

**Testimony Regarding**  
**H. B. 5209: An Act Concerning Small Business Tax Credits**  
Testimony of Joachim Hero  
To the Commerce Committee  
February 25<sup>th</sup>, 2010

Senator LeBeau, Representative Berger, and distinguished Members of the Commerce Committee,

I submit testimony today on behalf of Connecticut Voices for Children, a research-based public education and advocacy organization that works statewide to promote the well-being of Connecticut's children, youth, and families. Connecticut Voices for Children is very concerned about the state's economic competitiveness. We annually prepare a report, *The State of Working Connecticut*, that looks at the state's economy, including wage trends, shifts in employment, productivity and gross state product. We also follow best practices in state economic development policies, and closely follow studies that examine the effectiveness of various state policies at stimulating economic growth.

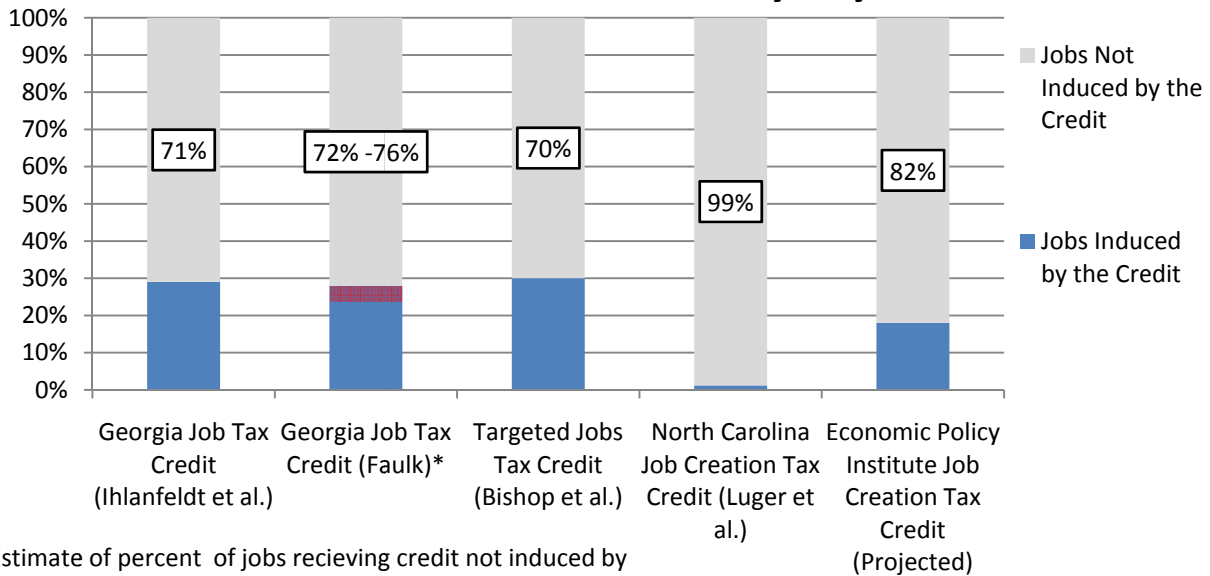
My testimony today will share a few comments and concerns regarding House Bill 5209: An Act Concerning Small Business Tax Credits.

During these extraordinary economic times, with unemployment in Connecticut higher than it has been in decades<sup>1</sup> and a projected state budget deficit of close to \$4 billion dollars in FY2012, we recognize that the General Assembly is under considerable pressure to enact policy that will create short-term employment growth while having constrained budgetary capacity to act. We do not believe that H.B. 5209 provides a particularly compelling solution to this problem. However, if the General Assembly decides to embrace a jobs tax credit program, there are several ways in which we think the bill should be improved.

Before presenting these recommendations, I would like to first alert the Committee to concerns raised in multiple academic studies about the effectiveness of state-level job creation tax credits and why CT Voices therefore questions whether these sorts of policies are the best way to use state resources to create jobs.

Our first major concern is that **empirical evidence generally finds job creation tax credits to be economically inefficient**. Multiple analyses of job creation tax credit programs have found that 70% or more of the credits granted employers would be awarded for jobs that would have been created without the credit.<sup>2</sup> 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 been created anyway. (See Figure 1.) A recent summary of the literature by the New England Public Policy Center at the Federal Reserve Bank of Boston concluded that while job creation tax incentives do influence firms' hiring decisions, "the companies would have created a majority of the subsidized jobs anyway."<sup>3</sup>

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



Our second general concern is that **expanding the job creation tax credit risks making Connecticut's corporate tax system less fair, less efficient, harder to administer, and less transparent.** Tax credits are not subject to the same standards of transparency and accountability of direct economic aid 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<sup>4</sup> in 1990 to an estimated \$331.8 million in 2009.<sup>5</sup> **(Additional information on tax expenditures is available at the end of this testimony)** The Governor's proposal includes some responsible safeguards (that are not present in many of Connecticut's other tax credits<sup>6</sup>) 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 tax credits (which may cost 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 and increasing and extending unemployment supports.

