CONNECTICUT VOICES FOR CHILDREN

State Job Creation Tax Credits

March 2010

Poor labor market conditions in Connecticut have produced a flurry of proposals to try to jump-start job growth through tax credits for businesses that create jobs.[1] The Governor prominently proposed an expansion to an existing jobs tax credit in her FY 2011 budget adjustments. The Governor's bill and several similar bills are under active consideration by the General Assembly.[2] Comparable credits have been proposed in several states across the country, including Maryland and Massachusetts.[3] This report examines the empirical literature on "job creation" tax credits, evaluates their potential effectiveness in Connecticut, and analyzes the Governor's specific proposal.

Job creation tax credits have recently gained support as federal policy, but experts doubt their effectiveness at the state level. At the national level, policymakers have been actively debating measures that would provide tax relief to employers that hire new employees. On February 24th of this year, the U.S. Senate passed a $15 billion dollar jobs bill—likely to be enacted—that includes a job creation tax credit for businesses that hire new employees who had previously been unemployed for at least 60 days.

Though there is not broad agreement on the details of national job creation tax credits, many economists believe that they can boost employment if the credits are temporary, robust, and offered when unemployment is high.[4] Expert support persists despite the mixed success of past and existing national job creation credit programs such as the New Job Tax Credit and the Work Opportunity Credit and Welfare to Work credits.[5] Experts also hotly contest the specific elements of an effective national job creation tax credit.[6]

While political support is coalescing around some form of a national credit, support among experts for state-level job creation tax credits is much lower. The Economic Policy Institute, which strongly supports a national credit, cautions that state-level equivalents are often poorly designed and can encourage a zero- or negative-sum game among states.[7] State tax incentives for various types of job creation have proliferated over the past few decades, an indication of the fierce competition among states trying to influence employer location decisions.[8] Interstate tax competition is frequently a prisoner's dilemma that leads to wasted state and local resources, leading some prominent economists to call on the federal government to intervene.[9] Additionally, states' balanced budget requirements mean that any tax expenditure, like a jobs creation tax credit, must be offset with higher taxes, reduced spending, and/or greater borrowing.[10] Often, politicians and policymakers wary of the political ramifications of raising taxes choose the latter two options. The requirement to offset job creation credits at the state level by either borrowing or limiting state spending can significantly decrease any potential net benefit.

Research has found that only a fraction of the money spent on job creation credits goes toward creating new jobs that would not have been created without the credits. Most recent evaluations of state-level job creation credits find modest to moderate effectiveness in boosting job creation.[11] Inducing job growth through credits, however, can be costly and inefficient. Multiple academic analyses of job creation tax credit programs have found that 70% or more of the credits granted employers would be awarded for jobs that likely would have been created without the credit.[12] Said another way, for every $1 million given out in tax credits, only about $300,000 would be linked to the creation of jobs that would not have been created without the credit in place. One analysis of the job creation tax credit in North Carolina found close to *all* the credits claimed were for jobs that would have

