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Wishful Thinking about Corporate Tax Breaks

Are tax incentives for corporate investment good for the economy? The question is becoming increasingly important as the state struggles to fill the FY 2004 budget gap and as hoped-for reforms fall by the wayside. The principal incentives at issue are the investment tax credit, the research and development tax credit, and the single-sales-factor formula for calculating corporate taxes.

The ITC permits corporations to reduce their corporate excise tax liabilities by 3% of the cost of acquiring, constructing or erecting qualified tangible assets. The R&D tax credit permits corporations to take a 10% credit against research and development expenses and to take a 15% credit for donations to research organizations. The single-sales-factor formula permits eligible corporations to compute their taxable income according to their in-state sales, rather than property or payrolls.

Business groups argue that these tax breaks enhance competitiveness and create jobs.[1] The facts are not so simple. While corporate tax breaks do confer benefits on the economy, the benefits do not directly manifest themselves in new or preserved jobs.

Indeed, as it turns out, *eliminating* the business tax breaks at issue would actually end up in the creation of a few more jobs. While that effect would be quite small and the amount of damage done in terms of lost investment quite high, it is, to say the least, wishful thinking to argue for such tax breaks on the basis of their contribution to job creation.

What Corporate Tax Hikes Really Do

The amount of harm inflicted by a tax hike depends on how the tax hike falls on jobs and investment. Increases in broad-based taxes like the personal income tax or sales tax are doubly damaging to the economy. Raise the personal income tax or the sales tax, and Massachusetts firms will cut back on investment *and* eliminate jobs.

The reason is that such taxes exert a double whammy: By discouraging workers from taking jobs in Massachusetts, the income tax makes it more costly for Massachusetts firms to hire workers. And by reducing take-home pay, it brings about a contraction in demand that in turn leads to layoffs and to investment cutbacks.

[1] See, for example, Massachusetts Taxpayers Foundation, Associated Industries of Massachusetts and Greater Boston Chamber of Commerce, *Fragile Progress: Reining in Massachusetts' High Business Costs,* February 2003, and Ernst & Young, *The Economic and Fiscal Effects of the Massachusetts Investment Tax Credit* (prepared for the A.I.M. Foundation), April 14, 2003.

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The sales tax has a similar effect, largely by inducing shoppers to shop in New Hampshire. Raise the sales tax and the loss of sales to out-of-state retailers, located in other nearby states as well as in New Hampshire, will be all the greater. The fall in consumer demand for products retailed in Massachusetts will lead retailers to lay off workers and cut investment.

Raise the corporate income tax, on the other hand, and Massachusetts firms will react mainly by cutting back on investment. To be sure, this inflicts harm on the economy by reducing worker productivity and therefore living standards. But there is no corresponding shrinkage in jobs. Indeed, as in fact happens in Massachusetts, firms create some additional jobs as labor becomes less expensive relative to the now more-highly-taxed capital.

When corporations go to the legislature promising that narrowly defined, targeted tax breaks will make it possible for them to create or secure more jobs, they therefore make a promise that they can't keep.

What the Numbers Show

To put some numbers around these arguments, let's consider what would happen to the state economy if the legislature rescinded all three corporate tax breaks at issue: the single-sales-factor formula, the R&D tax credit and the investment tax credit.

The Beacon Hill Institute has developed a computer model called STAMP® (State Tax Analysis Modeling Program) to handle this problem. Option 1 in the Table 1 below shows the principal effects. Investment, as predicted, falls substantially, by $592 million or 1.23%. But, the state actually gains 1,321 new jobs. The state also gains $300 million in new tax revenue, after all the negative effects on jobs, investment and the like are taken into account. The minus side of the ledger therefore has the state with less investment, and the plus side has it with more tax revenue and a few more jobs.

Table 1

Economic Effects of Tax-Hike Options

Option	Jobs	Investment ($millions)	Tax Revenues ($millions)
1. Rescind Tax Breaks	+1,321	-592	+300
2. Raise Income Tax to 5.5%.	- 8,505	-39	+327
3. Raise Sales Tax to 5.5%	- 3,094	-51	+319
4. Raise Property Tax Rate by 4.3%	+1,066	-529	+296

Rescinding the corporate tax breaks does not lead to job losses. On the other hand, raising the same amount of revenue through an increase in the income or sales tax would, for reasons given above, lead to job losses.

Consider an Option 2, under which the state raises the income tax from its current level of 5.3% to 5.5%. Like Option 1, this tax hike would raise about $300 million in new revenue. The difference is that it would also destroy 8,505 jobs. Like Option 1, it would destroy some, though not nearly as much investment.

Or consider an Option 3, under which the state raised the sales tax by enough to bring in a similar amount in new revenue. We find that this would require a rise in the rate from 5.0% to 5.5%. Again, jobs and investment are lost, though the effects are smaller than under the income-tax-hike option.

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A fourth option would consist of raising property tax rates by enough to raise a similar amount of new revenue. Taking into account dynamic effects, raising property tax rates by 4.3% would yield $296 million in new revenue. Here the dynamic effects are much the same as those associated with rescinding the corporate tax breaks. Some jobs would be created but at a cost of $529 million in lost investment.

Politics and Tax Hikes

Tax increases generally inflict economic losses, as they increase the penalty on job and capital creation. Unsurprisingly, tax increases that penalize the accumulation of property manifest themselves mainly in reduced investment. Tax increases that penalize earnings (the income tax) or spending (the sales tax) manifest themselves in both reduced employment and reduced investment. While it might be desirable for political purposes to emphasize job effects, persons wishing to defend corporate tax breaks (or, for that matter, lower property taxes) cannot point to such effects as a reason for preserving those tax breaks.

Indeed, the defenders of the single-sales-factor formula and the other corporate tax breaks have some explaining to do. In 2002, four prominent business groups combined to support cancellation of a scheduled reduction in the income tax from 5.3% to 5.0%. The supposed reason was the need to avoid a falloff in revenues in the face of a widening budget deficit.

Whatever the merits of that idea, the foregoing analysis shows that, if the goal is job preservation, the appropriate solution would have been to rescind the corporate tax breaks rather than to halt the scheduled decrease in the income tax. Halting that decrease cost the state about 10,328 jobs. Massachusetts employment is down by about 32,000 since last year. Had the decrease gone into effect, the fall in employment would have been about one-third lower.

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