If the General Assembly decides to embrace a jobs tax credit program, H.B.5209 should be improved in several ways.

- **The jobs creation tax credit should reward net job creation not simply new hires.** In the bill's current form, it 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%.<sup>7</sup> A credit that is based upon new hires, rather than net 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. In order to focus the credit on job expansion, credit eligibility should be based upon net jobs created.

- **The proposed language for the tax credit would allow participating firms to cut a newly hired worker after one month of employment. The credit should close a potential hire-and-fire loophole to ensure that new employees are hired for a minimum time period.** Under the proposed bill, employers would have 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, if the General Assembly adopts the approach to job creation, it should require that each new employee for which a credit is claimed remain employed for a set minimum timeframe (e.g. 12 months, like in Maryland's credit<sup>8</sup>).
- **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 liabilities to the state budget that are difficult to predict and can fluctuate significantly from year to year, which hurts the state's ability to practice fiscal responsibility. 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.<sup>9</sup> 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 open-ended state revenue loss through tax credits from year to year.<sup>10</sup> Other states have begun to take steps to tax credit expenditures. For example, both Oregon and Nevada require mandatory sunset dates on most business tax credits.
- **The legislature must seek clarity on how the credit would function for pass-through entities or sole-proprietorships.** The proposed tax credit could be used 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.<sup>11</sup> 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 to create a new job 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.

We thank the committee for its time, and for considering this testimony.

**Further Background on H.B. No. 5209**

***Description***

As part of her jobs strategy, Governor Rell proposed expanding the Jobs Creation Tax Credit Program.<sup>12</sup> 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 the new law, 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 Schedule for Initial Year of Hire**

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

**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.<sup>13</sup> 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.

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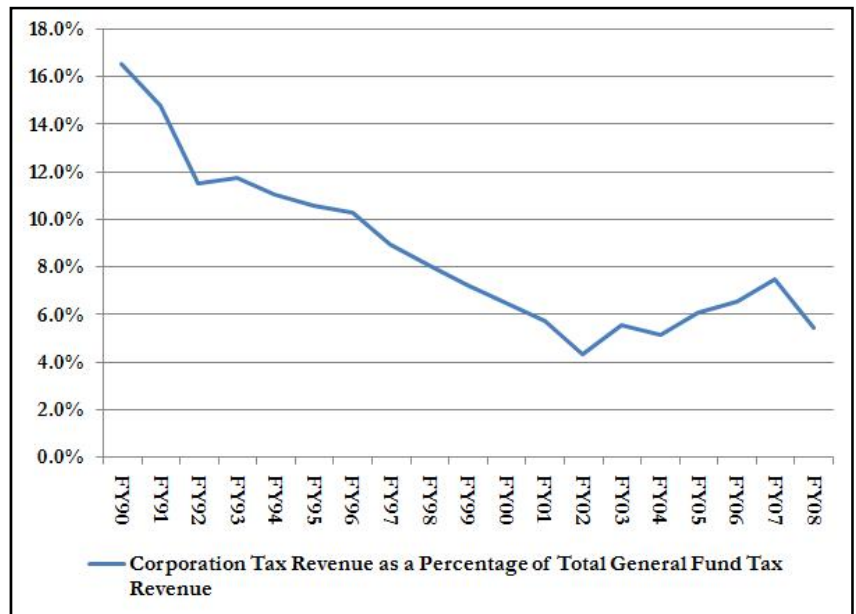
### Some More Background on Connecticut’s Business Tax Credits

Figure 2 shows the dramatic decline in corporation business tax revenues as a share of General Fund revenues over the

past two decades. While the initial decline can be accounted for by the more significant role played by the personal income tax after its adoption in 1991, the ongoing erosion of revenues from the corporate business tax is due in part to the dramatic growth in corporate tax expenditures.

In the absence of routine oversight by the Connecticut General Assembly, Connecticut’s business tax credits risk becoming blank checks for economic development. While such an approach is highly questionable as economic policy, as fiscal policy it is clearly flawed, and contributes significantly to the deficit situation in which Connecticut currently finds itself.<sup>14</sup>

