OBTAIN WORK EXPERIENCE IN THE
20 INNOVATIVE INDUSTRIES.

Tax incentives are

BAD

POLICY

We speak of jobs lost ...



We speak of jobs saved ...

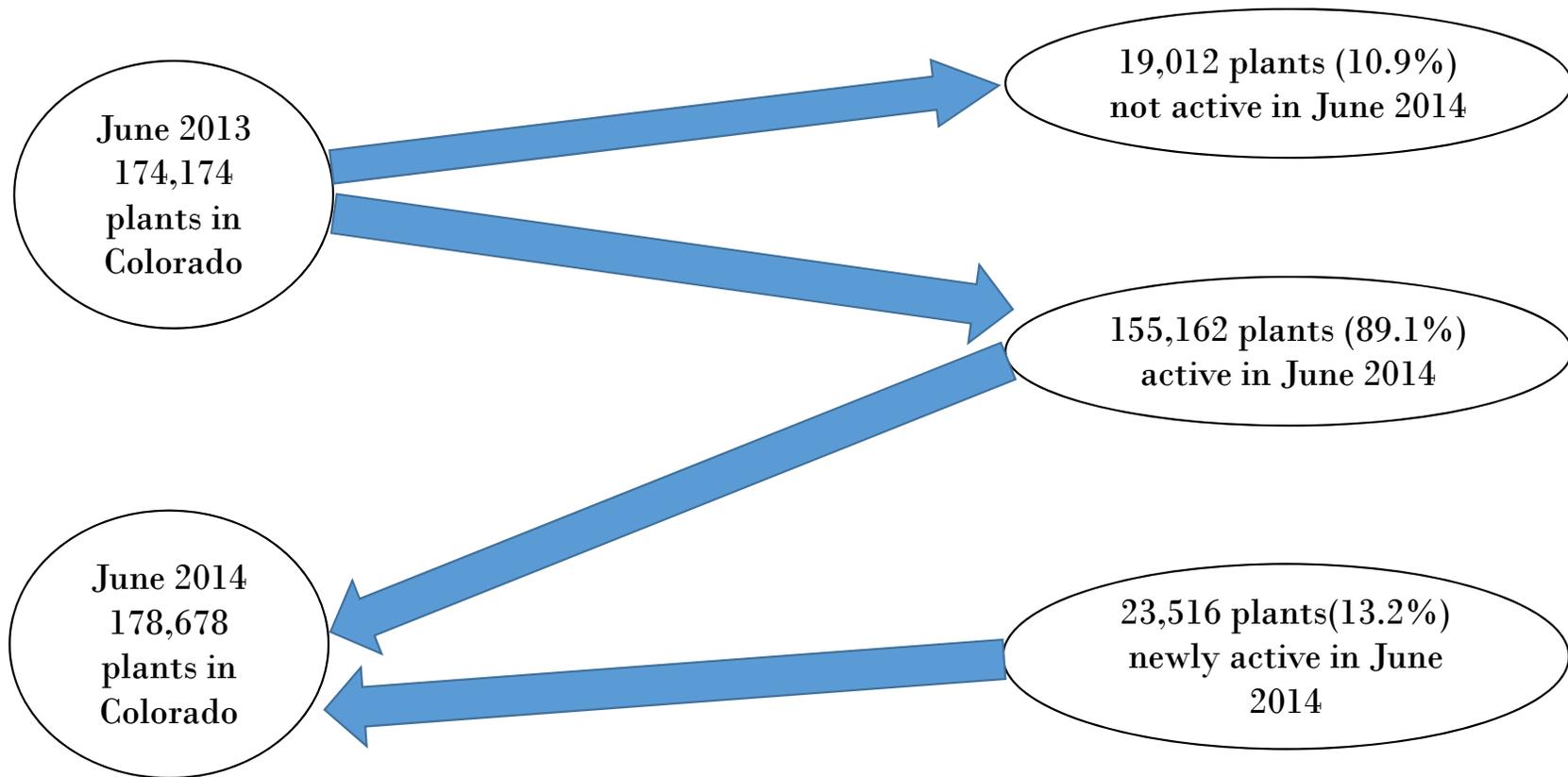


Jobs and businesses are organisms

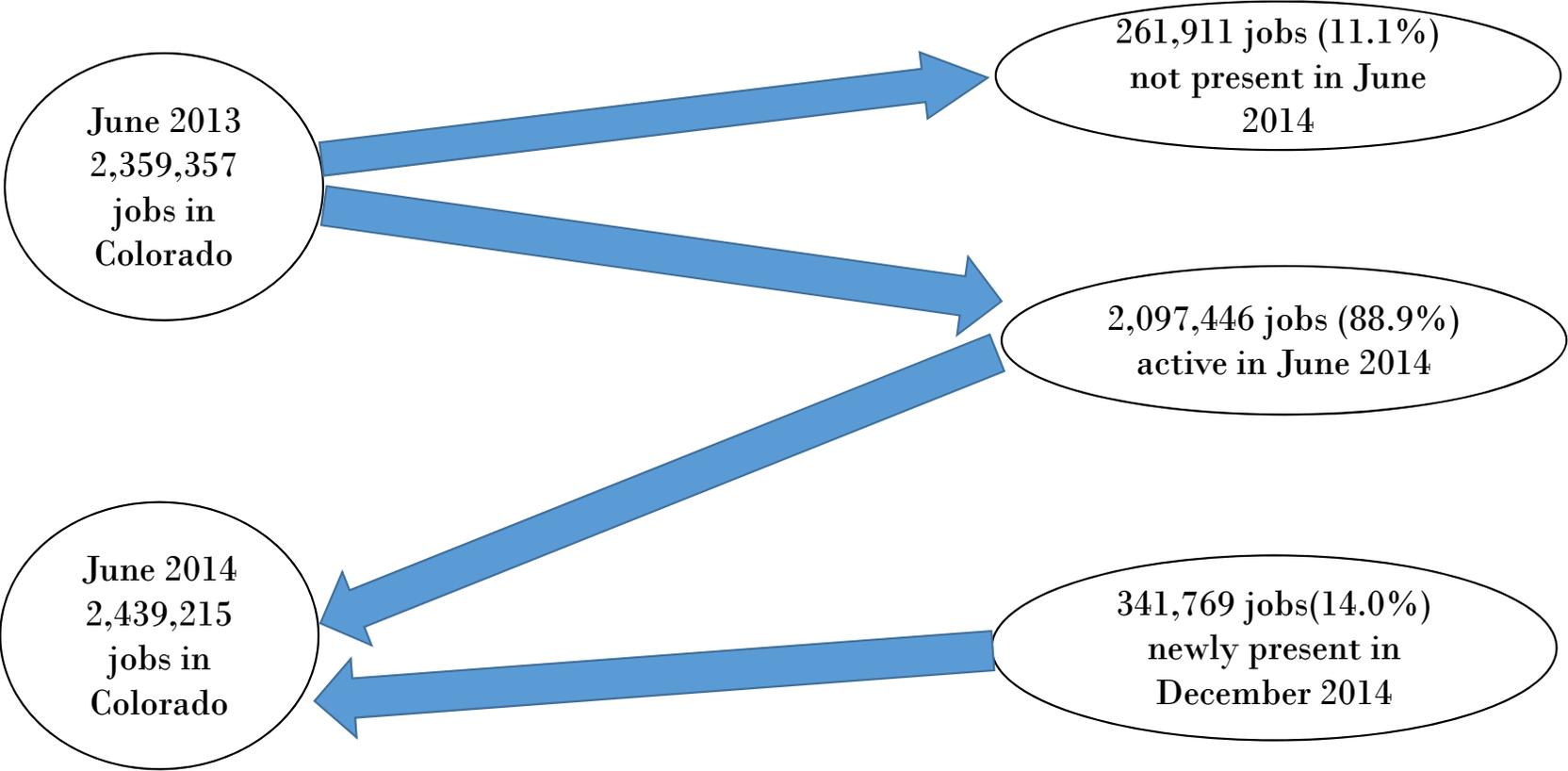
- Like any other,
 - They are born
 - They mature
 - Perhaps they relocate
 - They die
- Interference with this process is
 - Perpetuating inefficiency
 - Prolonging activities that should be superceded
 - Retarding rather than encouraging growth



Natural rates of plant turnover are large



Natural rates of job turnover are large



Predicted effects are unreliable

- Methodology
 - Mercantilism
 - Multipliers
 - Partial equilibrium
 - Ignore losses to non-beneficiaries
 - Ignore alternative uses of funds

Predicted effects are unreliable

- **Accountability**
 - Contracting parties have interests at stake
 - No penalty for ex post inaccuracy

