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Executive Summary

# Tradable Tax Credits: Analysis and Guidelines for Israel

Gilad Beery
Research Supervisor: Dr.Sagit Leviner

Jerusalem Institute for Israel Studies
Milken Innovation Center

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The Program awards annual fellowships to outstanding Israeli graduate students. We train and deploy some of Israel's best and brightest young professionals to create pragmatic financing and economic policy solutions.. Our applied research and Financial Innovations Labs® are a launching pad for transformative change, using innovative financing mechanisms, programs and policies to bridge social, regional, economic and productivity gaps within Israel and between Israel and the world.

In addition, Fellows craft their own projects during their internship aimed at barriers to job creation and capital formation in Israel. The Fellows' research, carried out under the guidance of an experienced academic and professional staff, support business and policy makers to shape economic reality in Israel. The program offers the ultimate training opportunity, combining real-life work experience with applied research.

Throughout the year, Fellows receive intensive training in economic and financial analysis, public policy and research methods. They acquire tools for communication and presentation, policy analysis, leadership and project management. The fellows participate in a weekly research training workshop where they work with senior economic and government professionals, business leaders, and top academic and financial practitioners from Israel and abroad. They also participate in an accredited MBA course, taught at the Hebrew University School of Business Administration by Prof. Glenn Yago.

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*Tradable tax credits are tax benefits which can be exchanged from taxpayers who are unable to redeem the full extent of a tax credit to those that are able to redeem the full extent of a tax credit. This is because tax credits can only be utilized fully if a taxpayer has a tax liability large enough to use the entirety of the credit.*

1. **Background**: The vast majority of tax credits in the world, and in Israel in particular, are "non-tradable," meaning they can be used only by the original beneficiary and cannot be transferred to another taxpayer. In the United States, however, there are a variety of intervention programs in which tradable tax credits are used, i.e., the original beneficiary could sell the credits to another entity, and thus realize the incentive of the benefit. A prominent example is the LIHTC (Low Income Housing Tax Credits) program, which is a central intervention of the federal government in the area of affordable housing. Over the course of its 27 year existence, the LIHTC program has seen more than $ 100bn invested, and more than 2.5 million new housing units have been built.
2. **Research Questions and Methodology:** This American deviation from the accepted practice of non-tradable tax credits raises the following questions:
   A. Why was this unusual way of incentivizing chosen, and what are the characteristics, advantages and disadvantages of tradable tax credits?
   B. What are the guidelines for using tradable tax credits in the Israeli context?

   This study surveys the literature on tradable tax credits and presents a case study of the LIHTC program (the largest and oldest tradable tax credits program) to answer these questions.
3. **Conclusions:** The study shows that the use of these credits is advantageous for two main reasons:
   A. <u>Solution for the "upside-down bias" of tax credits</u> - The ability to utilize tax credits increases with the size of the tax liability. High-earners who have a large tax burden are thus more apt to take advantage of tax credits. Making tradable tax credits may improve the uniformity of the incentive, making it more just and effective.
   B. <u>Tradable tax-credits can become an effective platform for public-private partnership (PPP)</u> - the incentive structure that could be created by using these tradable tax credits could encourage non-governmental actors to reach the targets set for them by the government. This is an attractive feature because structuring an effective cooperation is one of the central challenges of PPP.
4. **Challenges**: alongside the added value of tradable tax credits there are also considerable challenges:
   A. <u>Complexity:</u> We point out the relatively high complexity of financing through tradable tax credits. This complexity may increase 'transaction costs' and thus erode the incentive. Indeed, in the example of LIHTC we show that the process of raising money to build a project within the program is significantly more time consuming and costly than non-LIHTC construction project.
   B. <u>Sensitive to market shocks:</u> utilization of tax credits requires a tax liability of an adequate size. Consequently, a tradable credits market is vulnerable in a scenario in which the tax liability of many taxpayers shrinks in the case of a financial crisis.

C. <u>A subsidy for the rich</u>: the beneficiaries of tradable tax credits are usually corporations with high tax liability. This reality gives the rich an extra advantage over the poor.

5. **Case Study - The LIHTC Program:** The Low Income Housing Tax Credits is the groundbreaking program for tradable tax credits in the United States. It is a vivid example of both the advantages and disadvantages of these credits. On the one hand, the program managed to mobilize private capital for affordable housing in a scalable and sustainable way for both for-profit and non-profit entities. On the other hand, the program is fraught with high 'transaction costs', eroding the government's incentive to participate. In addition, the financial crisis of 2008 exposed its sensitivity to economic shocks. Lastly, it reduces the tax liability of an already large and powerful corporations, thus suggesting that it may contribute to growing inequality.
6. **Guidelines**: based on the literature review and the analysis of the LIHTC program, we propose the follow guidelines for the implementation of tradable tax credits in Israel: Since Israel is a small market lacking social investment incentives for financial institutions, tradable tax credits are less attractive in an Israeli context so an ecosystem of supportive of tradable tax credits must be built. At the same time, the presence of many non-profit institutions in Israel makes tradable tax credits more relevant in Israel.

   Still, we recommend restricting tradability at least initially, to allow easier supervision of the credits. We also recommend creating guidelines for how the government can intervene in the use of tradable tax credits. For example, the government should perform a comprehensive cost-benefit analysis of the tax credits. In addition, the government should simplify and standardize the process of obtaining the credits.

   Finally, it must be noted that certain policy areas are more suitable for tradable tax credits than others. For example, as the sector can help to aid vulnerable populations, and the more it needs to ensure compliance with the objectives over time, it is more appropriate to use tax credits tradable.

Overall, this study concludes that there is potential gain in the adoption of tradable tax credits as an additional, innovative tool for the government. However, the study also concludes that careful decision-making and design of a tradable tax credit program is key to its success.

Jerusalem Center for Israel Studies
Milken Innovation Center
20 Radak Street, Jerusalem 9218604
Tel: 972-2-5630175 ext.34
www.jiis.org.il
www.milkeninnovationcenter.org