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Tax Policy and Economic Development: A Roundtable Assessment

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Tax policy and economic development: A roundtable assessment

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Economic development continues to be a top policy issue for the state of Maine. Within the broad topic of economic development is the issue of tax policy, and the state continues to experiment with changes in traditional taxes, such as sales and income, as well as with newer approaches, such as Employment Tax Increment Financing. What works and what does not work? Can the state afford the potential loss of revenues associated with tax incentives? Who wins and who loses from these policies?

To answer these questions, MPR convened a panel of experts to review Maine's record. Two represent state government and have been involved directly in the administration of tax incentives--Brian Mahany and Alan P. Brigham. They are joined by two policy analysts with expertise in economic development--Christopher "Kit" St. John and Charles Colgan. A surprising degree of consensus exists about the inevitability of tax incentives and the value of their judicious application. Yet, it also is clear that they are not the centerpiece of economic development policy, and we must monitor their impacts on the equitable distribution of public funds.

Maine Policy Review (MPR): We would like to begin by asking each participant to summarize his perspective on the key issue in Maine tax policy.

Christopher "Kit" St. John: Tax incentives are not the best way to promote economic development. A considerable body of literature has found, on balance, that tax incentives are not instrumental in promoting economic development or in attracting businesses from one state to relocate in another.

Maine has not used tax incentives to the extreme degree some other states have; for example, Alabama's tax package for Mercedes ended up costing hundreds of thousands of dollars per job. I'm happy Maine has not made that serious or extreme use of tax incentives.

But I am concerned that even the modest tax incentive programs in Maine, which are growing, have the inevitable effect of distorting the tax system, and whoever is given a break is benefiting at the expense of their neighbors, both individual residents and neighboring businesses. This distorts the basic economics of businesses and costs the state revenue needed for education and other services essential to economic activity. We would be served better by having either no tax incentives for economic development or, at a minimum, targeting the incentives to achieve particular results.

Alan P. Brigham: I appreciate Kit's position. It should be clear Maine's tax incentives are designed not to be giveaways to companies but instead to level the competitive playing field for business and industry. We know when a company operates in Maine it has certain disadvantages, not the least of which is location with respect to national markets and access to international markets. We're closest to Europe but don't necessarily have adequate port facilities. Businesses have to deal with some expenses not found in other parts of the country, including high labor costs.

When companies make capital budgeting decisions, they look at the return on those investments. Regarding the total cost of doing business, taxes are one cost we can do something about. Thus, it is appropriate to use taxes in a responsible and a measured manner to allow companies to improve their return on investments.

All our tax incentives are performance-based, so Maine does not deliver tax incentives until a company makes the promised investment, hires the people it has promised, and pays its taxes. Thus, Maine tax incentives are essentially returns of collected revenues. The only non-performance-based incentives in Maine are some of our workforce development or job training incentives. These must be delivered up front, so if jobs don't work out at least the workforce is trained and able to be hired in other venues.

While some published works may say tax incentives are not effective, the evidence in Maine is quite to the contrary. Several recent major investments have resulted from tax support mechanisms and other incentives. Workforce development, job training, and partnerships with government also played key roles. Everyone has heard the story about National Semiconductor, for which Maine was, so to speak, tenth on a list of three final locations. We just weren't being considered for this project. But when the state presented a package of local and state tax incentives and support, featuring a strong partnership and workforce development program, suddenly Maine became first on that list. As a result, the state has gained an \$831 million project that will create 550 jobs with an average salary of \$53,000.

Another good example is the investment International Paper made in Jay, a \$424 million project. It was a capital budgeting situation for which the company had to decide whether it was going to invest in its New York plant or in Maine. It chose Maine. The decision was based on the ability of the state and the community to return a portion of the property taxes resulting from that investment, thereby providing a competitive return. So, these incentives do work.

Charles Colgan: The debate about tax incentives has been waged for a long time, going back at least 100 years in Maine. By and large, Maine has not used tax incentives much, in large part because of the constitutional provision about just taxation, or just value, in the property taxes. This has limited dramatically the ability of the state and its municipalities to offer the kind of property tax incentives, such as reduced valuation, that are typical in many other states.