**Corporate Tax Revenue as a Share of GF Tax Revenue (FY 1990-2008)**

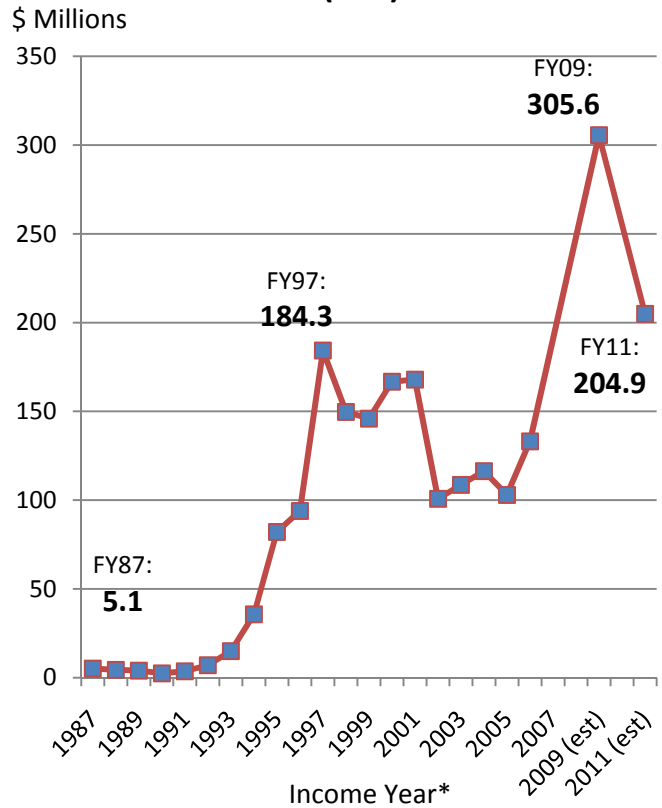


**Connecticut’s revenue loss from corporation business tax credits has increased 40-fold since 1987.** In 1987, Connecticut had a total of nine credits against the corporation business tax. In that year, 289 corporate tax returns claimed a total of \$5.1 (adjusted to 2009 dollars) million in tax credits. By 2003, the number of credits had increased to twenty-three, and 7,266 returns claimed a

total of \$108.5 million.<sup>15</sup> OFA now projects a \$204.9 million revenue loss in FY 11 from corporate business tax credits.<sup>16</sup> This is 40 times greater than the revenue loss from corporate business tax credits 20 years ago. Connecticut's revenue loss from corporate tax credits was seven times greater than the total economic development budget of the Department of Economic and Community Development.

The fiscal and economic crisis Connecticut currently faces requires the adoption of new approaches to governance, and prudent oversight of Connecticut's resources. Business tax credits have been taking a huge (and growing) bite out of state revenues. This crisis presents an opportunity for Connecticut to revisit its approach to economic development, while taking a more responsible approach to oversight of the tax expenditure side of the budget.

### Real Revenue Lost through Corporate Tax Credits FY87 - FY11 (est.)



<sup>1</sup> Connecticut's unemployment rate was 8.9% in December of 2009.

<sup>2</sup> 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.

<sup>3</sup> Jennifer Weiner, "State Business Tax Incentives: Examining Evidence of their Effectiveness" New England Public Policy Center. Discussion Paper 09-3 December 2009. Pg. 27.

<sup>4</sup> Inflation adjusted to 2009.

<sup>5</sup> 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>

<sup>6</sup> Shelley Geballe, "Business Tax Credits: The Blank Check in Connecticut's Economic Development Portfolio?" Connecticut Voices for Children, March 2008

<sup>7</sup> Katherine Klemmer. "Job openings and hires decline in 2008" Monthly Labor Review, Bureau of Labor Statistics. May, 2009. Pg. 35 <http://www.bls.gov/opub/mlr/2009/05/art2full.pdf>

<sup>8</sup> See Senate Bill 106, § 11-1104(A)

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<sup>9</sup> Nicholas Kaldor, “Wage Subsidies as a Remedy for Unemployment,” *Journal of Political Economy*, vol. 44, no. 6 (December 1936)

<sup>10</sup> Shelley Geballe, “Business Tax Credits: The Blank Check in Connecticut’s Economic Development Portfolio?” Connecticut Voices for Children, March 2008

<sup>11</sup> See House Bill 5209, § 1(e).

<sup>12</sup> CONN. GEN. STAT. § 12-217ii (Westlaw 2010).

<sup>13</sup> 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.

<sup>14</sup> For greater detail, see Shelley Geballe, Business Tax Credits: The Blank Check in Connecticut’s Economic Development Portfolio?, (Connecticut Voices for Children, 2008).

<sup>15</sup> OFA, *Connecticut Revenue and Budget Data* (February 27, 2006). Note: the plateau in the growth of credits claimed around FY 01 resulted in part from the fact that S corporations no longer were subject to the corporation business tax, so could not claim tax credits against it. The decline in the economy, coupled with a change in the law preventing tax credits from extinguishing a company’s tax liability (see note 14 below) contributed to the dip in credits claimed around FY 03.

<sup>16</sup> OFA, *FY 10-FY 14 General Fund and Transportation Fund Budget Projections and Fiscal Information* (November 13, 2009), p. 34.