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No Way To Do Business

When Government Picks Winners, Connecticut Loses

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No Way to Do Business

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Connecticut spent the last decade in the economic doldrums, and the forecast for the next decade isn't much sunnier. The state recovered less well from the Great Recession than just about any other state in the union. Its unfunded pension liabilities have soared, while budget deficits – which have plagued the state for years – stretch far into the foreseeable future.

The Malloy administration's approach to the economy exacerbated years of fiscal mismanagement. A pair of tax increases that rank among the largest in Connecticut history played a significant role in dampening the state's economy. So too, though, did the misguided uses of the state's dwindling resources.

One of the most egregious of these uses was the state's "economic development incentives" programs. These programs spend more of the state's income every year than is raised by the administration's 2015 corporate tax increases – the increases that drove away General Electric and other major Connecticut corporations. The results, meanwhile, appear ineffectual: even the corporation that received the most of such incentives has recently announced plans to leave the state.

A state does not prosper when its government assumes the responsibility – and the knowledge – to pick winners and losers, to increase taxes generally then to hand that tax money to privileged favorites. If we're going to turn Connecticut around we need to adopt the best and cheapest incentive programs ever invented: low taxes administered fairly and equally for all, "paid for" by eliminating unaffordable and counterproductive programs like these "incentive" plans.

Taxes Up, Businesses Out

During the 2015 legislative session, lawmakers voted for a 2016-2017 biennial state budget that included more than $1.3 billion in tax increases over two years. The passage of this budget had disastrous consequences for the Connecticut economy, including: Increased outmigration of wealthy residents; stalled job and wage growth; almost no economic growth; and the exodus of several businesses.

The two-year budget hit corporations especially hard, leading to the extraordinary step of several corporate leaders speaking out publicly against the budget. Despite these very public warnings, legislators approved the budget in votes of 78-65 in the House and 19-17 in the Senate.[1]

One of those corporations whose management warned the state of the disaster in the making was GE, which called the tax increases "truly discouraging," and questioned whether the firm would remain in Connecticut.[2]

General Electric warned Connecticut's lawmakers that it would leave if the state raised corporate and personal taxes again in 2015 in the wake of its massive 2011 tax hikes. When the state raised taxes anyway, General Electric (along with other large Connecticut firms) left.

It was little surprise, then, when GE announced in early 2016 that it would move its headquarters from Fairfield to Boston, garnering national attention.[3]

State budget analysts significantly overestimated how much the tax increase would bring in, likely because they did not take into account, despite the warnings from corporations as well as from policy organizations including the Yankee Institute, the counter-moves by corporations to either minimize their tax exposure or leave the state altogether. The analysts projected that corporate taxes would increase $481 million over the biennium.[4] In fact, according to the Connecticut Department of Revenue Services, corporate taxes increased only from $1.53 billion in FY 2014-15, to $1.86 billion in FY 2016-17, an increase of about $323 million, or about $161.5 million a year.[5] In other words, the state was expecting fully fifty percent more revenue from these tax increases than actually materialized.

Giving with One Hand, Taking Away with the Other

In fiscal year 2016, as most of the corporate tax increases took effect, the state's Department of Economic and Community Development, which is tasked with "strengthening Connecticut's competitive position,"[6] spent about $358 million, according to OpenTheBooks.com – more than twice the amount that the corporate tax increase actually brought in – to entice businesses to come to or remain in Connecticut.

This spending included direct payments or loans to businesses, direct payments and loans to municipalities, and other economic development spending. It does not include, though, tax abatements and exemptions given to businesses, which are detailed in the DECD's annual

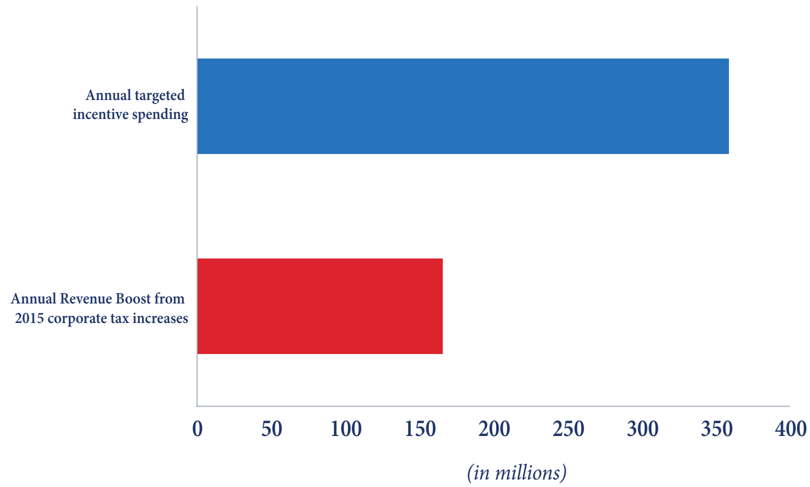
Edible Arrangements is one of the most recent corporations to leave, heading from Wallingford to Atlanta.