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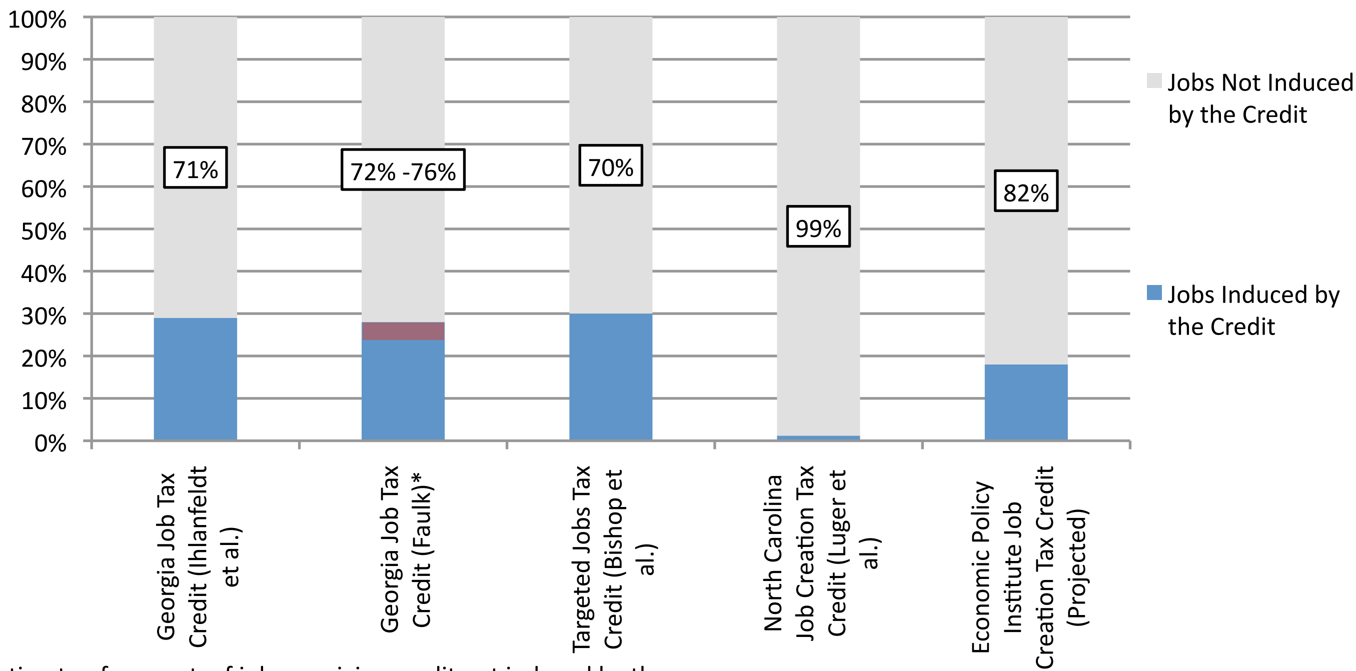
been created anyway.[13] In a recent report on the effectiveness of business tax incentives, the Federal Reserve Bank of Boston concluded that job creation tax incentives do influence firms' hiring decisions, but that the companies would have created a majority of the subsidized jobs anyway." The figure below shows results from five leading studies that attempted to estimate job creation tax credit efficiency. The chart shows the estimated proportion of job creation tax credits that were awarded for jobs that would not have been created without the credit.[14]

Figure 1. Most Jobs Claimed for Credit Would Have Been Created Anyway



*Estimate of percent of jobs receiving credit not induced by the Georgia tax credit ranged from 72-76%

Expanding the job creation tax credit risks making Connecticut's corporate tax system less fair, less efficient, harder to administer, and less transparent. In this fiscal climate, policymakers may prefer to promote job creation through tax credits rather than direct spending because the costs associated with credits are opaque. Tax credits are not subject to the same standards of transparency and accountability as direct economic aid (e.g., through grants or loans from the Connecticut Department of Economic and Community Development), even though the fiscal impact on future state fiscal stability from a steady, yet unexamined, erosion of business tax revenues can be greater.

Connecticut's total expenditure on business and insurance tax credits has grown significantly over the past two decades, from $2.4 million inflation-adjusted dollars[15] in 1990 to an estimated $331.8 million in 2009.[16] The Governor's proposal includes some responsible safeguards (that are not present in many of Connecticut's other tax credits[17]) that would limit the fiscal impact of the credit, such as a cap on annual expenditures and a January 2013 sunset date. However, the total expenditure through these tax credits (up to $50 million over 5 years) should be weighed against alternatives, including other types of supports to small employers that may be more economically efficient in helping to create jobs or increasing financial supports for currently unemployed workers. Currently, programs and services that are linked to workforce development and improving Connecticut's economy face deep cuts. For example, the Governor's recommended FY11 budget adjustments would eliminate funding for Connecticut's Youth Employment Training Program, which links Connecticut's youth to work experiences and helps put money in the pockets of a population that is likely to spend it. Cuts also have been proposed for programs such as Care4Kids, which provides child care subsidies that allow parents to work who otherwise could not. Since job creation tax credits would reduce revenues that would otherwise be available to other programs and services important to our economic recovery, the anticipated revenue loss should be offset by some new revenue source or other savings that do not further exacerbate our downturn.

