Revenue Revealed: It's Time to Amend DC's Tax Expenditure Programs

By Amy Lieber

The District offers several economic development tax incentives that cost the city millions in lost revenue each year, yet fail to contribute to economic growth. Modifying or eliminating ineffective tax expenditure programs would be good public policy and would free up revenues to address priorities in the fiscal year (FY) 2020 budget.

For example, the District offers substantial tax subsidies to high technology companies, resulting in millions in foregone revenue each year, according to a review from the DC Chief Financial Officer (CFO).[1] Similarly, tax incentives for grocery stores have significant costs without any real evidence that they work and have not contributed to new stores in the city's food deserts, especially in Ward 7 and Ward 8.

Tax incentive programs, while popular, often fall short of their expectations. This is especially true for economic development incentive programs. Taxes are a relatively small share of any company's costs, so tax subsidies don't do much to affect a company's bottom line. It is hard to target these programs for only new or relocating businesses; tax incentives often go to companies that already would be located in DC because it meets their needs or were already engaging in the incentivized behavior for any number of reasons. More generally, tax incentive programs often get forgotten in the tax code, with little or no review of their impact. Until recently, DC had engaged in no analysis of its tax incentive programs whatsoever.

Importantly, the lost revenue from tax incentives makes it harder to invest in services that matter to economic success, including education and public transportation.

The revenue lost to ineffective tax incentives, like DC's high tech and grocery store incentives, can and should be redirected for necessary services to make DC an equitable and safe place where all residents can thrive.

What Are Tax Expenditures?

Programs operated through the tax code are called "tax expenditures." They are special provisions in the tax code that benefit specific taxpayers or groups of taxpayers. They can come in the form of exclusions, deductions, deferrals, credits, and special rates.

Tax expenditures broadly fall into two categories. Some tax expenditure programs use the tax code as a way to provide financial assistance to selected groups— like the Earned Income Tax Credit, which boosts the income of workers with low to moderate earnings, or DC's tax credit for lower-income residents seeking assistance paying property taxes (known as Schedule H). Using the tax code is a relatively simple way to deliver benefits, as long as eligible recipients know about them and how to apply.

A second type of tax expenditures are designed as incentives to encourage certain kinds of behavior, such as economic development tax incentives intended to spur economic activity. City and state governments often use tax incentives in an effort to lure targeted companies to locate there, or to expand certain types of businesses.

Amazon's HQ2 is a highly public example of this second type: competing cities offered generous subsidy packages (such as refundable tax credits, building incentives, and performance-based incentives) to entice Amazon to choose their city.[2]

Other incentives are designed to help the city meet broader goals. For example, a tax break for companies adopting eco-friendly business practices can support a city's environmental goals.

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DC's Key Economic Development Tax Expenditures Are Failing to Deliver

Hundreds of companies in the city are claiming tax breaks from economic development tax expenditure programs, resulting in millions of dollars in foregone revenue, yet the city has little to show for the lost revenue. The District should end or scale back tax incentive programs that are ineffective.

Most notably, since 2001 DC has provided a generous set of tax subsidies for companies that are considered "high tech," yet recent analysis suggests that the costly tax incentives are not benefitting DC's economy.[3] Similarly, tax incentives intended to bring grocery stores to under-served communities haven't achieved that goal. Both of these tax expenditure programs should be revamped or eliminated.

Qualified High Technology Company Incentives

On the DC.gov page for the Office of the Deputy Mayor for Planning and Economic Development there is a description that reads like an advertisement for the Qualified High Technology Company (QHTC) incentive:

> Are you a company that delivers technology products and services? Qualified High Technology Companies can claim one of the most attractive incentive packages for high technology businesses in the country. These benefits include reduced corporate franchise and capital gains tax rates, as well as lowered costs to hire, train, and relocate workers.[4]

This tax incentive was examined in the CFO's 2018 review of economic development tax expenditures, which found that this expenditure results in $40 million in foregone revenue *every fiscal year* when all of the different available tax breaks are factored in.[5]

The QHTC tax incentive program began in the early 2000's during the tech boom as a strategy to attract the industry to DC. For nearly two decades, this incentive program has been on the books, giving "high tech" companies a slew of benefits including:

