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Characteristics of Effective Tax Incentives

Pennsylvania Budget and Policy Center
Testimony on HBs 2181, 2182, 2183, and 2184
Pennsylvania House Finance Committee Hearing
September 19, 2012

Good afternoon Representatives Benninghoff and Mundy, as well as other members of the Finance Committee. Thank you for the opportunity to comment on House bills 2181 through 2184.

The Pennsylvania Budget and Policy Center is a non-profit, non-partisan policy research organization that evaluates tax and budget policy, with an emphasis on revenue adequacy and tax fairness.

With unemployment hovering near 8%, the public and elected officials are looking at strategies to stimulate the economy and create jobs. Tax credits programs are a popular tool in the toolbox. However many have not earned their good reputation. In Pennsylvania and across the nation, tax credit programs too often are poorly designed, lack clear goals, and fail to make good on promises. Often, the programs pay for activity that would have otherwise occurred.

House Bills 2181 to 2184 propose a series of tax credits in an effort to add to the state's economic incentive toolbox, and attract more investment. Portions of the bills may have merit, but as currently proposed, do not offer the Commonwealth the "bang for the buck" necessary to warrant their enactment.

It is important to note at the outset that the Commonwealth has made billions of dollars in business tax reductions, and enacted hundreds of millions of dollars of tax credits, in an effort to spur development. There is little information to judge whether these large tax expenditures have borne fruit. Before enacting new tax credit programs, the Commonwealth needs to determine whether the strategy has been at all effective.

Making the most of business incentives

Before discussing the merits of these particular proposals, I'd like to discuss eight commonsense principles for effective and accountable business incentives. It is against these principles that these and other tax credit programs should be evaluated. Tax credits have the same impact on the state budget as expenditures programs – both reduce revenue available for other state priorities, such as education or health care,--and as such should be subject to annual evaluation.[1] This can be done by setting credit amounts every year, based on available resources, or through rigorous program evaluation.[2] An issue that came up in the Legislative Budget and Finance Committee's 2010 review of credit programs is that program monitoring was not being adequately staffed. If these programs exist, the government needs to devote resources to make sure they are being operated effectively.

1. **Get a money back guarantee on subsidies.** To help ensure accountability economic development programs should have clear purposes, measurable outcomes, and regular reporting requirements. Subsidies should have "money back guarantees" or "clawbacks" where funds can be recovered from companies who fail to live up to their commitments to the state.

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[1] Budget and Finance Committee, *Pennsylvania's Tax Credit Programs: Conducted Pursuant to Senate Resolution 2009-20 and House Resolution 2009-127*, June 2010, http://lbfc.legis.state.pa.us/reports/2010/49.PDF.
[2] Chuck Cross, et al., *Report of the Missouri Tax Credit Review Commission*, State of Missouri Tax Credit Review Commission, November 30, 2010, http://tcrc.mo.gov/pdf/TCRCFinalReport113010.pdf.