Evaluating the Governor's Proposal (H.B. No. 5209)

Description

As part of her jobs strategy, Governor Rell proposed expanding the Jobs Creation Tax Credit Program.[18] The proposal creates a targeted credit for small businesses with fewer than 25 employees. Unlike Connecticut's existing Jobs Creation Tax Credit, the proposed credit would be open to a wide range of corporate structures, including pass-through entities such as LLCs, LPs, and S-Corporations.

Under her proposal, qualified small businesses would be eligible for a $2,500 per year credit for each new full-time employee hired between January 1, 2010 and December 31, 2012. After the first income year in which a new employee is hired, the business could claim credits of $2,500 for each of the two successive income years in which the employee has been employed for the full year, making the maximum credit for a single employee $7,500 over three years. Businesses that hire a new employee in the last six months of the income year could only claim $1,250 for that employee during that year. However, in 2010, the full $2,500 is available for hires made at any point during year (Table 1). No credit may be claimed for any new hire made during the last month of an income year, and tax credits not used in a given income year would expire. The Commissioner of the Connecticut Department of Economic and Community Development would be required to rule on each company's application for a tax credit, which must be filed before hiring each new employee; other types of tax credits cannot be claimed with respect to the same new employee.

Table 1. H.B. No. 5209, Tax Credit Amount for Initial Year of Hire

Year	Credit for full-time employee hired in first six months of income year	Credit for full-time employee hired in last six months of income year, excluding the final month
2010	$2,500	$2,500
2011	$2,500	$1,250
2012	$2,500	$1,250

Credit for each full year of employment following initial year of hire (up to two years): $2,500

Notably, the proposed Jobs Creation Credit Program (which would include both the existing job creation credit and this new small business component) would remain capped at $10 million dollars annually, in the words of the Governor, "in order to safeguard the state budget."

The Governor's small business jobs credit does not represent the first effort in Connecticut to incentivize job creation through credits. In 2006, Connecticut created a credit for any company that created at least 50 new full-time jobs (reduced to 10 new employees in 2007). Connecticut's Department of Economic and Community Development has reported that initial uptake of the credit has been weak, which prompted efforts to make it more attractive by increasing the credit amount and relaxing job creation requirements from 50 to 10.[19] In spite of these efforts, few companies have claimed the credits, and credits for fewer than 300 new jobs have been claimed over the first four years.

Analysis

For the reasons stated earlier in this report, inducing job creation at the state-level through use of a tax credit is likely to be inefficient and have uncertain benefits, and—because of the state's balanced budget requirement—potentially can inflict offsetting harm on the state's economy that results from the required revenue increases and/or cuts in appropriated spending needed to offset the credits awarded. Further, the money that would be used to fund a credit could be used in other ways, including towards direct services, like financial supports for currently unemployed workers, the benefits of which are more immediate and better documented.[20] However, given the desperate need to improve the state's economy and the political popularity of these proposals, some form of legislation though to promote job growth is likely. If the General Assembly decides to embrace a jobs tax credit expansion, the Governor's proposal should be improved in several ways.

The jobs creation tax credit should reward net job creation not simply new hires. The Governor's proposal would allow employers to claim credits for new full-time employees even if the employer reduces overall firm employment. Allowing employers to claim credits for every new hire reduces the efficiency of the credit since the state would be partially subsidizing natural turnover in the labor market. Even during a recession when overall employment levels fall, the volume of hiring remains high. For example, in 2008, new hires as a proportion of total private employment was 46%.[21] In order to focus the credit on job expansion, credit eligibility should be based upon net jobs created. Net jobs could be defined as the change in firm employment compared to a static date, as in the Massachusetts credit, or as compared to a moving reference point, such as employment in the same month of the previous year.