Now we're moving into a new era. Today's economy is one in which virtually every company feels the pressure of competition. The absence of inflation, which is a good thing, means companies cannot use pricing to earn revenues. Instead, everybody is focused on cost structure as the principal element for earning a profit.

When cost structures are considered, taxes are not high on the list. Evidence is overwhelming that taxes rank somewhere from sixth to tenth place among variables companies use to make location decisions. Companies are more likely to be involved in tax decisions when locating within a specific region, such as around a city. Be that as it may, companies do seem more focused on tax issues today than in the past.

Faced with strong competition from other states, Canadian provinces, and other countries, Maine has had to get into the tax incentive business. So far, we have made reasonable and prudent decisions, but there is a real danger we have not considered fully. The tax policies and incentives we are offering are based largely on the principle of offering the incentive now and eating the revenue loss later. What we're doing with a combination of adjustments in the income tax, the property tax on machinery and equipment, the sales tax, and property incentive districts being created at the municipal level, is moving toward a tax system that forgoes most of the increased revenues that would be generated by economic growth. This is the most fundamental change in Maine's tax policy of the last twenty years.

During the next decade we will begin to see the effects of this approach. Even under the best scenario, we could have a steadily growing economy with virtually no additional revenue realized from that growth. Some people philosophically are inclined to say this would be a wonderful thing to happen, and perhaps it is. But it's only a wonderful thing if one can envision a state situation in which economic growth produces no additional demands for government services--such as education, infrastructure development, social services, and criminal justice improvements. I know of no theoretical or practical experience that suggests economic growth ceases the demand on government services. So, while we have made some decisions that might look sensible from today's perspective for economic development, I fear we will have a very large down payment or a very large balloon payment due in years to come.

Brian Mahany: Maine has a very balanced approach to tax incentives. To be sure, there is room for improvement, but we don't have the excesses that have occurred in other states. Let's return to the Mercedes example, in which Alabama spent hundreds of thousands of dollars for each new job. Several other examples come to mind. A city in the southwestern U.S. mails out \$8 million checks with a restrictive endorsement that allows a company to cash the check if it agrees to locate there. There's also the story of the back-office operation for an airline that was lured into a state by the promise of a large loan. The airline moved in, took the money, and a year later moved to another state.

Maine has avoided these problems because we target our incentives to performance. Newer incentives, such as Employment Tax Increment Financing, the Jobs and Investment tax credit, or the Small Jobs Credit bill (which was passed but never funded) all have ongoing performance measures. If jobs are not retained, the company would not continue to receive the credit or the benefit. The newest incentive in the state's program, Employment Increment Tax Financing, is tied to quality jobs. Qualifying jobs are those that are full-time and have health insurance, a retirement program, and pay better than average wages.

Many of our programs are intended to create quality jobs. The jobs created by National Semiconductor pay on average about \$53,000 per year for 550 jobs. Jobs resulting from

Employment Tax Increment Financing pay higher-than-average wages and include benefits. Hopefully, people who receive quality jobs will not need the same level of state programs, including welfare and insurance programs. Tax incentives are a determining factor when businesses make expansion or location decisions. In a state like Maine they are even more important. Although Maine has some natural advantages, it also has some disadvantages--high utility costs, high property taxes, climate problems, high transportation costs, and the fact it is not centrally located. Because of these disadvantages, tax incentives become even more important. Tax incentives are just one part of economic development policy. Maine has a balanced approach; we use tax incentives along with other incentives such as rapid permitting and jobs training.

MPR: Two disagreements appeared in the opening remarks. First, do tax incentives work to encourage economic development? Second, can we afford them?

Brigham: We must look at tax incentives as one component of the overall business climate. Other important components include a quality infrastructure and job training. As director of the state's Office of Business Development for the past four years, I've worked with most of the companies involved in major expansion or relocation projects in Maine. Many projects would not have occurred without an overall package of support that included tax incentives. Tax incentives were not the single determining factor in any of these cases. Until last year, the Employment Tax Increment Financing program, which uses local property taxes, was really the only tool we had with any flexibility. Now we have other programs that add to our flexibility.