2. **Match the subsidy to the goal**. If the goal of the subsidy is to create employment, provide subsidies that help reduce the cost of labor, rather than those that lower the cost of capital improvements. Often, capital improvements lead to the need for less labor.[3]
3. **Focus subsidies not only on job creation, but also the creation high-quality jobs (paying market-based wages with health insurance and other benefits provided)**.[4] Subsidizing low-quality jobs can place additional demand on state Medicaid programs as workers have to rely on government programs for healthcare.
4. **Set clear goals for economic development programs and draw clear conclusions in their evaluation**. The Legislative Budget and Finance Committee's recent review of Pennsylvania's tax credit programs was cited by the Pew Center on the States as being a good example of plainly stating how programs were measuring up to their goals.[5] This should be the norm for all tax credit programs. Every program should have clear, stated goals at the onset and unvarnished evaluation of the results.
5. **Insist on transparency for subsidy programs**. The Commonwealth should report what entities receive subsidies under any program, job creation or investment promises, and progress made toward those goals. These reports should be made public and not cloaked in secrecy as "confidential taxpayer information." It is not clear what public good is served maintaining this type of confidentiality, particularly when receiving tax dollars.
6. **Ensure subsidy programs are accountable for results.** To be accountable, program outcomes must be measured and analyzed. Authorizing legislation should include accountability provisions, including reporting requirements. Without the measurement and reporting of outcomes, it is difficult to tell how effectively a program is addressing its purpose. A program that can foster the creation of a quality job for $2,000 per year is a better investment for the Commonwealth than a program that costs $10,000 or more per job. Without an accounting for results - and having the mechanisms to do so, lawmakers will have no idea what their investment buys.
7. **Make program reporting as uniform as possible.** Currently, there is little uniformity in reporting requirements among the state tax credit programs. Creating a core set of reporting requirements for all programs would make the programs easier to administer and monitor, as well as ease recipient compliance for companies receiving benefits. Having more uniform requirements could help make the programs more attractive to potential applicants and result in greater use of the programs.
8. **Set program limits and sunsets.** Programs should have statutory limits, to prevent one company from receiving more benefits than intended and to limit the Commonwealth's financial exposure. If the limits fail to be met over time, lawmakers should evaluate the efficacy of the program and reduce the limits.[6] Programs also often outlive their usefulness. The use of sunsets forces programs to be periodically re-evaluated to help ensure scarce resources are being used wisely. Without specific legislative action, the programs end.

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[3] Keith R. Ihlanfeldt, "Ten Principles for State Tax Incentives," *Economic Development Quarterly*, Vol. 9, No. 4, November 1995.

[4] Thomas Cafcas and Greg LeRoy, *Connecticut Economic Development Subsidies: Costly and Blunt*, Good Jobs First, October 2011, http://www.goodjobsfirst.org/sites/default/files/docs/pdf/ct_subsidies_oct2011.pdf.

[5] The Pew Center on the States, *Evidence Counts: Evaluating State Tax Incentives for Jobs and Growth*, April 2012, http://www.pewstates.org/research/reports/evidence-counts-85899378806.

[6] Legislative Budget and Finance Committee.

Policy considerations

As lawmakers consider and design business incentives, several policy considerations should be considered.

In some cases, writing checks is more effective. If you are trying to subsidize a single company or project, direct appropriations are more efficient than a tax credit and can be monitored on a year-to-year basis by the legislature. New companies often have little tax liability, so tax credits must be carried forward for several years to be used. If made sellable, as is becoming more common in Pennsylvania, the credits are sold for less than face value, with a share of the funds going to intermediaries. This provides fewer resources to the company originally receiving credit and reduces the effectiveness of the credit.[7]

Investment in public goods can be the best development route. Rather than subsidizing specific companies, Pennsylvania should strengthen its efforts to grow its own companies by investing in the public goods of a 21st-century economy. These 21st-century public goods start with education and traditional infrastructure but also include technological infrastructure and amenities, cultural assets, and natural endowments that make Pennsylvania an attractive place to live and work. Today's public goods also include institutions that support specific industry sectors, such as training partnerships and sector-specific innovation centers that build on Pennsylvania's higher-education institutions.[8] One particular benefit of the training partnership is that workers retain the skills even if particular companies come and go.

Keeping companies invested in Pennsylvania can be more effective than paying companies to relocate. It is often easier and cheaper to convince businesses already doing business in the state to expand their operations, compared to the cost of luring businesses to relocate from other states.[9]

Companies that are persuaded to relocate to a different state for a specific incentive are also the most likely to leave when the incentives expire. Much like a shopper who heavily uses coupons and goes from store to store in search of the best deal, these "shopping" companies may move to greener pastures as soon as the deal ends, leaving the Commonwealth largely where it started.

Aggressive smokestack chasing and pirating of jobs from other states feeds a destructive race to the bottom on business taxes, shifting the joint responsibility for paying for government services to individuals.