Incentive contracts are inevitably one-sided

- Performance requirements
 - None
 - Meaningless
 - Meaningful requirements are difficult to construct
 - Preservation of existing jobs perpetuates inefficiency
 - Gross job growth goal may yield little net job growth
- Penalties are difficult to impose
 - Any penalty can be viewed as “harming growth”
 - No penalty is available if the beneficiary closes

Incentive contracts are inevitably one-sided

- There's usually no counterfactual
 - Applicants are likely to expect to fulfill any conditions
 - This suggests that they might fulfill any conditions without incentives
 - In this case, the incentives have no effect

Incentive contracts are inevitably one-sided

The industry could be anything:

2 (c) "INNOVATIVE INDUSTRY" MEANS ADVANCED MANUFACTURING,
3 AEROSPACE, BIOSCIENCE, CONSTRUCTION, ELECTRONICS, ENERGY AND
4 NATURAL RESOURCES, ENGINEERING, AND INFORMATION TECHNOLOGY
5 INDUSTRIES, AND ANY OTHER INNOVATIVE INDUSTRY AS DETERMINED BY
6 THE DEPARTMENT.

Incentive contracts are inevitably one-sided

The job could be anything:

- 13 (III) ALLOW STUDENTS TO GAIN VALUABLE WORK EXPERIENCE IN
14 AT LEAST TWO OF THE FOLLOWING OCCUPATIONAL AREAS:
- 15 (A) COMPUTER SYSTEMS, INCLUDING SOFTWARE DEVELOPMENT
16 AND INFORMATION TECHNOLOGY SUPPORT;
- 17 (B) PRODUCTION, INCLUDING FABRICATION, ASSEMBLY, AND
18 QUALITY ASSURANCE;
- 19 (C) ENGINEERING;
- 20 (D) BUSINESS AND FINANCIAL OPERATIONS, INCLUDING SUPPLY
21 CHAIN MANAGEMENT;
- 22 (E) CUSTOMER SERVICE, SALES, AND MARKETING, INCLUDING
23 PROPOSAL DEVELOPMENT;
- 24 (F) RESEARCH, PRECLINICAL, CLINICAL, AND COMMERCIAL
25 DEVELOPMENT;
- 26 (G) INSTALLATION, MAINTENANCE, AND REPAIR OF MACHINERY
27 AND EQUIPMENT;

Little *ex post* accountability

- Compliance
 - Reviews are infrequent
 - Penalties for failure are rare

Little *ex post* accountability

GASB:

TAX ABATEMENT DISCLOSURES—PROJECT PLAN

Background: Tax abatement programs are highly prevalent in the U.S. The results of external research conducted under a Gil Crain Memorial Research Grant from the GASB suggest that tax abatements are an issue of concern among citizen groups, county board members, and municipal bond analysts, and that each group desires to receive information about the level of abatement activity and the results of the abatement programs. However, the researchers found relatively few states (six) with statutes requiring any level of external reporting after tax abatements are granted. These findings indicate that there is an important information need that is largely unmet.

Little ex post accountability

- **Colorado Job Growth Incentive Tax Credit (Hauptman)**
 - **Day 1**
 - Apply for credit
 - **Days 1-365**
 - Expand workforce by at least 20
 - Average pay for new jobs > 110% of county average
 - **Days 366-730**
 - Maintain net job increase
 - **Day 731**
 - Apply for tax credit, applied to days 366-730, of 3.825% of salary for new jobs

Little ex post accountability

- Colorado Job Growth Incentive Tax Credit (Hauptman)
 - In general, firms that had previously grown grew more slowly
 - However, JGITC recipients continued to grow
 - Implied elasticity of labor demand was > 9
 - Typical elasticities of labor demand are $< .5$
 - Strongly suggests that JGITC recipients
 - Had planned to continue growing independently of the JGITC
 - Happily accepted the credit because who turns down a subsidy?

Little ex post accountability

3/7/2015

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Publication: The Denver Post; Date: Mar 6, 2015; Section: Business; Page: 12A

“Pedal to the metal”

Denver plans no letup in economic development efforts

By Aldo Svaldi *The Denver Post*

Economic development efforts in Colorado tend to ramp up when unemployment is high and fall off as the volume of complaints rise about all the newcomers congesting the roads.

But Denver Mayor Michael Hancock and his economic development director, Paul Washington, promised Thursday to “keep the pedal to the metal.”

Denver’s business development plan,

known as JumpStart, helped create 3,311 new jobs, retain 4,083 jobs and contributed to \$139 million in capital investments last year, according to a report from the Denver Office of Economic Development.