- 0 percent corporate franchise tax for the first five years
- After five years, a lifetime tax rate of 6 percent, as opposed to the usual 8.25 percent rate
- Capital gains tax of only 3 percent
- New hire wage tax credit (up to $15,000 annually for two years) for each qualifying employee
- New hire retraining tax credit (up to $20,000) for each qualifying employee
- Ten-year tax exemption from the date of acquisition on personal property used for operating business
- Relocation tax credit up to $7,500 per employee
- Five-year freeze on real property taxes for office improvements
- Sales tax exemption for purchase of hardware, software, equipment, and more

- Increased business expense deduction

While some of these benefits are one-time or short-term, some of the key benefits are permanent with no caps on the dollar amount. That means that there are businesses who have been claiming this tax credit for almost 20 years.

The requirements to qualify for these generous tax incentives are relatively modest.

- Lease or own an office in the District of Columbia
- Derive at least 51 percent of gross revenues earned in the District from one or more permitted high technology activities
- Two or more qualified employees in the District (employed for at least 35 hours per week in any of the permitted activities)

The process for claiming the incentive is self-certification by the companies, with the Office of Tax and Revenue having the burden to prove ineligibility (which is a difficult task, as a 2012 court case shows[6]). Additionally, for legal reasons, there is no disclosure of which companies receive the benefits or how much they receive. This means that taxpayer money is going into the pockets of unknown beneficiaries that have few restrictions to qualify.

The CFO found that many of the companies claiming these incentives are headquartered outside DC, often in Northern Virginia, but maintain a small operation in DC or have employees who contract with the federal government.

The report also found that many of the companies claiming the tax incentives were already engaged in the same business in the same location before they started claiming tax subsidies. This means the incentive gave away millions in tax breaks to companies for activities they likely would have undertaken anyway, without necessarily generating growth. Because the QHTC tax subsidies are not targeted to new businesses or to businesses that are expanding—and because no DC agency has gathered information to assess the program's effectiveness—the CFO was "not able to reasonably identify what new actions were taken due to the incentives" or "what economic benefits are attributable to the incentives."[7] The CFO also concluded that the gains in DC's high-tech sector "cannot be attributed to QHTC incentives."[8]

It's also important to note that there is no "clawback" provision that prevents companies who have claimed the incentive from leaving town. For example, the CFO noted that the "company that received the single largest QHTC credit [in one year] moved outside of DC in the following year."[9] Under DC's current QHTC rules, the company was under no obligation to re-pay the District for the subsidies it received.

Qualified Supermarkets

According to a D.C. Policy Center report, 11 percent of the city's area is considered a "food desert"[10] –an urban area in which it is difficult to buy affordable or good-quality fresh food. The DC government took steps in 2000 and 2010 to address this issue by providing several tax incentives to grocery stores willing to locate in lower-access areas. The Qualified Supermarket incentive (also known as the DC FEED Act) has given $29 million from 2010-2017 for grocery stores to get one or more of the following benefits for up to ten years after development:

- Real property tax exemption
- Business license fee exemption
- Personal property tax exemption
- Sales and use tax exemption on any materials needed for construction

Between 2000 and 2015, 22 supermarkets received incentives but only two of these supermarkets located in the highest need areas east of the Anacostia River –and one of the two closed shortly after opening.[11] Wards 7 and 8 contain 82 percent of the area considered a food desert in DC, with only *three* supermarkets between the wards to serve over 160,000 residents.[12] Yet this is not where new grocery development happened.[13] Most of the claimed credits went toward opening supermarkets in Wards 1, 5, and 6. These supermarkets have located in transitioning and higher-income areas that likely would have drawn a supermarket anyway. While the DC government requires that the incentive only go to new grocery stores in specific parts of the city, the targeting is not limited to the highest need areas, and the incentives have not been enough of a draw to bring an adequate number of stores to these areas.