When incentives are poorly defined, targeted, and administered, the government subsidies can truly be "money for nothing."

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[7] Oregon Center for Public Policy, "Reel Inefficiency," February 8, 2011, http://www.ocpp.org/2011/02/08/reel-inefficiency/.
[8] Maria Cristina Herrera, et al., *Good Jobs, Strong Industries, A Better Pennsylvania*, Keystone Research Center, March 2010, http://keystoneresearch.org/publications/research/good-jobs-strong-industries-better-pennsylvania-towards-21st-century-state-eco.
[9] Timothy Bartik, "What Works in State Economic Development?" In Growing the State Economy: Evidence-Based Policy Options, 1st edition, Stephanie Eddy, and Karen Bogenschneider, eds. Madison, WI: University of Wisconsin, 2009, pp. 15-29. http://www.familyimpactseminars.org/s_wifis27report.pdf.

Measuring up the proposals

House Bill 2181. This bill creates a new type of tax credit never used before in the Commonwealth. The "Manufacturing Jobs Tax Credit" would be available to qualified manufacturing facilities that retain jobs and for suppliers to those manufacturers that create a minimum of 5 new jobs.

The tax credit is funded using the income taxes withheld from employees, rather than other tax dollars. By doing so, the employees are effectively paying for the tax incentive received by their employer. The Commonwealth loses out, too, as the tax dollars are diverted away from the General Fund. The Commonwealth should think long and hard before enacting this new type of tax credit.

While the bill includes a number of reasonable accountability provisions, overall the costs of the bill vastly outweigh its benefits, particularly if no new jobs are created at the manufacturing facility. The legislation sets a low bar for the manufacturing facilities to receive the credit. The manufacturing facility does not have to increase employment, it is only required to make capital investments and relocate or create new a product line at the facility, not create jobs.

The bill violates one of the key principles for a good job creation tax credit program; it subsidizes capital investments rather than jobs, and could lead to an overall reduction in employment at qualified manufacturing facilities. Ironically, because the tax credit is funded through employee withholding, it could result in a situation where employees are paying to subsidize the equipment that will be used to replace them. Once qualified, the facility is entitled to keep half of the PIT withheld from its "retained workers" for a period of up to ten years.

This may be an unneeded subsidy for a manufacturer that is re-organizing its product lines due to market conditions, with or without the credit. Additionally, credits may be awarded to facilities where employment actually decreases – a strange feature for a tax credit supposedly aimed at manufacturing jobs.

The standards for qualified suppliers are higher. The supplier must create new jobs to receive the credit and must pay at least an industry average wage and partially employer paid benefits to qualify for the credits. The supplier must derive 10% or more of its sales to a qualified manufacturing facility. In return, the supplier may keep 100% of the PIT withheld from the newly added employees for three years. If the supplier pays 120% of the average industry wage, the period is extended to five years.

The proposal is thoughtful in several of its accountability provisions. It sets annual tax credit limits, has specific annual reporting requirements and sets wage and benefit standards for suppliers. The bill also would exclude qualified manufacturing firms from double-dipping through participation in other Commonwealth tax credit programs.

The proposal contains no clawback mechanism for previously awarded credits. If a manufacturer or supplier fails to retain jobs maintained or created in previous years, no further credits are awarded.

House Bill 2182

This bill creates a "Hotel and Resort Property Construction and Renovation Tax Credit." This program provides up to $50 million per year in tax credits for qualified hotel or resort construction projects. The cost of the construction/renovation project must range between $10 million to $100 million to qualify for the credit. Credits

awarded are equal to 10% of the construction or renovation costs incurred. No specific goals for the program, such as increasing employment, are stated in the bill.

The proposal includes a strict time limit (2012 through 2015), prohibits double dipping with federal tax credits and expensing, and has annual caps on credits that can be awarded.

