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## **Connecticut Corporate Tax Breaks Challenged**

### ***State group says public investment in children's programs offer more proven benefits to state residents***

As Connecticut continues to struggle to close a state budget deficit, a new report released today by the Economic Policy Institute – *Rethinking Growth Strategies: How State and Local Taxes Affect Economic Development* – raises questions about whether the hundreds of millions of dollars in state and local tax cuts and incentives given to corporations each year are providing the state with an adequate return on its investment. The research report finds that low taxes and business tax incentives are *not* the most effective strategies for attracting businesses and jobs.

“This national report comes at a most important time,” comments Ellen Scalettar, Senior Policy Fellow at CT Voices for Children and a former state legislator. “Connecticut’s business taxes are at a historic low after more than a decade of tax cuts, yet despite these tax cuts, Connecticut is continuing its ‘job-loss’ recovery with an ongoing erosion of jobs. The EPI report raises questions about *why* such reliance on tax cuts as a core economic development strategy may not be working.”

The report also comes as the legislature’s finance committee is considering bills that would shed increased light on *which* corporations are getting the benefit of these tax breaks and what Connecticut’s taxpayers are getting in return, and at a time of heightened public concern about favoritism in the awarding of state contracts and other state benefits.

Like many other states, a key part of Connecticut’s economic development strategy to attract new businesses to the state, and retain existing ones, has been to enact wide-ranging corporation business tax exemptions, deductions and credits. These have reduced dramatically the tax liability of many Connecticut corporations. In addition, the corporation tax rate has been cut from 13.8% in FY 90 (a rate that nearly all agree was too high) to 7.5% in FY 02 (the national average). Since 1995, business taxes have been cut by more than \$600 million per year and, in FY 02 alone, Connecticut provided \$169 million in tax credits to corporations.

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The Economic Policy Institute report concludes, however, that these strategies are not the best or most cost-effective ways to attract new businesses and jobs. Factors that outweigh taxes in business decisions on where to locate are the availability of qualified workers, proximity to

customers, and the quality of public services. This means, the report finds, that tax cuts can be counter-productive. By reducing funding for public services, they can actually cause job loss and economic slowdown.

Increasing attention is being given in Connecticut to state economic development efforts, including tax incentives:

- In 2003, the Connecticut Department of Economic and Community Development provided a \$40 million tax break to one of the world's largest liquor distributors to move offices from Stamford to Norwalk, raising questions about the efficacy of this tax benefit given competing state needs.
- Connecticut was one of only three states in which overall state and local business taxes declined *in the last three years*, according to a report by the Council on State Taxation – a business-funded trade organization. The study also found that the state ranked among the bottom 10 states on three out of four measures of overall state and local business tax burden.
- A 2001 report by the State Auditors of Public Accounts highlighted inadequate oversight of Connecticut's economic development programs: "In distributing the financial assistance deemed necessary to promote economic growth, the Department of Economic and Community Development has only partially fulfilled its responsibilities to Connecticut's citizens. A very important part of the job is to monitor the projects to ensure that the money is spent according to the budget and that the project yields the intended results."
- For tax year 1999, the only year for which this information is publicly available, 38 of Connecticut's 95 largest corporations owed no corporate business tax because of their tax breaks. Nearly two-thirds of corporations in the state (more than 52,000) paid only the Alternative Minimum Tax of \$250.<sup>1</sup> This resulted in new state limitations on the use of tax credits to totally eliminate corporate tax liability.

Yet, despite the costs to the state when revenues from business taxes are significantly eroded, little is known about the benefits to Connecticut of specific tax cuts and incentives, according to Connecticut Voices for Children, which has worked with the Economic Policy Institute in past releases of *The State of Working Connecticut*. Neither legislators nor the public can currently access information concerning the identities of companies claiming tax credits and in what amounts, whether certain tax breaks tend to benefit or burden large or small corporations, and what return on investment the state is receiving for economic development funds granted through tax credits and other incentives.