It warrants mention that the Governor's proposal will include an important safeguard to prevent employers from claiming the credit for a newly hired employee if that employee had been employed by a "related person"[22], such as a related business, in the previous twelve months. For example, this would prevent a firm from claiming credits simply for shifting employees to a wholly owned subsidiary.

The current credit would allow participating firms to terminate a newly hired worker after one month of employment, without any penalty imposed. The credit should be modified to ensure that new employees are hired for a minimum time period. Under the current legislative language, employers are under no obligation to retain a newly hired employee after a credit is received. In order for a business to claim a credit for a newly hired employee, that employee must be employed at the close of the income year. Since an employer can claim a credit for an employee hired in any but the last month of an income year, an employee hired before the end of the second to last month of an income year could be fired the first month of the following income year, while still earning the employer a credit for the year of hire. This is a particular risk in 2010, when the full $2,500 credit is available for jobs created in the second half of the year. To promote job retention, the General Assembly should require that each new employee for which a credit is claimed remain employed for a set minimum time (e.g. 12 months, like in Maryland's credit[23]). The addition of claw-back provisions, like those in Connecticut's existing job creation tax credit, would enable the Department of Revenue Services to reclaim credits from firms that fail to retain employees.[24]

The credit's cap and sunset date safeguard the state budget; the same safeguards should be applied to all business credits. Without caps, tax credits are open-ended liabilities in the state budget that are difficult to predict and can fluctuate significantly from year to year, impairing the state's ability to enact a balanced budget. The suggested $10 million dollar cap on Connecticut's job creation credits would limit Connecticut's financial exposure at a time when its budget is in crisis. The Governor's proposed credit would also expire at the end of December 2012, a measure that is consistent with the view among experts that job creation tax credits are most effective when unemployment is high.[25] Sunset dates for tax expenditures also increase accountability by requiring that credits be reevaluated by the legislature. In light of the state's fiscal challenges, annual caps and sunset dates should be considered for *all* tax credit programs, many of which have not been reviewed since their inception, until each can be fully reviewed and evaluated for its effectiveness and efficiency. Previous research by Connecticut Voices for Children has documented that about two-thirds of all state business tax credits are uncapped, only one has a sunset date, and only four have been repealed or limited over the last two decades, resulting in an increasing, and open-ended, state revenue loss though tax credits.[26] Other states have begun to take steps to limit tax credit expenditures. For example, both Oregon and Nevada require mandatory sunset dates on most business credits.

The legislature must seek clarity on how the credit would function for pass-through entities or sole-proprietorships. The tax credit is intended to offset the *personal* income tax liability of the owner of a pass-through entity or a sole proprietorship. However, the legislative language submitted by the Governor does not clarify who constitutes the owner eligible to receive a credit against their personal income tax liability.[27] It simply states that "the tax credit may be claimed by the shareholders or partners of the qualified small business." In cases of partnerships, joint ventures, or S-Corporations with shareholders, will this $2,500 credit be distributed pro rata according to percentage ownership? For example, it is difficult to imagine 100 equal shareholders in an S-Corporation being motivated by the prospect of a $25 credit against their Connecticut personal income tax liability. It is equally difficult to believe that this pro rata distribution of personal income tax benefits is worth the administrative cost.

Focusing a tax credit on small business can pose special risks that emphasize the importance of restricting eligibility to net job creation. The Governor's expansion of current job creation tax credits would be limited to businesses of fewer than 25 employees. Targeting the credit in this way may have some merit. Some evidence suggests that small businesses are more responsive than larger businesses to job creation tax credits. A survey of businesses in California found that smaller firms (fewer than 100 employees) were likely to agree that a hypothetical $3,000 per-job tax credit for job creation[28] would lead them to increase employment, while larger firms were indifferent.[29] A detailed analysis suggested that the smaller firms (among those with less than 100 employees) were the most likely to indicate anticipated employment growth in response to the credit. However, the Congressional Budget Office recently cautioned that restricting eligibility for job creation credits to small firms, where conditions are especially volatile and turnover is high, decreases the efficiency of the credit; a greater share of the tax credits subsidize jobs that would have been created even without the credit.[30] A credit based only on new hires, rather than net gain in employment, would be especially prone to inefficiency when restricted to small employers, which experience high rates of job creation and loss, as well as high rates of entry and exit from the market.