MPR: How about the revenue implications, Alan? Can we afford these programs?

Brigham: Again, we try to be very responsible in how these incentives are delivered. Are we giving away too much now? Are we too excited about the delivery of these incentives now so we ignore the long-term impacts? I would say incentives like Employment Tax Increment Financing return only a percentage of the incremental taxes to the company. So, for every new job that's created, the state is keeping between 50 and 70 percent of the income taxes generated. We're sharing. There will be increased revenue, and we also have provided an incentive to those businesses. Tax increment financing also is limited; communities can use a maximum of 5 percent of their property and 5 percent of their town's total value in these programs.

Colgan: Let me clarify my point. First, Employment Tax Increment Financing is a modest endeavor. Neither it alone, nor any of the programs singly, would cause the death of state or local government. Each of these approaches has its own merit and justification. Each has been crafted with an eye to the balance that needs to be struck.

My concern is with the cumulative impact of multiple approaches and the seductiveness of an occasional success, which could lead to an expansion. On the same basis, that is, we will avoid having an impact on this year's budget and will postpone the real impact until a future time. I do not mean to advocate the repeal of these incentives; rather, I want to alert people to the potential dangers in their cumulative effect as well as to the fundamental shift in our thinking about taxes--that we can forgo future revenues in order to get current economic development.

Let me return to the issue of whether these things work. It is very difficult to prove that an incentive tipped the balance for a business, because business decision makers may not know exactly what tipped the balance. So, to prove that any of these things work, neither the proponents nor the opponents of tax incentives really can have a conclusive case. I agree with Alan that in many cases this is an important element in the final decision.

At the same time, it is an interesting conundrum when we attempt modest and targeted incentives, but if these approaches really are important then we're probably doing too little. How much of an effect can incentives have in an economy with 700,000 jobs? While National Semiconductor's 550 new jobs certainly are important, they are nevertheless only one one-hundredth of the jobs in Maine. How ever well-paying those jobs are, maybe we should be doing a whole lot more rather than a whole lot less. We're probably nibbling at a few things around the edges, but we want to be careful about how we use these things because the potential dangers are significant.

St. John: I've told the story before about Pratt & Whitney and I still think it holds. We created a special jobs tax credit to lure them to North Berwick. After Pratt & Whitney made substantial investment and created some very good jobs, it hadn't created quite enough jobs or made enough of an investment to actually make use of the tax credit created for that purpose. A few years later, Digital located in Augusta without even knowing this tax credit was available. When Digital got ready to file its tax return, its accountants told the company to take advantage of the credit because the requisite investment was made and the requisite jobs were created. In this case, this tax credit didn't have the intended consequence, but rather an unintended consequence of eroding revenue in an investment that was going to be made anyway. There's something fundamentally wrong when Maine taxpayers subsidize companies as extraordinarily successful as L.L. Bean or National Semiconductor. I just don't think it's the best use of our resources.

MPR: Are you saying government has a different role to play?

St. John: The problem is that when the state supports one business, somebody else's taxes have to increase to replace the revenue loss. To ask property taxpayers in Corinna, for example, to sacrifice state aid this year because of continuing amounts of state aid flowing to South Portland--the state's formula for education aid is going to be blind to the new investment and therefore the aid is going to continue to support South Portland schools--just isn't right. When I look at the relative needs of the two communities, I think Corinna has a greater need for reduction of property taxes and support for its schools than does South Portland.

Therefore, I think we really need to rein in Employment Tax Increment Financing programs because there is a mismatch between who is making the decisions and who is paying the costs. Local officials are making tax increment financing decisions, essentially at very little cost. Thus, the state is paying for the advantages being given to particular localities by education aid and other forms of revenue sharing.

A second problem is that we don't budget these things in a manner that allows us to compare them with other needs. For example, the new paper company environmental fund was created as an affirmative grant program. It could be assessed the next year, and it could be decided that

many other needs are more important than grants to paper companies. The Legislature's appropriations committee was able to decide that we couldn't afford it when weighed against all these other needs, so we'll just forgo that one this year. But once in place, a tax credit is just there to be touched at the discretion of the people seeking it and therefore is not weighed against other needs and budgeted. State resources are spent without the state weighing the expenditure.