The General Assembly's Finance Committee is currently considering two bills that would begin to address this lack of information. "Our legislators need concrete and current information about the costs, benefits and burdens of corporate tax credits and all other state economic development

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<sup>1</sup> This information was prepared by the General Assembly's Office of Fiscal Analysis in response to a request by Senate Democrats.

incentives in order to make informed budget decisions. But they don't have all the information they need to determine what return on investment, if any, the taxpayers of Connecticut are receiving for the hundreds of millions of dollars spent on economic development each year," noted Shelley Geballe, Co-President at CT Voices for Children.

While challenging the efficacy of tax incentives as a tool for economic development, the EPI report provides support for continued public investment in education and infrastructure as essential tools to promote business growth. "We know that investing in our children's education and development will pay off in terms of improving our quality of life and economic future," said Douglas Hall, Policy Fellow at Connecticut Voices for Children. "Connecticut can afford to support programs that work for kids. Indeed, for our future economic prosperity, we can't afford *not* to make these investments."

For example, numerous Connecticut and national studies have demonstrated both the short and long-term return on dollars invested in high-quality early childhood programs, such as Connecticut's School Readiness programs. A study by the Minneapolis Federal Reserve Bank estimates a 16% real internal rate of return on dollars invested in quality early childhood development programs.<sup>2</sup> And, studies across the country show a benefit-to-cost ratio of up to \$8 for every \$1 invested. These savings accrue from reduced spending on special education services, reduced welfare assistance, higher taxes paid for higher earnings, and reduced crime costs.<sup>3</sup>

Concludes Janice Gruendel, Co-President of CT Voices for Children, "Now is the time for children's investment advocates and business investment advocates to sit at the same table and frame a bold new vision of economic development for Connecticut, one based on building human capital from early childhood on."

The report was issued by the Economic Policy Institute (EPI), a nonprofit, nonpartisan economic think tank ([www.epinet.org](http://www.epinet.org)). Connecticut Voices for Children is a statewide, research-based policy and advocacy organization committed to promoting leadership, policy change, and investment on behalf of all of Connecticut's children and youth ([www.ctkidslink.org](http://www.ctkidslink.org)). Connecticut Voices is a state partner in the Economic Analysis and Research Network (EARN), a collaboration between EPI and state-level economic research organizations.

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<sup>2</sup> Rolnick, Art, "Early Childhood Development: Economic Development with a High Public Return," *The Region*, December 2003. Online at -- <http://minneapolisfed.org/pubs/fedgaz/03-03/earlychild.cfm>

<sup>3</sup> Bruner, Charles, "A Stitch in Time--Calculating the Costs of School Unreadiness," The Finance Project, 2002. Online at -- <http://www.financeproject.org/stitchintime.pdf>

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# Economic Policy Institute

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## STATE TAX BREAKS DON'T GROW JOBS, RESEARCH SHOWS

In the scramble to lure businesses and jobs to their state, policymakers have operated for many years on the assumption that low taxes and business tax incentives make the best bait. A new study published today by the Economic Policy Institute offers strong evidence that such policies are neither the best nor the most cost-effective strategies for attracting businesses and jobs. Conversely, raising taxes to support public services can promote economic and jobs growth.

In *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development* author Robert G. Lynch provides a comprehensive overview of the current research into the factors that influence business decisions about where to locate. The result is a powerful refutation of the idea that cutting taxes and shrinking government and services will attract new businesses and jobs.

Lynch analyzed hundreds of research studies that examined the effectiveness of state and local tax cuts, tax incentives, and public services in creating jobs and promoting economic development. That analysis led him to conclude that there is little evidence that state and local taxation figures prominently in business location decisions.

Factors that outweigh taxes in business decisions on where to locate are the availability of qualified workers, proximity to customers, and the quality of public services. Not only are tax cuts an unreliable way to attract businesses and promote economic development, according to Lynch, but they are also less effective than tax increases that are used to expand the quantity and quality of public services.

