

State Business Tax Incentives: Examining Evidence of their Effectiveness



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What are business tax incentives?

- A common economic development tool.
- Preferences in the tax code meant to encourage some type of business activity that would not have occurred—or would have occurred to a lesser degree—without the incentive.
- Often appear in the form of a credit which allows a business to reduce its tax liability dollar-for-dollar.
- Potential benefits include expanded economic activity; potential costs include forgone tax revenue. Both are difficult to measure because we cannot observe the “counterfactual.”

Aims of the report

- Consider state business tax credits in the context of commonly accepted tax policy goals.
- Examine selected business tax credits offered by New England states, with a focus on the choices policymakers have faced in creating them.
- Evaluate the approaches and findings of studies examining the effectiveness or cost-effectiveness of state business tax credits.

Business tax credits vis-à-vis commonly accepted tax policy goals

Tax policy goal	In general, do business tax credits support or undermine this goal?
Equity	Unclear ; depends on who bears burden of taxes
Neutrality	Undermine ; by their nature tax credits are a means of using the tax code to influence economic behavior
Simplicity	Undermine ; tends to make tax code more administratively burdensome for firms and states
Transparency	Undermine ; harder to tell which taxpayers are paying taxes and how much they are paying
Adequacy	Unclear ; depends on whether tax credits generate a net revenue loss and desired level and mix of public services
Competitiveness	Unclear ; depends on whether a state's relative level and mix of taxes and public services is attractive to firms

Business tax credits in New England

State	Investment	R&D	Job Creation	Film Production
CT	<ul style="list-style-type: none"> • Fixed Capital Investment • Film Infrastructure Investment • Machinery and Equipment Expenditure 	<ul style="list-style-type: none"> • R&D Expenses • Research & Experimental Expenditures 	<ul style="list-style-type: none"> • Job Creation 	<ul style="list-style-type: none"> • Film and Digital Media Production • Digital Animation Production
ME	<ul style="list-style-type: none"> • Jobs and Investment 	<ul style="list-style-type: none"> • Research Expense • Super R&D Expense 	<ul style="list-style-type: none"> • Jobs and Investment 	<ul style="list-style-type: none"> • Certified Media Production
MA	<ul style="list-style-type: none"> • Investment • Life Sciences Investment 	<ul style="list-style-type: none"> • Research 	<ul style="list-style-type: none"> • Jobs Incentive Payment 	<ul style="list-style-type: none"> • Payroll for Motion Picture Production • Production Expense for Motion Picture Production
NH		<ul style="list-style-type: none"> • R&D 		
RI	<ul style="list-style-type: none"> • Investment • R&D Property • Biotechnology Investment 	<ul style="list-style-type: none"> • R&D Expense 		<ul style="list-style-type: none"> • Motion Picture Production
VT	<ul style="list-style-type: none"> • Vermont Employment Growth Incentive 	<ul style="list-style-type: none"> • R&D 	<ul style="list-style-type: none"> • Vermont Employment Growth Incentive 	

Designing tax credits: Key considerations

- What type of economic activity is a credit designed to induce?
 - Explicit versus implicit goals
- Which firms will receive the credits, and how does the state distribute them?
 - Eligibility requirements for firms
 - Entitlement versus discretionary
 - Open-ended versus capped

Designing tax credits: Key considerations

- How will a credit be calculated?
 - Spending on “qualified” activity multiplied by rate
- What happens if a credit exceeds a firm’s tax liability?
 - Carry-forwards
 - Transferable versus refundable
- What happens if a firm fails to deliver?
 - Recapture or “claw-back” provisions

Evaluating business tax credits: A framework

- Does the credit induce the targeted activity?
 - What actually happened with the credit in place versus what would have happened without the credit (the “counterfactual”)
- What is the credit’s overall economic impact?
 - Direct effects
 - Indirect effects (positive and negative)

Evaluating business tax credits: A framework

- What is the credit's fiscal impact?
 - Changes in state revenues and spending resulting from the credit
- Is the credit cost-effective?
 - Relative to a standard threshold (e.g. HUD's \$35,000 per permanent job)
 - Relative to other policies

Examining the literature

- Identified evaluations for each of the four credit types
- Geographic coverage:
 - Multi-state studies
 - Individual state studies: New England versus non-New England
- Methodological approach:
 - Descriptive
 - Econometric
 - Input-output

What the evidence shows

- State business tax credits do seem to foster their targeted activities, but often at expense of other states. Some subsidized activity would have occurred without the credits.
- Indirect effects are important.
- Business tax credits do not appear to “pay for themselves” in most cases.
- It is difficult to draw clear conclusions on cost-effectiveness.
- Assumptions matter.

Concluding thoughts

- As data improve, more high-quality studies may emerge, allowing for sounder conclusions on cost-effectiveness.
- Policymakers and other stakeholders need to understand the strengths and weaknesses of existing studies when using them to inform the debate.
- It is also important to consider the larger picture—including how business tax credits mesh with other tax policy goals and who is benefiting and how—when determining the role of credits in economic development policy.



State Business Tax Incentives: Examining Evidence of their Effectiveness

- 8:00 a.m. Registration and continental breakfast
- 8:30 a.m. Welcome and introduction
- 8:40 a.m. Presentation: State Business Tax Incentives: Examining Evidence of their Effectiveness
- 9:10 a.m. Panel discussion and questions from the audience
- 10:30 a.m. Forum concludes