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[1] A count off the Connecticut General Assembly website as of February 24 turns up 4 separate bills that would offer a tax credit for job creation.

[2] H.B. 5209 "An Act Concerning Small Business Tax Credits."

[3] Governor Deval Patrick filed legislation on February 10th to create a $2,500 credit for small businesses. Details are available on the Governor's website: http://www.mass.gov/?pageID=gov3modulechunk&L=1&L0=Home&sid=Agov3&b=terminalcontent&f=features_2010-02-10_jobs&csid=Agov3 (Last accessed 2/20/2010); Maryland's credit would provide a $5,000 credit for employers who hire workers in 2010 who receive or had received unemployment benefits in the past 12 months. Senate Bill 106.

[4] P.R.G. Layard and S.J. Nickell, "The Case for Subsidizing Extra Jobs," *Economic Journal*, vol. 90, no. 357 (March 1980), pp. 51-73; Timothy J. Bartik and John H. Bishop, "The Job Creation Tax Credit" EPI Briefing Paper. Economic Policy Institute Briefing Paper #248. October, 2009.

[5] For deeper analyses of each of these credits, see Robert Tannenwald, "Are Wage and Training Subsidies Cost-Effective? Some Evidence from the New Jobs Tax Credit," *New England Economic Review,* September.October 1982, pp. 25-34; Departments of Labor and Treasury, *The Use of Tax Subsidies for Employment,* A Report to Congress, Washington, May 1986 ; and Sarah Hamersma, "The Work Opportunity and Welfare-to-Work Tax Credits," *Urban-Brookings Tax Policy Center, Tax Policy Issues and Options.* No. 15, October 2005.

[6] See, i.e., Timothy J. Bartik, "Not all job creation tax credits are created equal." Economic Policy Institute. February 12, 2010. http://www.epi.org/analysis_and_opinion/entry/not_all_job_creation_tax_credits_are_created_equal/ (last accessed, 2/21/10)

[7] Timothy J. Bartik and John H. Bishop, *The Job Creation Tax Credit*, Economic Policy Institute Briefing Paper #248, Oct. 20, 2009.

[8] Terry F. Buss. "The Effect of State Tax Incentives on Economic Growth and Firm Location Decisions: An Overview of the Literature," Economic Development Quarterly. 15;90 (2001).

[9] General Counsel Melvin L. Burnstein and director of research Arthur J. Rolnick of the Federal Reserve Bank of Minneapolis, for example, called on congress in 1994 to end the bidding war among the states by "prevent[ing] states from using subsidies and preferential taxes to attract and retain businesses."; Melvin L Burnstein and Arthur J. Rolnick. "Congress Should End the Economic War Among the States." Annual Report Essay, 1994. Federal Reserve Bank of Mineapolis. (1994). http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=672 (Last accessed, 2/24/09)

[10] Iris J. Lav and Robert Tannenwald, "The Zero-Sum Game: States Cannot Stimulate Their Economies by Cutting Taxes." Center On Budget and Policy Priorities. March 2, 2010. http://www.cbpp.org/cms/index.cfm?fa=view&id=3100#_ftn9

[11] Frequently these estimates are based upon methods and assumptions that are questionable. E.g., estimates of credit effectiveness rely upon some assumption of the elasticity of labor demand (firm responsiveness to labor costs) that may not hold true under recessionary conditions. In the few empirical studies that exist, jobs induced by the credit is gauged by comparing job creation in eligible firms that claimed the credit to eligible firms that did not, a method that carries significant endogeneity challenges.