reports.[7] According to OpenCheckbook.CT, which is maintained by the Office of the State's Comptroller, of the $358 million spent in FY 2016 by DECD, $80 million came from federal or restricted funds.[8]

Worse still, most of this economic development spending was borrowed. The legislature budgeted only $39.7 million for DECD in FY 2016, but the department actually spent many times that amount by accessing bond funds to pay for many of its incentive programs.[9] OpenCheckbook shows that the state spent $169 million in borrowed funds in FY 2016 on economic development activities. This was $7.5 million more in bonded borrowing for these incentive programs than the state took in in new corporate tax dollars that year.

The top recipient of funds from these programs in FY 2016 was Alexion Pharmaceuticals, which received $26 million, part of a $51 million total package through the state's "First Five" program.[10] The success of this spending can be judged from a single fact: recently, Alexion

Economic Incentive Spending More than Double Corporate Tax Hikes



announced it would move its headquarters from New Haven to Boston.[11] While only one example, Connecticut's experience with Alexion shows that even large state payouts do not always make up for an otherwise uncompetitive business environment. The company announced it would pay the state back for most of the assistance it received, but this doesn't make the program any more successful.

Tax Increases + Payouts to Businesses = Bad Outcomes

The strategy of giving government handouts to businesses to increase jobs and grow the economy, which was a cornerstone of Gov. Dannel Malloy's economic development policy, has not proven effective. This is particularly true because this strategy was implemented at the same time as the Malloy administration sought for and passed large tax increases.

In 2016, the year most of the corporate and income tax increases passed in 2015 went into effect, Connecticut's economy showed many signs of stagnation. The poor indicators included:

- **OUTMIGRATION:** From 2015 to 2016, Connecticut saw a record outmigration of personal wealth. According to data released by the Internal Revenue Service, Connecticut had a net loss of around 20,000 residents to other states, and a net loss of $2.6 billion in adjusted gross income. The outmigration of high earning households was particularly troublesome, with $2.5 billion in net loss from households earning over $200,000 a year.[12] One after-effect of outmigration was plummeting income-tax receipts, which came in more than $400 million below estimates in FY 2017.[13]
- **JOB AND WAGE GROWTH:** Connecticut experienced almost no job growth in 2016. The state added just under 3,800 jobs, a 0.2 percent increase.[14] Wage growth similarly stalled in 2016, with an imperceptible 0.5 percent increase.[15]
- **ECONOMIC GROWTH:** The state's economy grew by an anemic 1 percent in 2016.[16]
- **BUSINESS LOSSES:** Besides GE's public announcement, other companies that announced large job cuts or moves in 2015 and 2016 include Hallmark, RBS, Bristol-Meyers Squibb, Boehringer Ingelheim Pharmaceuticals, and Rogers Corp. – which moved its headquarters from Connecticut to Arizona.

Connecticut's Tax Incentives

Connecticut offers businesses a variety of incentives, including through the First Five Program, the Small Business Express Program, and tax breaks targeted to specific businesses through legislation.[17] Much of the money spent on these programs is borrowed, so the cost is actually much higher than advertised. Recent data show that Connecticut has borrowed $1.7 billion for economic development since 2011, but the state has had little economic growth during that time.[18]

According to information on OpenTheBooks.com, the top ten recipients of funding from the Department of Economic and Community Development in 2016 were[19]:

Alexion	$26,000,000.00
Edac Technologies Corporation	$16,435,000.00
Connecticut Center for Advanced Technology	$11,265,729.00
Hartford Hospital	$11,079,417.00
Fuelcell Energy Inc	$10,000,000.00
Praxair Inc	$10,000,000.00
Synchrony Bank	$10,000,000.00
Steelepointe Harbor	$9,000,000.0
Conair Corporation	$8,000,000.00
Carecentrix Inc	$7,200,000.00