Mahany: Kit, while it doesn't show as an appropriation, the tax incentives do show up on the state's tax expenditure report. Each tax exemption shows up as a line, including what the state is not receiving in revenue.

St. John: And, are they growing faster than other budget items?

Mahany: Yes, there has been growth, but the economy in general also has been experiencing slow growth. These programs are required to be reviewed by the Legislature periodically. You mentioned the situation in which residents of Corinna subsidize jobs in South Portland. We realized when we created Employment Tax Increment Financing that the state should take an active role in trying to create jobs where there was a higher unemployment rate or a greater need.

I keep coming back to the Employment Tax Increment Financing, because it's our newest incentive program and represents our ongoing improvement process. This program provides increased benefit for companies creating jobs in high unemployment areas.

Many other folks participate in the state's business assistance team--experts from the Department of Environmental Protection, Labor, Taxation and the Maine Quality Centers. A business locating in South Portland, where there are a lot of skilled workers, probably would not receive the same level of training assistance as would a business locating in Corinna or another area of the state where skills are limited.

Colgan: Let me pick up on Brian's last point. He said, quite correctly, that the Taxation Bureau does account for the tax expenditures and, in fact, has done so for more than twenty years. Maine long has been a national leader in accounting for tax expenditures; what has been lacking is the debate about them. It is true the Legislature revisits these things periodically and an occasional legislator will glance through these expenditure tables and create a debate about its worth. But we've not had a systematic review of the tax expenditures, other than the periodic waves of tax reform. This could change dramatically in the future. A real opportunity exists if we systematically can incorporate the tax expenditure analysis the bureau puts together into the performance budgeting process that will be implemented in two years.

MPR: We seem to have a real difference of opinion between best-practices research from the people who are on the front line doing economic development and the results from the economic development literature or the Corporation for Enterprise Development. The literature states that investment in long-term capacity and the creation of an entrepreneurial environment fare well in the long term. What's wrong with this picture?

Brigham: It's a healthy debate, and in the end the truth lies somewhere in the middle. For every scholar who would present an argument that these incentives are not important, I could bring an

equal number of business decision makers, capital budgeters, and investors together who would say they were essential.

Further, policy making is about tough choices. For example, we recognize when we create a Employment Tax Increment Financing program district there is an opportunity cost every other community in Maine realizes because the community that gets the new investment is able to shelter that investment. At some point, the taxes that derive from those investments actually accrue to the general fund and the value is added to the town's equalized state value. Everyone gets to share in that, even after depreciation is subtracted.

Colgan: Let me make two points. First, the vast majority of studies have concluded that there's been little effect from tax incentives. Many of these studies have used interviews of business people who say there's been little effect.

Alan said something that is the key to understanding this. That is, we really cannot take the risk that the incentives would not have been important. Government cannot be seen as unwilling to take action to attract jobs or help businesses relocate or expand. The perceived political price is too high. That is a rational choice on the part of political leaders, and I understand it completely. I have worked for three governors who shared exactly the same view, and they are no different from legislators, town councilors, or governors in other states. Let me go one step further and say that many people believe the single most important factor affecting the Maine economy is what government does. Given this, action is expected regardless of its effectiveness as measured by economists.

St. John: I'd like to suggest three areas of needed change. First, I suggest we get rid of the machinery and equipment investment tax credit because we now have a better targeted device specifically designed to relieve the burden of personal property taxation on new investment in equipment. That was the reason for the machinery and investment income tax credit in the first place. The better device is called the Business Equipment Tax Reimbursement program. I understand from the Taxation Bureau's calculation that the investment tax credit costs something like \$22 million a year. Considerable evidence exists that the machinery, equipment, and investment tax credit has rewarded companies for eliminating jobs by upgrading equipment and improving productivity. So, let's get rid of it.

Second, regarding the new small jobs credit, Brian correctly noted that the proposal contained some targeting, but there was a tax credit given for jobs of any quality at all. If we're going to do tax credits, I think the Employment Tax Increment Financing model of targeting those credits to a particular quality of job makes more sense than just throwing around that credit for any job.