[12] Keith R. Ihlanfeldt and David L. Sjoquist, "Conducting an Analysis of Georgia's Economic Development Tax Incentive program." Economic Development Quarterly. 15: 217. (2001); Dagney Faulk, "Do State Economic Development Incentives Create Jobs? An Analysis of State Employment Tax Credits." *National Tax Journal.* 55: 2. (2002); Michael I. Luger and Suho Bae, "The Effectiveness of State Business Tax Incentive Programs: The Case of North Carolina." *Economic Development Quarterly.* 19: 327. (2005); John H. Bishop and Mark Montgomery. "Does the Targeted Jobs Tax Credit Create Jobs at Subsidized Firms?" Industrial Relations. 32: 3. (2008); Timothy J. Bartik and John H. Bishop, *The Job Creation Tax Credit*, Economic Policy Institute Briefing Paper #248, Oct. 20, 2009.

[13] In fact, there is also reason to believe that close to 100% of the job creation tax credit expansion the Governor proposes would end up subsidizing jobs that would have been created anyway. This is because, by the author's estimate using data from the United States Bureau of Labor Statistics, 35,000 or more jobs are created by small businesses (fewer than 20 employees) in Connecticut each year, even during a recession (though in a recession, there will be a *net* job loss if more jobs are eliminated than added) . The Governor's proposed credit, which can be claimed for up to 4,000 jobs at the full credit amount, would be easily subsumed by the natural rate of small business job gains.

[14] Ibid.

[15] Inflation-adjusted to 2009.

[16] Figures represent the combination of corporate tax credits and insurance premiums tax credits. Office of Fiscal Analysis. Connecticut Revenue and Budget Data, July 2009. Pgs. 68-71 http://www.cga.ct.gov/ofa/Documents/RevItems/TaxFacts/taxfacts2009.pdf; Office of Fiscal Analysis. Connecticut Revenue and Budget Data, February 2006. Pgs 52-54. http://www.cga.ct.gov/ofa/Documents/RevItems/TaxFacts/taxfacts2006.pdf

[17] Shelley Geballe, "Business Tax Credits: The Blank Check in Connecticut's Economic Development Portfolio?" Connecticut Voices for Children, March 2008

[18] CONN. GEN. STAT. § 12-217ii (Westlaw 2010).

[19] The Connecticut Department of Economic and Community Development reports show that no credits were awarded in the 2006-2007 fiscal year. In the 2007-2008 fiscal year, a single company (Sparta Insurance) claimed a $508,000 credit for creating 30 jobs. In the 2008-2009 fiscal year, DECD allocated tax credits to two companies (Carter's Retail, Burris Logistics) totaling $1.5 million. *See* DECD ANNUAL REPORT FOR FISCAL YEAR 2006-2007; DECD ANNUAL REPORT FOR FY 2007-2008; DECD ANNUAL REPORT FOR FY 2008-2009.

[20] Lawrence Chimerine, et al., "Unemployment insurance as an economic stabilizer: evidence of effectiveness over three decades, U.S. Department of Labor, Employment and Training Administration, UI Occasional Paper 99-8, Table 3, p. 67-68. (1999)

[21] Bureau of Labor Statistics, Job Openings and Labor Turnover Survey

[22] For a full definition of "Related person" *See* House Bill 5209, § 1(a).

[23] *See* Senate Bill 106, § 11-1104(A)

[24] Clawback provisions may become complicated and costly to implement in instances where the credit has been claimed against the personal income tax of a firm's partners or shareholders.

[25] Nicholas Kaldor, "Wage Subsidies as a Remedy for Unemployment," *Journal of Political Economy*, vol. 44, no. 6 (December 1936

[26] Shelley Geballe, "Business Tax Credits: The Blank Check in Connecticut's Economic Development Portfolio?" Connecticut Voices for Children, March 2008

[27] *See* House Bill 5209, § 1(e).

[28] The question asked businesses to agree or disagree with the statement, "A tax credit of 15% on the first $20,000 of wages paid to each new full-time employee, resulting in a net increase in the number of persons employed, would increase employment at your firm."

[29] Ralph A. Pope and James L. Kuhle, "Tax Credits for Job Creation and Job Retention in the California Economy." Public Finance Review. 24; 192; 1996.

[30] Testimony, Douglas W. Elmendorf. "Policies for Increasing Economic Growth and Employment in the Short Term." Congressional Budget Office. February 2010. Prepared for the Joint Economic Committee.