

Response to Committee Explorations of State Tax Incentives to Encourage Value Added Processing in Alaska

Thank you for the opportunity to respond to ideas expressed during your meeting of September 3, 2002. The specific proposal was to reestablish the fisheries business investment tax credit limited to investment in specific value added processing equipment used in Alaska. Members of the committee expressed concerns about the potential for abuse and an intention to design a carefully targeted incentive. This discussion provides general comments on tax incentives and identifies key considerations should the committee opt to design a tax credit. Also included in this response is a short summary of studies on state tax incentives and the experiences of other states.

Discussion

The effectiveness of an incentive can be measured by the incremental activity generated – that which would not have occurred without the incentive. Arguably, amounts awarded for activity that would have occurred without the incentive represent an unintended subsidy. The efficiency of an incentive can be measured by the cost of a unit of desired activity.

A common failing of investment based credits is that they are extremely difficult to focus on the target to produce cost effective results. A narrowly focussed credit will be more efficient than a broadly focussed credit. However, narrow credits may go unused because they lack the flexibility necessary to align with the business needs of a large number of taxpayers. The trick is to find the key points of leverage where non-tax conditions are marginal such that the incentive tilts the scale. If this marginal balance is not present the incentive is either unused or awarded for actions that the taxpayer would have taken anyway.

The designer of a targeted credit for investment in value added processing faces a difficult task. Since the state and local tax burden is generally low, tax incentives may produce little influence compared to fundamental business considerations such as the location of existing investments, a skilled and stable work force, proximity to markets, and other operational factors. There are some basic questions to answer in the process of drafting an effective tax incentive. How much revenue is there to work with? Is the available revenue enough to cause actions that the market is not currently supporting? Can the incentive be targeted to limit wastage to an acceptable level? Is the incentive the best use of the available revenue?

The committee will need to make a recommendation on whether to push the cost of incentives down to the municipalities in the form of reduced shared tax revenue. If municipalities are expected to share the cost of incentives the committee must also consider how to spread the cost between municipalities. The state absorbed the entire cost of the fisheries business investment credit before its repeal.

The committee may wish to explore the possibility of an incentive that is not limited solely to activity within the state. A significant portion of the benefits of a credit

restricted to in-state investment will leak out of the state. The in-state limitation will restrict credit utilization because it draws significant non-tax considerations into the business decision. It is possible that a meaningful level of specific processing or packaging activity, wherever conducted, would produce more benefits to Alaska than would an underutilized credit limited to in-state activities.

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Chuck Harlamert asked me to review the results of studies of local tax incentives. This is not intended as an exhaustive review of the literature. Instead, our hope is that the following information, gleaned from studies, can aid committee members in choosing between many different policy options.

Overview

Although, in general, economic studies have shown that “tax incentives play little or no role in investment decisions”¹, or more charitably “have a small, statistically significant effect on interregional location behavior”², tax credit programs continue to remain popular with states³. However, one study by Dagny Faulk (2002) argues that because most studies, such as those cited above, “address average effects of all programs operating in a geographic area, the response of individual firms to specific tax incentive programs cannot be teased out.” He then estimates that one out of every four jobs that qualified for employment credits in Georgia was created as a result of the credits.⁴ Of course, the effect of a particular tax credit is going to depend on the structure of the tax credit, the current levels of taxation and interregional differences in tax structures.⁵

Another consideration is what economists call opportunity costs. That is, are there alternative ways to promote economic development that are more cost effective? Lynch (1996) reports that “the evidence for positive economic effects of increases in public services is abundant.”⁶ This may be particularly true in Alaska where tax credit benefits are probably more likely to leave the state than benefits from infrastructure or service improvements.

In spite of all of the misgivings cited above, it does appear that tax credits can and do have some effect on choices made by businesses. However, because the structure of the credit itself will contribute to how effective it is, we have the following suggestions and cautions.

¹ See Robert G. Lynch, *Do State and Local Tax Incentives Work* (September 30, 1996). State Tax Notes. p. 949. This study summarizes both survey and empirical research on tax incentives.