Third, I propose to end local tax increment financing districts and create a stronger role for the state to decide whether this is a good investment decision. There should be a stronger state role because those are state dollars that are being given away. It doesn't make sense to have local decision makers giving away state dollars. Those targets we put on Employment Tax Increment Financing also could be put on tax increment financing at the local level, and that also would be an improvement.

MPR: Let's continue what Kit started. What are your one or two top priorities for legislative action in the next session to improve our tax system?

Mahany: The first would be a small jobs credit. We have good incentives and good tools available for such companies as National Semiconductor. But most of Maine's businesses are small businesses. With the exception of Employment Tax Increment Financing, we don't do much for small business. I would like to see the small jobs credit enacted and funded.

Second, I would like to continue the process of reviewing our incentives and making sure they have measurable performance targets. In other words, only if a business performs does it receive the incentive. I think Maine already is a leader in this regard. We avoid the destructive relocation competitions common to many states.

Finally, let me briefly respond to Kit's point about overlap. While some overlap does exist, this adds to our flexibility. I think the additional tools give the economic development folks and the business community more flexibility. We can better tailor our programs to the needs of a given community and business. There are limitations, for instance, in the Business Equipment Tax Reimbursement program that force a company to elect between the Investment Tax Credit and Business Equipment Tax Reimbursement programs. You can't have both. There is a similar limitation with Employment Tax Increment Financing. You can take the Employment Tax Increment Financing or you can take the Jobs and Investment Tax Credit, but not both. By having those limitations, you preserve the flexibility while ensuring no one is receiving too much subsidy.

Regarding my proposed small jobs credit, we have to remember it is aimed at microbusinesses in Maine, the "Mom and Pop" operations. It is difficult to tell a business that employs two people and wants to hire a third, "Oh, by the way you have to have an ERISA-qualified retirement plan and health insurance, and so on." That's very difficult for a small employer. Representative Simoneau's bill from the last session of the Legislature retained quality language, but to a standard more appropriate to very small businesses.

Brigham: My first priority would be a small business tax credit program. I am very comfortable with Maine's mix of tax incentives and tax support mechanisms, which allow us to deal with almost any type of investment or job creation issue except for those pertaining to small businesses. I would like to see the Legislature fund the Simoneau bill passed last year.

We also should continue to review the viability and accountability of our incentive programs. We were required by law this year to conduct a study of all financial incentives Maine delivers to businesses, whether or not they're carrying out their intended purpose, and the return on those investments. That report should be completed soon, and will include the results of a series of interviews with all the program managers and agencies that deliver these services.

My last point concerns the use of tax increment financing as state dollars. I want to disagree with Kit about this. His position assumes the investment project would have occurred absent the incentive and that, as a result, there would have been additional State Aid to Education or revenue-sharing dollars that could be shared with other communities in the state. The taxes that

actually go into the incentive are local property taxes. So, it is about 98 percent local money used in that incentive, and to the extent the investment is sheltered there's a very small state component. When a town adds major value through a large project, that community gets less in state subsidies. It doesn't mean the level of state subsidies changes in total; it just means the allocation is different. So, as South Portland gets wealthier, it loses some of that subsidy money, which is redistributed to other communities. While these are state dollars, they are constant dollars. It is a relatively minor reallocation considering that money from one project is spread across all other towns in the state.

Colgan: It sounds to me like we agree with the need for a comprehensive review of these incentives. I'll be interested to see this study, and I would like to see this review integrated into the performance budgeting process. Secondly, let me not disappoint those who expect academics to make interesting but irrelevant recommendations. As we look ahead to the use of these incentives, it would be a good idea to take the following approach. First, add up the value of all incentives on the books and then eliminate them as special provisions in the tax code. Then, take the revenue gained and simply reduce overall tax rates on businesses, either in the form of the corporate income tax rate or the personal income tax level for those who are filing as sole proprietors. Then, Maine could say it had reduced its overall tax rate on all businesses by the resulting percentage of the calculation. I don't know if that's a good idea or not because I haven't run the numbers. Maybe the resulting change in tax rates would not be big enough to matter, but I do think that as we move ahead, it's worth asking the question: Do we want to continue to have a tax policy that essentially builds on the Swiss cheese principle or do we want to have a tax policy that, in fact, imposes the lowest possible rate on the broadest possible base? That question has not been asked. It's certainly not a question I've ever seen addressed in my twenty years of dealing with this issue.