According to the DECD FY 2016 final report, the state has a total outstanding loan and grant portfolio of $951 million. The state also extended tax credits worth over $163 million in FY 2016.[20]

Looking Ahead

Connecticut is warring against itself. The state spends hundreds of millions of dollars trying to attract businesses – or, more often, trying to keep them – while at the same time increasing taxes on those same businesses as well as all other businesses and residents of the state. The result has been an anemic economy, and the taxpayer flight chronicled above. There is reason to believe that, if properly measured (see next section), we would see that these "incentive" programs have left the state worse off than if there had been no programs at all.

Connecticut generally scores poorly on business environment surveys. For example, a recent Tax Foundation study ranks Connecticut 47th out of 50 states for its business tax climate.[21] Instead of trying to lure businesses one by one, lawmakers and agency heads would do better to focus on making the state a more hospitable place overall. This should start by creating a more favorable tax environment, and by demonstrating that Connecticut is not a state that will tax unfavored businesses in order to grant special financial rewards to a privileged set of well-connected competitors. That's the way for Connecticut to do business.

Misevaluation of Economic Incentive Programs

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In attempting to determine the impact of targeted economic-development programs on state economies, most prior studies have used standard economic-impact analysis to determine the benefits to arise from the program. This empirical technique, however, is not the most appropriate method to use when examining the overall impact – and therefore the real relative value – of such programs.

An economic-impact analysis that focuses only on benefits is only appropriate when the initial expenditure (the expenditure that draws the company to the area) comes from outside the region being examined. So, if a firm were to relocate to Connecticut without any assistance from the state or its municipalities, that would constitute an external initial expenditure that would produce induced and indirect spending in the state and create additional employment there.

In contrast, the state's paying a firm to maintain its workforce at current size, or paying a firm that is already in the state to add to its payrolls for a limited period of time, would not constitute an external initial expenditure. Rather, these types of economic incentive programs reallocate money from some individuals in the state, by taxation, to other persons or entities in the state – namely the recipients of tax-funded grants and loans. This makes standard economic-impact analysis incomplete in a way that radically overstates the value of such programs.

Alexion received more in DECD funding in 2016 than any other business – more than $50 million. But this didn't keep it from moving its headquarters to Boston in 2017.

The appropriate way to determine the efficacy of targeted economic-development programs would be to conduct a standard economic-impact analysis but then to subtract the costs from the benefits to obtain a net benefit. Here is a detailed example of how that would work:

Net economic impact is defined as follows:

Net Economic Benefit = Total Economic Benefit - Total Economic Cost

The *total economic benefit* is estimated as follows:

Total Economic Benefit = Direct Impact + Induced Impact

The *direct economic impact* is the total amount of economic benefit generated that can be directly attributable to the economic incentive program.

The *induced impact* results because businesses must hire additional personnel and purchase additional supplies to accommodate the increased customer volume that results from greater employment and/or incomes. These newly-hired individuals then possess additional income that they can spend at other Connecticut businesses. These businesses will then have to hire additional personnel which will then increase the income and spending flow even further. This process is known as the *multiplier effect* in economics and is usually a substantial part of the benefit of a new business locating in the state.

To calculate the *induced impact, a multiplier factor* must be used to capture this multiplier effect. Relevant multiplier information such as that contained in the Regional Industrial Multiplier System (RIMS II) can be obtained from the United States Bureau of Economic Analysis. This multiplier is estimated for various industries for specific regions and counties throughout the US.

But here the process is only half completed. Now attention must shift to the program's *total economic costs.* These are calculations mirror the benefit calculations, so:

Total Economic Cost = Direct Economic Cost + Indirect Economic Cost

Costs are, theoretically, determined in the same way that benefits are, with the same inputs. Total costs must be determined because without them it is impossible to have any idea whether economic incentive programs have provided any net benefit at all, or are in fact causing a net drag on the economy. Because costs are difficult to determine, however, and because they would reflect poorly on government-sponsored initiatives, they are seldom calculated. If you are trying to "sell" a program, you would much rather use "total benefit" than "net benefit."

Endnotes

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