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Ensuring that Economic Development Programs Are Good Deals for the City

Recommendations to the New Mayor and DC Council

Summary

Economic development projects can be important catalysts to create jobs for District residents and increase tax revenues for government services. But with limited dollars to support development projects, the District needs to invest in initiatives that will effectively benefit the city without posing undue risks. This transition document acknowledges the positive steps the District is taking and highlights one development initiative – incentives for the high-technology sector – where further improvement is needed.

Recent Progress in Oversight of Economic Development Tax Incentives. This year, the District passed legislation that requires the Office of the Chief Financial Officer (CFO) to analyze the effectiveness and economic impact of all tax incentive programs, including business tax breaks, over a five-year cycle. The analysis will include jobs created and filled, wages of new jobs, and an assessment of whether the same outcomes would be achievable without the tax subsidy. This legislation adds more transparency and oversight to DC's tax-based economic development strategies.

Areas for Improvement. Currently, the District has one large economic development initiative that requires the same level of thoughtful analysis – initiatives to grow the bourgeoning technology (or high-tech) sector. This issue brief makes the following recommendation to help these initiatives benefit the city in a financially responsible way.

- ***Grow the Technology Sector Without Tax Cuts to Wealthy Investors and Companies.*** Over the last several years, the technology sector has begun to grow in the District. The District has a variety of programs to support tech start-ups and provides a rich set of incentives and grants. While high-tech companies could be a major vehicle for future economic growth, recently adopted tax cuts that largely will benefit wealthy tech investors (starting in 2019) are unlikely to do much to promote the tech sector and stand to worsen income inequality. If the District wants to promote tech investment, it can do so by providing entrepreneurs with the upfront supports and resources they need.

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Issue #1: Grow the Technology Sector without Tax Cuts to Wealthy Investors and Corporations

In the wake of sequestration and expectations of a declining presence of the Federal government, policymakers have increasingly looked to strengthen DC's emerging technology community as a major vehicle for economic growth. Unfortunately, the discussion has turned to tax cuts for wealthy tech investors, which are unlikely to do much to promote the tech sector. Instead, tech tax breaks would worsen income inequality in DC and divert tax resources from things that can strengthen DC's business climate and help local start-ups. DC can take several other steps to provide entrepreneurs with the upfront supports and resources they need to attract investors.

Recent legislation approved preliminarily in November 2014 proposal lowers the corporate and personal income tax rates to 3 percent for companies and individuals who experience a capital gain after holding stock or options in a Qualified High Tech Company for 24 months and selling them.

It is important to note that the DC Tax Revision Commission considered and rejected a similar proposal to cut income taxes by two-thirds for income from tech investments. Before that, the DC Council voted against the same measure. Here's why:

- Tax cuts for capital gains are not shown to increase investment.
- The cut would be very costly and could reduce resources for programs that strengthen the workforce and improve the business climate.
- The 3 percent rate on capital gains would increase income inequality.

Tax breaks are not effective in increasing investments. A tech capital gains tax cut would cost a lot but do little to affect tech investments. There is no evidence that lowering capital gains taxes leads to higher economic growth[1] and in fact, there are reasons to suggest that this District-specific tech tax break would not be effective. Investors make decisions to invest in a particular company based on the riskiness of the investment and the possible rate of return, not the tax rate. Lowering the tax rate will not turn a bad investment into a good one. Consider being offered a chance to invest tax-free in a risky company with a modest expected rate of return, or to make a taxable investment in a less-risky company with a higher expected rate of return. Paying taxes on a substantial gain is much better than paying no tax on a small gain.

[1] Chye-Ching Huang and Chuck Marr, "Raising Today's Low Capital Gains Tax Rate Could Promote Economic Efficiency and Fairness, While Helping Reduce Deficits." Center on Budget and Policy Priorities http://www.cbpp.org/files/9-19-12tax.pdf

Beyond that, District tax breaks only apply to DC residents who invest in DC high-tech firms. Yet any company looking for venture capital will need to look beyond District-based investors. The likelihood that a successful DC start-up company would be able to have its entire capital needs met by DC residents is slim. This means that the proposed tax break, even if you believe it will act as an incentive, will probably not do much to meet the overall capital needs of high-technology companies.

Tax cuts on tech investments could be very costly. A capital gains tax cut would benefit investors after companies take off and become successful, when the investment gains would be large. The Fiscal Impact Statements for the most recent legislation shows a cost of $13 million annually once in effect (2019).

Whatever the cost, the loss of revenue would divert significant resources and make it harder to support things that make DC an attractive city – such as schools, parks, and libraries – or that directly help business, such as public grants for workforce development and business incubators.

A capital gains tax cut would increase income inequality. Tax breaks for tech investments would primarily benefit wealthy investors and an industry that already gets substantial tax support. Any capital gains tax cut would likely mean that investment income would be taxed at rates lower than those faced by working DC residents.

The recent legislation sets the income tax rate for gains on such investments at 3 percent starting in 2019, a reduction of two-thirds from the existing 8.95 percent top income tax rate on such gains. This would set a tax rate on investment income even below the 4 percent income tax rate paid by workers in the lowest tax bracket. It would create DC's version of the "Warren Buffet Problem," with low-paid workers in the city paying a higher income tax rate than some of the highest-income investors. No other industry gets such large subsidies for companies and their owners.

Policy Recommendations. Focusing incentive programs on income taxes benefits very few and does nothing to help DC's tech start-up community grow. If the District wants to promote tech investment, it can do so by providing entrepreneurs with the upfront supports and resources they need to attract investors – highly skilled employees, affordable workspace, and access to experienced business expertise.

Here are a few ways to do that:

- ***Make investments in workforce development.*** Ensure that District residents have the resources and capacity to take high-tech, high-skilled positions. Expand internship and mentoring programs for high school, trade school, and community college students and help small businesses access skilled labor via the District's universities.

- ***Ease access to capital.*** Augment efforts by the Small Business Administration to guarantee loans for long-term business financing. This may mean targeting a locally funded loan-guarantee for small tech start-ups.

- ***Provide affordable workspace.*** Continue the support of tech company incubators and consider targeted property tax assistance for tech businesses with limited revenue.