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Responding to COVID: How to Deal With Nearly \$100 Billion in Wasted Incentives

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Responding to COVID: How to Deal With Nearly \$100 Billion in Wasted Incentives



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There is never a good time to raise taxes. When the economy is going gangbusters, opponents of tax increases argue “let the good times roll.” Why interfere? When the economy is in a tailspin, why kick taxpayers when they are down?

But this column deals only superficially with increasing taxes; the focus is on eliminating waste in spending, always a popular rallying cry among conservatives. That cry, however, suddenly and mysteriously disappears when that spending takes the form of tax expenditures.

Tax Expenditures

A tax expenditure is a special provision, like a tax incentive for economic development, which represents a spending program implemented through the tax system. A tax expenditure can be viewed as if the taxpayer had actually paid the full amount of tax owed and simultaneously had received a grant equal to the savings provided by the special provision. Congress and many states compile tax expenditure budgets. In some states, the amount spent through tax expenditures exceeds the amount in any other budgetary category.

A tax expenditure is a neutral term. Tax expenditures are not necessarily good or bad. They need to be evaluated like any other spending program and subjected to the normal budgetary criteria: How much money is being spent? How is this money being distributed? Is the expenditure achieving its intended goal? Is the expenditure the best means of achieving that goal? Tax expenditures compete for dollars like any other spending program and thus should be subjected to, and survive, a cost-benefit analysis.

Many commentators, however, do believe, and with ample empirical support, that most tax expenditures would not survive such an analysis,

and label them as loopholes.⁴⁴ As states debate laying off employees to help cope with the pandemic depression, these commentators view lopping off loopholes as an alternative to lopping off heads.

How to Think About Tax Incentives for Economic Development

The goal of most tax incentives for economic development is simple: jobs, jobs, jobs. A siren call in the midst of a pandemic. The goal is to reach nirvana: (1) the sought-after activity would not take place without the incentive, and (2) the benefits of the activity outweigh the costs. Win-win? Not necessarily.

If the benefits are jobs, what are the costs? Forgone tax revenue, congestion, pollution, strain on the infrastructure (schools, sewers, roads), pressure on the real estate market, and the like. On the benefit side, what kinds of jobs? Full time or part time? Minimum wage or higher? Health insurance? Sick leave? Maternity leave? Retirement benefits?

But too often, the incentive is not calibrated finely enough to achieve nirvana. Often the incentive benefits another group: “close but no cigar.” Although this group would also not engage in the activity without the incentive, nonetheless the benefits they receive do not outweigh the costs.

Too many incentives use a shotgun rather than a rifle, sweeping way too broadly with their largesse, spraying their benefits like buckshot, wide of the mark. Bystander corporations scoop those benefits up, even though many would engage in the sought-after activities even without the incentives. In this case, the costs are unnecessary and collateral damage. This situation can be described as a “waste of time and money.” Then there are those companies that save us from ourselves: They will have nothing to do with the state regardless of any incentive.

What the literature demonstrates is the difficulty of designing an incentive to reach nirvana without wasting money on the other outcomes. For example, suppose a state targets an

⁴⁴ See Richard D. Pomp, *Taxing Smarter and Fairer: Proposals for Increased Accountability and Transparency in the Connecticut Tax Structure* (2005), at 34-43.

activity by granting it a rate reduction. And suppose viewed in isolation the blessed activity occurs, generating a net benefit: seemingly the blessed state of nirvana.

The problem is that the net benefit for the nirvana group is overwhelmed by the cost imposed when other corporations needlessly receive the deduction. Supporters of the tax reduction all too often focus on nirvana, declare success, and congratulate themselves on their economic acumen. Meanwhile, the total loss in revenue may be hundreds of thousands of dollars per job created.

Even when a rifle is used, such as a special benefit for targeted new investment only, the literature suggests that it too often spills over beyond nirvana, reaching the “close but no cigar” and “waste of time and money” groups. To reach a few corporations at the margin that will be influenced by the benefit, it must be given to the freeloaders as well. The result is that the tax system is skewed, inefficiently squandering taxes with no offsetting net benefits.

The Seductive but Fruitless Allure of Tax Incentives

Politicians have few policy tools at their disposal to encourage economic development in the short term. So many of the critical elements that affect businesses’ locational decisions — weather; cost of labor, energy, or transportation; proximity to customers or supply chains; access to major airports with direct flights to key places; access to public transportation; cost of living; quality of education; attractiveness to PhDs — are simply not easily controlled by politicians.

Out of frustration, rates can be lowered, apportionment formulas changed, exemptions, deductions, and credits adopted, state personal income taxes diverted for the use of employers, and corrupt federal incentives like the Opportunity Zones can be piggybacked onto. Businesses will applaud these tax changes, whether they are effective or not. Businesses typically do not turn down free money (or not so free if it is the result of campaign contributions). And politicians will claim that any or all positive effects in the economy whatsoever would not have taken place without their intervention, and the beneficiaries will hardly disagree. Like those

who follow the elephants in Aida with dust brooms, economists are left dealing with the detritus.

The politics become even more irresistible when state politicians adopt incentives and impose them on municipalities. The state politicians claim the credit, and the municipalities pay the price.

The Movie Industry: There’s No Business Like Show Business

Yes, making movies is glamorous, which may account for the nearly \$2 billion in annual incentives spent on the industry. Film subsidies are probably the most studied of all state tax incentives. The studies consistently show that the jobs created are temporary and often go to nonresidents brought in specially for the movie. The jobs last only as long as the movie is being made. Residents do get jobs, but these tend to be low-paying and disappear when the movie is finished.

True, there are increased sales taxes from restaurants and hotels that the cast and crew use, but these pale in comparison to the dollar amount of incentives. And because film production is mobile, and risky, it chases the incentives in a race to the bottom. Like all incentives, that race is often won through complicit politicians who put their short-term self-interest ahead of rational economic planning. And they get away with this because by the time any rigorous — and embarrassing — cost-benefit study can be completed, showing the politicians were patsies, they have declared victory and have long moved on.⁴⁵

An Immediate Moratorium on Existing Tax Incentives⁴⁶

The extant economic literature demonstrates that the burden of proof should be placed on those advocating the effectiveness of tax incentives. I

⁴⁵ Many of the older studies resulted in states either eliminating their film industry tax incentives or cutting them back substantially. For a recent critical study, see John Charles Bradbury, “What Do Film Incentives Mean for the North Carolina Economy,” Western Carolina University, CSFE Issue Briefs (Fall 2019).

⁴⁶ Greg LeRoy, “INSIGHT: 10 Steps States Should Take to End Corporate Giveaways,” *Bloomberg Tax*, May 6, 2020.

propose an immediate moratorium on existing incentives pending the formation of a commission to evaluate, corporation-by-corporation, whether the existing incentives represent nirvana or fall into the other categories. On that commission should sit a few of the open-minded politicians who do not have skin in the game, provided they are powerful enough to implement any recommendations. Joining the politicians should be those who have a proven record of dispassionate and impartial evaluation of incentives, who are free from any conflict of interest.

The next step is for the commission to evaluate any proposed tax incentives on a beneficiary-by-beneficiary basis. Once the existing landscape is cleared of dead rotting branches, the commission should make sure no weeds or poison ivy take over. Anyone wanting the benefit of an incentive will have to survive the gantlet of a cost-benefit analysis to make sure the benefits they bring to the table exceed all the costs they impose. How can any conservative (or libertarian), true to their principles, not rally in support of eliminating waste in spending and keeping the government from inefficiently interfering with the market?

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