Lynch found little evidence that tax cuts stimulate economic activity or create jobs or that job transfers between states are a consequence of business tax incentives. On the other hand, reductions in public services due to state and local tax cuts can cause job loss and economic slowdown.

“The cuts in services that inevitably follow tax cuts can actually undermine economic development efforts,” Lynch said. “A business needs a location where its operations are supported by good quality public services and infrastructure. Taxing decisions that eliminate or erode those services make that location less attractive to business than another one where there is a policy of investing in services and infrastructure that can support economic development.”

Lynch’s report takes a systematic look at arguments that are commonly used to justify state and local tax cuts and incentives and reveals the weaknesses in each of those arguments, as borne out by current research.

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*The Economic Policy Institute is a nonprofit, nonpartisan economic think tank founded in 1986.  
The Institute can found on the web at <http://www.epinet.org>.*

Those arguments are:

- **The tax burden argument:** Some argue that state and local taxes are significant burdens on the firms that pay them and that this burden markedly lowers their profitability. In fact, these taxes add up to only 0.8% of the cost of doing business. Cuts in taxes are likely to be offset by additional costs incurred by businesses forced to make up for the loss of public services. For example, a business may have to invest more in worker training, health care, workplace security, or other services formerly paid for with tax dollars.
- **The supply-side argument:** According to this theory, tax cuts give people an incentive to work harder and produce more and they also free more money for investment by letting individuals and firms keep more of their earnings. However, the evidence shows that tax cuts for individuals are just as likely to inspire less, not more work, since it takes less work to produce the same income. And for businesses, even if investment rose it would not necessarily be investment in the state or community that gave the tax breaks.
- **The demand-side argument:** This argument holds that tax cuts are a good way to stimulate the local economy because at least some of the increased after-tax income of individuals or businesses will be used to purchase more goods and services. Although this argument is widely accepted as true at the federal tax level, it doesn't hold true for state and local taxes. That's because the increase in private spending is typically more than offset by reductions in public spending at the state and local levels. With most states constitutionally required to balance their budgets, cuts in revenues almost always produce spending cuts that more than wash out any gains from private spending.
- **The business climate argument:** Some argue that lowering taxes makes an area more "friendly" and therefore attractive to businesses. However, the businesses that are the savviest – and therefore the most likely to make a lasting contribution to the economic health of the state or locality – aren't likely to be swayed by vaguely defined concepts of "friendliness." They want to know that they can rely on high quality public services – such as well maintained roads, bridges, ports, and airports; prompt snow removal; reliable fire and police protection; and a good education system. These high quality services will attract the high paying jobs. All these services require public investment and all are jeopardized by a tax-cutting strategy.
- **The competitiveness argument:** This argument, in essence, says that everybody is doing it and if we don't cut taxes and offer incentives, too, we won't be able to get and keep businesses here. Despite the seeming logic of this argument, researchers have not found evidence that states are losing any significant number of jobs to other states that offer tax cuts or incentives to businesses.

Lynch's study makes the case that tax cutting at the state and local level is not only ineffective at attracting businesses, it is also a very poor use of scarce state and local resources. For example, for every dollar cut in state and local taxes, a business realizes a revenue increase of only about 60 cents. The other 40 cents goes to the federal government and other jurisdictions because the firm's deduction for state taxes has fallen. In addition, for every private sector job created by state and local tax cuts, governments lose between \$39,000 and \$78,000 in annual tax revenues. This revenue loss forces lay-offs of more employees in the public sector than were gained in the private sector, producing a net loss of jobs from the tax cuts.

"The real lesson here for legislators and local policy makers," Lynch concluded, "is that what makes a community a good place to do business looks a lot like what makes a community a good place to live. That means good schools, good police and fire protection, a modern and well-maintained transportation infrastructure, and good all-around public services. Instead of creating jobs, tax cutting strategies that undermine government's ability to provide quality services can end up destroying jobs."

Robert G. Lynch holds a Ph.D. in economics from the State University of New York at Stony Brook and chairs the Department of Economics at Washington College.