Unlike the QHTC incentive, the goal and outcome can be clearly defined here. We know who has claimed the tax breaks, where their supermarkets went, and whether they addressed the community need. The supermarket tax expenditure has not addressed the problem of food deserts in high-need areas and has still cost the city millions. According to the CFO, "Assessing the incentives on their original goals shows that almost $29 million of foregone District revenues cannot be shown to have affected supermarkets' location decisions, generally, or produced economic or other benefits that would not have happened but for the incentive."[14]

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Economic Development Tax Incentives Often Are Problematic

The QHTC and Qualified Supermarket incentives are examples of economic development subsidies that aim to get a company to move somewhere or to engage in a specific type of behavior for the economic benefit of a city or state. Yet studies around the country have shown major flaws in the core concept of these economic development tax expenditures, as well as problems with their design and review process. For several reasons, tax breaks intended to encourage business behavior often do not work well.

Taxes Are a Small Share of Business Expenses

The Institute on Taxation and Economic Policy (ITEP) found that "state and local taxes are only a small part of the cost of doing business—about 1.8 percent on average."[15] Tax incentives that offset part of a company's taxes are an even smaller share of overall expenses. It is unlikely companies would make such a pivotal decision about where to locate based on 1.8 percent of their business costs.

The limited impact of business tax incentives is evident in many examples. Amazon chose a location in northern Virginia even though Virginia did not offer the largest subsidies. Blackboard announced in 2018 that they were leaving DC despite generous breaks that they received from the District.[16] Foxconn significantly scaled back plans to build a manufacturing plant in Wisconsin after getting $3 billion in subsidies designed to entice them.[17] These are signs that tax incentives are not enough to impact major business decisions.

Tax Incentives Often Aim to Shape Outcomes that Would Happen Anyway

If a tax break is designed so that any business or individual who engages in the activity can claim it, much of the tax break will end up going to those who would have engaged in the activity anyway.

As noted above, most of the companies getting DC's QHTC subsidies were in DC before they started claiming the subsidies, because the QHTC program doesn't require any new business activity. The grocery store tax incentives appear to be going to stores that would have opened anyway. ITEP concluded that as many as 90 percent of investment decisions subsidized with tax incentives would have occurred regardless of the incentive.[18]

Economic Development Warfare is Bad for Everyone

When jurisdictions offer tax incentives to lure a company to move, this shifts where economic activity happens but does not create net economic growth. The benefit of some companies comes at the expense of others. ITEP finds that 90 percent of the benefits gained by tax incentives are offset by their competitor's losses. Incentive bidding wars do not make for a friendly or thriving business community. According to ITEP, "Local tax incentives are particularly troublesome…investment growth that one locality might consider 'new' is often simply 'poached'."[19]

Tax Incentives Eat Up Funds that Could Meet Economic Development Goals in Other Ways

Tax incentives for companies are costly because the District is giving away potential revenue. This is often at the expense of public services that help businesses and individuals. Those weighing the net benefit of an incentive must consider what the money would have been used for otherwise. Putting the funds towards infrastructure, public education, or other investments may be a better investment to promote economic growth in the city. Companies want to locate in places with an educated and skilled workforce and sound infrastructure. Diverting money away from these important investments and instead using them for tax incentives can have a negative long-term net effect.

Tax Expenditures Often Get Buried in the Tax Code and Are Not Monitored for Effectiveness

Because tax incentives are written into the tax code, their oversight and review is more challenging than programs that are administered by government staff and show up each year in budget documents. Until 2015, the District had no formal process for reviewing tax expenditures. In addition, most of DC's tax expenditures are adopted without assigning any DC government agency to monitor their impact. For example, the District offered substantial tax breaks to developers of The Line hotel in return for meeting several local hiring goals, yet the legislation did not give any DC government agency responsibility for assuring compliance. Now there are substantial questions about the company's compliance, but their tax break has not been rescinded.[20]

Since 2015, DC's CFO has reviewed different tax incentives every year, finding many to be ineffective or outdated. That means companies have been benefitting from tax breaks, without oversight or amendment, for years.

More fundamentally, in the writing of the expenditures, there are often not measurable targets that companies are required to reach. For example, the QHTC incentive has no clear definition of what "high technology" business means, and the tax breaks allow companies to claim tax subsidies permanently, even if the company never grows. A lack of measurable goals makes it impossible to assess whether tax incentive programs are working.