Despite these features, it is difficult to identify the public interest served through this legislation. It contains no job creation criteria of any kind. It also seems designed to subsidize certain types of projects without any clear public interested being served. Hotel construction has continued in the commonwealth despite the recession. Philadelphia just approved a new "W" hotel on Broad St. near the Pennsylvania Convention Center, which is the third high end hotel built in the city in recent years.[10]

Commercial construction has clearly suffered during the recession, but the remedy to this problem is to invest public funds in public construction projects – not for-profit hotels and resorts. Schools, libraries, parks, and historic sites need renovation and restoration and are also in need of state dollars. It is difficult to see how spending $50 million per year on hotel projects (that will be built based on demographics and consumer demand, rather than tax breaks) outweighs the need to restore school funding or other critical public needs.

The bill has no public reporting requirements, making it difficult to gauge the payback the state receives for its potential $200 million contribution to these projects.

House Bill 2183

This proposal creates a $2,000 per job "Renewable Energy Job Creation Tax Credit." Under the plan, companies receive tax credits for each new "renewable energy job" (defined as employment industries related to the field of renewable, alternative energy, including the manufacture and operation of products used to generate electricity and other forms of energy from alternative sources that include geothermal heating systems, solar heating systems, hydropower systems and biomass and biofuel systems). Each job can generate credits in three tax years, if it continues to be filled, for a total tax credit of $6,000 per job.

While encouraging the development of renewable energy is a worthy endeavor, this proposal has a number of issues. It contains no reporting requirements to help lawmakers assess its effectiveness or to indicate to taxpayers how many jobs have been created. It contains no limit to the amount of credits to be awarded in a year or to a single company. Furthermore, it contains no sunset date for the program.

It is confusing if jobs created in specific industries or if jobs created in specific occupations will generate credits under the proposed program. The bill defines "renewable energy jobs" as being in specific industries and that creating these jobs generates tax credits. However, Section 1803-E later states that the Departments of Revenue and Community and Economic Development will create a detailed list of occupations that qualify for the credit.

The broad manner in which renewable energy jobs are defined could make workers in many industries eligible for the credits, as they are related to renewable energy development. The bill contains no pay or benefit standards for qualifying jobs.

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[10] Suzette Parmley, "W Hotel project wins approvals to proceed," *Philadelphia Inquirer*, September 15, 2012, http://www.philly.com/philly/business/20120915_W_Hotel_project_wins_approvals_to_proceed.html.

Like the other credits, it is hard to determine if these credits are necessary, or if they are subsidizing something that would occur without the public subsidy. Public dollars may be better used for reducing consumers' cost of transitioning to renewable energy, rather than lessening labor costs for firms.

House Bill 2184

Very similar to HB 2183, this creates a "Clean Energy Job Creation Tax Credit" for the creation of clean energy jobs. In addition to jobs that qualify for HB 2183, jobs in hydrogen and fuel cell technology, landfill gas, and wind systems are considered clean energy jobs. As is the case in HB 2183, the bill lists industries where the jobs must be created, but later says individual jobs that qualify for the credit will be defined later.

HB 2184 includes a number of provisions that make it preferable to its counterpart. The credit is limited to jobs that pay at least $50,000, and the credit is limited to $500 per year per job for up to five years. Each company may receive credit for a maximum of 350 jobs and the program sunsets in 2017.

One failure of the program is that it allows double dipping of tax benefits: companies can operate in Keystone Opportunity Zones, where activity would be largely tax-free for state and local purposes, and still receive the clean energy job credits.

The bill could be improved with the addition of annual reporting, a program cap, and a more defined list of occupations/industries that qualify for credits.

Conclusion

The number and scope of tax credits offered by the Commonwealth of Pennsylvania have mushroomed over the past decade. These proposals follow that pattern.

Rather than developing new tax credits for every new type of business the state wants to support, a more cost-effective path would be to create a more unified economic development policy – with common standards and reporting requirements. This policy could help link economic development with workforce development, and help insure the state's finite resources are used in a way that maximizes the "bang for the buck."