St. John: Regarding the proposal to add a tax incentive for small businesses, this issue illustrates both what is wrong with tax incentives and how we could improve them. The small business credit will reduce the taxes to a small business that is adding a job. That business is very likely to be competing against an existing small business right down the street that is under tough constraints and might actually be laying off workers. It seems perverse for the state to step in and reward one business against the interests of a direct competitor. That is the sort of Swiss cheese principle Charlie mentioned.

I think it would be better for all businesses if the general rate of taxation could be kept low. The corporate income tax rate for small businesses up to revenues of \$250,000 is quite modest--3.5 percent. One of the paradoxes of our incentive program is that the investment tax credit resulted in reducing taxation on paper companies. The major companies in our state have seen a sharp decline in their contribution to public revenues. That got shifted onto the backs of small businesses and individual taxpayers, and that's the problem with the Swiss cheese approach.

MPR: Let me ask each of you to conclude with your assessment of how well Maine is doing. Are you optimistic or pessimistic?

Brigham: I'm optimistic. We have in place a series of measures that have laid the foundation for growth. The governor has done a tremendous job to improve the perception of those who are

making investment and hiring decisions in Maine and also in changing the perceptions of potential investors outside the state. In business, perception often is a huge part of the decision-making process. For many years, Maine was perceived as a state hostile to business and not caring about attracting quality investment. Now, we are focusing on that quality issue. We have set the course for some very responsible and strong growth in the future.

St. John: Perception is very important, and it's terrific the governor has taken a positive tone. In the eight years previously, we had a governor who went around the country telling people how negative our business climate was, so it's not surprising we developed the reputation for having a negative business climate. So, the primary change is the emphasis by our chief spokesperson. Without wanting to go against the happy chorus that says we are on the move and that things are improving, I think we still have some very difficult decisions to make about our direction and how the benefits will be shared. I would submit that the majority of people in Maine did not benefit from the economic boom of the 1980s. The majority barely kept even in terms of income, and because of the very rapid rise in housing costs and land prices they actually fell behind. For the bottom 20 percent of the population, it was most serious.

Mahany: I see slow growth for the Maine economy. I have the advantage of being a member of the state's revenue forecasting committee, and the signals are mixed. For every indicator that says the state will not see growth, there are other indicators showing growth.

The perception of Maine is changing. We are moving up on the list of places to locate a business. We're creating quality jobs, and we recognize the key to Maine's future is in reducing the disparity Kit talks about between the "haves" and the "have-nots."

I don't think we're going to see the economy grow by leaps and bounds overnight, but I do see continued slow growth. In the revenue report released for the first quarter of 1996, corporate revenues were up 46 percent. Income taxes remain up. Sales taxes remain up. More importantly, the withholding portion of the income tax, a good bellwether of how employment is doing, remains up. We're doing well.

Colgan: Maine's economy has been expanding since the first quarter of 1993. We have recovered all of the jobs lost, in net, that we lost during the recession of the early 1990s. We did that by the middle of 1995. We have been expanding consistently into new economic growth patterns since that time. I think that trend will continue. The 1990s are a relatively slow period of growth, certainly slower than the 1980s. My forecast is that slow growth will continue through the end of this decade. The principal determinant of that rate of growth will be the growth of the national economy, which also remains slow.

It also is important to realize that much of what we talk about in economic development does not affect the economy greatly in the short run, but does affect it greatly in the long term. For example, the real benefits of the economic development actions of the early 1980s did not begin to show up until the early 1990s. It's a peculiar phenomenon that while politicians and the political leadership are engaged in a very short-term focus, most of their actions will have effects a long time into their futures. In that sense, I think we potentially are positioning ourselves well, as long as we avoid the dangers I noted earlier.

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