This is a common problem for states across the country, as the dependence on these tax incentives has grown in the past few decades. A Pew study highlighted the issue in 2017, rating how well states monitor the efficacy of their tax incentive programs.[21] Some states, like Maine, have started including sunset clauses on all tax incentives—requiring the incentives to be renewed legislatively on a regular basis—to ensure that ineffective incentive programs don't operate indefinitely. Other states, like Florida, have designated multiple agencies to oversee different parts of the review process. Washington state has one of the longest-standing and most successful tax incentive evaluation processes whereby a nonpartisan committee reviews the tax incentives and makes recommendations to the legislature.[22] Oversight of these expenditures is necessary to ensure efficient and effective use of state funds.

Since DC began its own tax expenditure review process in recent years, the flaws with many programs have become more apparent. As noted, the QHTC program was created with no agency assigned to oversee its effectiveness and with no tangible performance goals to measure its success. It is a step in the right direction for the District to have begun an annual review of expenditures. But without taking action to amend or revise these expenditures, the District remains behind the pack when it comes to proactive revision of archaic expenditures.

Economic Development Tax Expenditures Often Lack Clawbacks When Companies Do Not Perform

In addition to lack of monitoring, the lack of clawbacks is another common problem for tax incentive programs, in the District and other jurisdictions. In attempting to attract business to the city, DC's tax incentives rarely stipulate what will happen if a company takes the incentive but fails to deliver on its end of the agreement, or leaves town altogether. The tech company Blackboard is just the most recent example. In addition to the QHTC deduction, Blackboard received subsidies on the construction of its DC office in return for agreeing to lease space in DC for a decade. Only four years later, it announced it would be departing the District without any obligation to pay the city back for the generous incentives it received. The failure to include clawback provisions adds to the chance that tax incentive programs will not be an effective use of government resources.

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Recommendations

A thriving economy, skilled workforce, good infrastructure, and high quality of life for residents are the most effective ways to attract a company to do business in a city or state.[23] Tax incentives intended for economic development divert funding from these foundational programs, ultimately hindering a jurisdiction's growth. DC's economic development tax expenditure programs should be devised with clear goals, monitoring processes, and clawback provisions.

The two tax incentives described in this analysis, the QHTC and the supermarket incentive were introduced with good intention, but they are not effective tools for promoting their goals. Drawing from the CFO's findings and recommendations, here are some ways to remedy the current ineffectiveness of the programs:

Eliminate the Grocery Store Incentive Program and Use Resources in More Targeted Ways

Given the lack of success in bringing grocery stores to DC's food deserts, the District should eliminate the grocery store incentive program, meaning that no new stores could claim the credit. Any resulting savings could be used to more directly invest in efforts to bring new grocery options to needed areas.

Scale Back and Strengthen High Tech Incentives

There are several ways to strengthen the QHTC program and limit its cost:

- **Tie new subsidies to companies that are new or expanding.** Moving forward, the QHTC incentives should be pinpointed to new companies in DC, if possible. A more transparent and thorough certification process would help ensure that only new companies or those expanding their work are benefitting.

- **Limit the time period that subsidies can be claimed.** Under current rules, companies can claim QHTC benefits in perpetuity. This can be amended by putting time limits on certain tax breaks. For the franchise tax, while still *generously* permitting companies to pay 0 percent for five years, DC could eliminate the benefit of a reduced 6 percent rate that companies currently continue to get after the five years. For capital gains, DC could put a time limit on the reduced rate of 3 percent, such as for five years. Doing this would continue to incentivize companies starting up but prevent the indefinite loss of revenue. For companies already benefitting from the reduced tax rates, there can be a transition period to return them to paying normal rates.

- **Limit the total amount that a company can claim in the fiscal year.** The CFO recommends capping the total amount a company can receive in deductions at either $100,000 or $250,000 per firm per year. This will prevent large companies from claiming too much in benefits.[24]

- **Implement clawbacks.** If a recipient corporation fails to maintain its end of the bargain of staying in the District and engaging in specific practices, it should be subject to subsidy recapture or rescission.[25] For example, if a QHTC company leaves the District within the first 2 years of receiving incentives, it could be required to repay all of the subsidies it receives. From 2 years on, a decreasing percentage of the subsidy could be repaid.

- **Create transparency and accountability.** All tax incentives should be assigned an agency apart from the CFO to oversee its progress, and should be established with a set of performance metrics.

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