Special Report

Tax Incentives for Investment: A Review of a Study of the Studies

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In this article, McIntyre reviews a recently published book by a noted public finance economist, Richard M. Bird, who is director of the Institute for Policy Analysis at the University of Toronto. Bird's book examines several dozen studies of tax incentives, which have been written in Canada, the United States, and elsewhere. As McIntyre outlines, Bird concludes that little is known about the actual effects of tax incentives, that available research techniques are not able to improve this situation very much, and that what evidence there is casts considerable doubt on the effectiveness of most tax incentives.

Listen with care
to this, now, and a god will arm your mind.
Square in your ship's path are Seirenes, crying
'Tax Incentives' to bewitch men coasting by;
woe to the innocent who hears that sound!
He will not see his lady nor his children
in joy, crowding about him, home from sea;
The Seirenes will sing his mind away
on their sweet meadow lolling. There are bones
of dead men rotting in a pile beside them
and flayed skins shrivel around the spot.
Steer wide;
Keep well to seaward; plug your oarsmen's ears
with beeswax kneaded soft; none of the rest
should hear that song.

Adapted from Kirke's warning to Odysseus in The Odyssey, translated by Robert Fitzgerald (or some other writer of the same name).

The siren song of tax incentives has bewitched the minds of politicians for decades. That song has particular allure for the new administration, which has come to power on a pledge both to revitalize the U.S. economy and to get the government off the back of the American business community. Policy makers in the new administration are inclined to believe that the federal government can effectively regulate the economy through the judicious use of bigger and better tax incentives. Before acting on that inclination, they should read a new book by Richard M. Bird entitled Tax Incentives for Investment: The State of the Art.[1] Unless they have already stopped their ears with wax, they will hear proof that tax incentives are an unreliable, perhaps ineffective mechanism for guiding private economic choices.

Mr. Bird undertakes in his book to examine critically the several dozen studies of tax incentives carried out in Canada, in the United States, and elsewhere. Though Bird's focus is on Canada, his 'three rather disconcerting conclusions' are equally applicable to the United States. First, Bird reports that economists and other researchers know amazingly little about the efficiency and effectiveness of the investment incentives used so profligately by many national governments. Second, he reluctantly concludes that 'the available research techniques are incapable of improving this sad state of affairs very much.' Third, Bird finds that the available evidence suggests that tax incentives 'are neither efficient nor effective in achieving most of the objectives for which they were supposedly introduced.' (p. 2.)

Why We Know So Little

Our general ignorance of the overall impact of tax incentives is due to the complexity of the measurement problem, not to a lack of research. Indeed, Bird thinks that 'further research along traditional lines seems unlikely to prove profitable.' (p. ix.) Measurement is difficult for at least three reasons. First, economists have not developed a 'generally accepted or acceptable theory of investment behavior.' (p. 56.) Economists feel forced to pretend that business executives make investment decisions according to the so-called neoclassical model — which assumes a fully competitive market, a profit-maximizing motive, and full knowledge of the likely yields from alternative investment strategies. In fact, of course, market forces do not [p. 492] operate freely in parts of the economy, and some evidence suggests that investors make their decisions more as a reaction to the expected level of future sales than to carefully calculated expected profit from those sales. (p. 36.) Small businesses, moreover, generally 'do not really do the explicit investment profitability calculations needed to make full use of the incentives.' (p. 52.)

[1] Published by Canadian Tax Foundation, Toronto, Canada, 68 pp., $4.50. Professor Bird is Director of the Institute for Policy Analysis at the University of Toronto and has written extensively in the field of public finance.

A second measurement problem arises because of the possible effects of an incentive on reducing investment in the disfavored portions of the economy. Bird notes that several studies show that investment incentives 'affect not the level but the composition of investment.' (p. 47.) This impact might be desirable under certain circumstances, but in other situations the change in composition of investment may reduce overall productivity or defeat whatever other goal the incentive may be pursuing. Studies based on interviews with business executives can tell nothing about the secondary impact of incentives; an executive in the favored manufacturing sector, for example, will have no reliable information about the possible negative impact of a manufacturing tax subsidy on the real estate sector. Econometric studies are better suited to taking those secondary effects into account, but Bird nevertheless concludes that the present state of the econometric art is not up to that task. (p. 48.)

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Finally, the impact of an investment incentive depends upon the economic environment in which it is offered. All tax incentives reduce government revenues otherwise available. That revenue loss can be financed through higher taxes, through deficit spending, or through spending cuts. All of these alternatives have difficult to determine but potentially dramatic effects on investment behavior. Yet studies of tax incentives have great difficulty taking these environmental factors into account.

Incentives Are Probably Ineffective

Because of the formidable measurement problems, Bird is agnostic about the effectiveness of tax incentives. He allows that some may be useful and some may produce unmitigated disasters though the 'whens' and the 'whys' are unclear. He does stress that there is absolutely no empirical or theoretical evidence to support the grand claims for tax incentives often made by their political advocates. On the contrary, almost all of the econometric studies he reviews conclude that tax incentives have not been successful in increasing investment levels — the claim most often made for them in the United States. Indeed some studies indicate that the typical investment incentive either destroys jobs or, at best, creates a few jobs at enormous cost, though job creation is another of the commonly stated objectives of investment incentives.

Even survey studies based on interviews with business executives often report a disappointing impact of incentives on the investment decision — generally showing a minor change in the timing of investment but none in the overall level of investment. One Canadian survey study showed a dramatic impact of incentives on the level of investment, but Bird seriously undermines the credibility of that study. For the reasons discussed above, the studies are not conclusive of the impact of incentives, but they certainly raise some strong negative presumptions.

What Use Are Studies?

Despite the inadequacies of the incentive studies reported by Bird, most of the studies are not a waste of time or money. Though they are tricky to interpret and do not give refined answers to important questions about the overall impact of tax incentives on the national economy, many at least reduce the area of uncertainty.

For example, studies can measure, albeit crudely, the relative effectiveness of different types of incentives in achieving specified goals. Similarly, they sometimes can determine an upper bound on the possible impact of incentives and can specify the conditions required for tax incentives to have any reasonable chance of achieving their objectives. Thus the studies provide some constraint on the idle boasts of those who seek to feed at the public trough.

Conclusion

Bird concludes that tax incentives may be good in some ways, or for some people, and bad in other ways or for other people. More importantly, he demonstrates that the theoretical and empirical foundation for tax incentive policies is extremely weak. This state of affairs is all too common in other areas of public policy—no one seriously believed, for example, that the Tellico Dam project could be justified on cost/benefit grounds. But Congress and the interested public at least are aware of the rules of the game when wasteful direct expenditures are enacted.

Tax incentives, in contrast, get support not only from the special interests and the back scratchers of Congress but from genuine, though misinformed patriots of all political stripes. Bird is resigned to the fact that ‘yet another report concluding that most investment incentives have been tried and found wanting’ will have little success in ‘dampening the enthusiasm of the advocates of such devices.’ (p. 2.) He has nevertheless made accessible to policy makers an analytical summary of the scholarly literature on tax incentives. The book is remarkably free of ideological bias and economic jargon. It deserves to be read by anyone who is tempted to ignore Kirke’s timeless warning to Odysseus.