“When things are going great is not the time to kick back,” Hancock told a roundtable of business owners he convened at Rosenberg’s Bagels in Five Points on Thursday afternoon.

Rosenberg’s Bagels, a New York-style deli, set up shop six months ago in the heart of

Five Points with the help of seed money the city provided to promote the revitalization of Welton Street. Rosenberg’s already is looking at a second location.

Strong job gains in recent years have drawn more newcomers to Denver, putting upward pressure on prices and rents. Denver adjusted its JumpStart plan with a pledge to create 3,000 affordable housing units in five years.

But business owners let Hancock know about another real estate shortage that could

DENVER • 14A

Explicit attempts to override the market

“That trick
never works!”



Explicit attempts to override the market

3/7/2015

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Date: Mar 6, 2015; Section: Business; Page: 14A

DENVER

◀◀FROM 12A

block their ability to grow: a lack of industrial space.

"Lease rates are going up astronomically," said Lisa von Gunten, CEO of Bison Innovative Products, which designs and manufactures roofdecks.

Washington responded that the city was looking into the creation of a large industrial park to better accommodate growing demand for manufacturing space.

Working training is another issue that the business execs told Hancock could hamper their ability to expand

and remain in Denver.

Low energy prices and higher production costs abroad are contributing to a resurgence in U.S. manufacturing, but the educational system isn't keeping pace.

College graduates wanting \$75,000 are a dime a dozen, but finding someone able to weld or happy to package and assemble items is much tougher, executives said.

Jim Ducker, general manager of NAMJet, a military boat maker that moved to Denver from Benton, Ark., last year told Hancock that far more applicants than he anticipated are failing mandatory drug tests required as part of the company's federal contracts.

"It is more challenging than we

thought," said Ducker, noting it could prove a problem as the company gears up hiring to fill a contract for 400 bridge-erection boats.

Washington, after the meeting, noted that one reason to not let up on corporate recruiting and retention efforts despite nearly full employment in the city is the hit the energy industry may face.

About a quarter to a third of downtown office space is used by companies in that industry, which faces a significant pullback if oil prices don't rebound.

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Explicit attempts to override the market

Always too small to be effective for this purpose: HB15-1230

1 REIMBURSEMENT MONEYS MUST HAVE LESS THAN ONE HUNDRED
2 EMPLOYEES. A BUSINESS MAY BE REIMBURSED FOR UP TO FIVE INTERNS
3 PER LOCATION AND UP TO TEN INTERNS TOTAL AT ALL LOCATIONS, BUT
4 THE MAXIMUM AMOUNT THAT A BUSINESS MAY BE REIMBURSED FOR EACH
5 INTERNSHIP IS FIVE THOUSAND DOLLARS. AT LEAST HALF OF THE
6 REIMBURSEMENT AMOUNT MUST BE PAID TO THE INTERN. TO BE

Explicit attempts to override the market

Always too small to be effective for this purpose: HB15-1230

18 (6) FOR THE FISCAL YEAR BEGINNING ON JULY 1, 2015, THE
19 GENERAL ASSEMBLY SHALL APPROPRIATE FOUR HUNDRED FIFTY
20 THOUSAND DOLLARS FROM THE GENERAL FUND TO THE DIVISION TO BE
21 USED FOR PROGRAM REIMBURSEMENTS. FOR THE NEXT TWO YEARS
22 THEREAFTER, THE GENERAL ASSEMBLY MAY APPROPRIATE MONEYS FROM
23 THE GENERAL FUND TO THE DIVISION TO BE USED FOR PROGRAM
24 REIMBURSEMENTS. IN ADDITION, THE GENERAL ASSEMBLY SHALL

This bill is expected to finance approximately 90 internships

Explicit attempts to override the market

Always too small to be effective for this purpose: JGITC (Hauptman)

Table 1: Numbers of Non-Eligible, Eligible, and Participant Establishments by Year

Year t	All	Non-Eligible	Eligible	Recipient
2011	223,213	222,509	704	6
2012	223,231	222,466	765	5
2013	215,056	214,329	727	8

Conclusion

- If you knew enough to reliably identify growth opportunities
 - You wouldn't give that away for free
 - You wouldn't work for the government
- Do you want to be in a relationship with a partner who has to be paid?
- Tax expenditures
 - Are almost always zero-sum games
 - Most scams begin with the failure to recognize a zero-sum game
- Can tax expenditures be fixed?
 - Maybe require tax expenditure advocates to invest their own money in each opportunity?