² See Michal Wasylenko, *Taxation and Economic Development: The State of the Economic Literature* (June 23, 1997). State Tax Notes. p. 1892. *This study addresses the effectiveness of intraregional and interregional tax incentives.*

³ See David Brunori, *Principles of Tax Policy and Targeted Tax Incentives* (June 9, 1997). State Tax Notes. p. 1731. This study examines targeted tax incentives from a tax policy perspective.

⁴ See Dagny Faulk, *Do State Economic Development Incentives Create Jobs? An analysis of State Employment Tax Credits* (June 2002). National Tax Journal. P. 277. This study estimates the amount of new employment created as a result of employment tax credits in Georgia.

⁵ See footnote 2. p. 1891 and 1892.

⁶ See footnote 1. p. 951.

Suggestions and Cautions

If policymakers do choose tax credits, the experience of other states can prove helpful in crafting the appropriate legislation. Tax credits sometimes result in unforeseen consequences. One example is the \$70 million dollar incentive package that was used by the state of Pennsylvania to attract a Volkswagen manufacturing plant to the region. After 10 years Volkswagen decided to close the plant. In Illinois, the state granted Sears \$250 million to not move its headquarters. Shortly after receiving the grant Sears “announced large layoffs in the state.”⁷ Arizona ran into trouble with its “alternative fuel credits.” One reason was that there was no provision in the bill to actually use the alternative fuel systems. The bottom line is that a credit that was supposed to cost the state \$3 to \$10 million is now estimated to cost the state \$200 million. It may have been as high as \$600 million, if not for a special session that reduced the potential revenue loss from the credit.⁸ The following are some ways to try to mitigate some of these accountability problems.

Clear and unambiguous definitions

If a tax credit can be broadly construed it probably will be. In the Arizona example taxpayers obtained the credit just by installing a propane tank in their vehicle. There was no requirement in the bill to actually use the alternative fuel. Clearly, this does nothing to reduce air pollution. Also, individuals received the credit for purchasing cars for out-of state residents. Thus, some benefits from the tax credit flowed directly out of state.⁹

Limit the size of the credit

If twenty-five percent of a qualifying investment is available for credit instead of fifty percent then it will take twice as much investment to use up the available credit. Also, it is less likely to be abused. That is, taxpayers won’t buy equipment that has marginal value just to take advantage of the tax cut. In Arizona individuals purchased vehicles “sometimes ridiculed as souped up golf carts” and were able to pay the entire cost of the vehicle with tax credits.¹⁰ To reduce the likelihood of large losses it may also make sense to set caps on the total amount of credit and percentage of total liability available.

Reporting requirements, sunsets and recapture provisions

Reporting requirements before a tax credit is allowed can insure that a particular investment qualifies under the intended rules and requirements. This avoids the expenditure of time and effort by the department to track down and recapture credits that were not legitimate and provides certainty to taxpayers who are considering the investment. Reporting requirements after the tax credit was issued can be used to evaluate how well the credit is working.

A sunset provision (repeal date provision) can be useful because it forces a reevaluation of the effectiveness of the legislation. Also, 16 states have explicit recapture (“clawback”) provisions. That is, to qualify for the incentive a business has to agree to pay the incentives back in full if they fail to meet their obligations.¹¹

⁷ See footnote 3, p. 1735.

⁸ See newspaper article from the Arizona Tribune (October 14, 2000). *Alternative Fuel Incentives* p. A1

⁹ See footnote 8.

¹⁰ See newspaper article from the Arizona Tribune (December 23, 2000). *Emissions-free vehicle owners can seek credit*.

¹¹ See Deloitte & Touche, Center for Multistate Taxation at the University of Wisconsin-Milwaukee. “A Lawmaker’s Guide to the Use of Business Tax Incentives” (1999). p. 29.

The Commerce Clause

A tax incentive that discriminates against interstate commerce runs afoul of this constitutional constraint. Apparently, “tax incentives that effectively impose greater burdens on out-of-state businesses than on competing in-state businesses will be discriminatory under the Commerce Clause.”¹² A constitutional challenge to a state tax credit would arise from disadvantaged competitors and not by those who take advantage of the credit.

¹² See footnote 11. p.33.