



# Reducing Budget Risks

Using data and design to make state tax incentives more predictable

# The Pew Charitable Trusts

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## Overview

A sudden, unexpected decrease in revenue is one of the most challenging budget situations that state governments can face. When policymakers are caught off guard, they often must quickly make difficult choices between raising taxes and cutting spending to keep budgets balanced.

Many factors cause revenue volatility and unpredictability. In particular, states have recently struggled with the cost of economic development tax incentives, which cause decreases in corporate tax revenue. Every state uses tax credits and other incentives to encourage business growth and job creation. In many cases, the fiscal cost of these programs has increased quickly and unexpectedly by tens or hundreds of millions of dollars.<sup>1</sup> Yet these problems are not inevitable; some states have proved that incentives can be used effectively without throwing budgets out of balance.

To understand both the sources of the difficulties and potential solutions, The Pew Charitable Trusts reviewed numerous state documents and news articles and conducted phone interviews with more than 40 government officials and experts from 20 states.<sup>2</sup> This group included legislative and executive branch officials who are responsible for economic development policy, state budgets, and forecasting revenue.

Many states are seeking to create jobs and expand their economies while avoiding budgetary surprises. Pew's research shows that states should use two strategies to address this problem.

### 1. Gather and share high-quality data on the costs of incentives by:

- Regularly forecasting the cost.
- Monitoring costs and commitments of large and high-risk programs.
- Sharing timely information on incentives across relevant agencies.

### 2. Design incentives in ways that reduce fiscal risk, including:

- Capping how much programs can cost each year.
- Controlling the timing of incentive redemptions.
- Requiring lawmakers to pay for incentives through budget appropriations.
- Restricting the ability of companies to redeem more in credits than they owe in taxes.
- Linking incentives to company performance.
- Requiring businesses to provide advance notice of program participation.

## Glossary

**Authorize:** Under some tax incentive programs, state agencies will authorize certain tax credits following an initial application. The authorization confirms that the company can participate in the program but does not necessarily guarantee that it will receive tax credits. In some cases, the applicant may need to meet performance goals, such as creating a set number of jobs, in order to benefit from the program.

**Caps:** Many states have placed annual limits, or caps, on the cost of specific tax incentive programs. Caps can be placed on the value of incentives authorized, issued, or redeemed in a year.

**Carry forward:** Some incentive programs allow companies to save, or carry forward, tax credits that have been issued to them and redeem them in future years.

**Cash incentives:** Besides providing tax incentives, states also offer direct payments in the form of grants and loans to businesses in an effort to change their behavior, encouraging them to create jobs, invest in equipment and facilities, or engage in other economically beneficial actions.

**Economic development tax incentives:** Every state's laws include provisions that are exceptions to regular tax rules, such as tax credits, exemptions, and deductions. These provisions are economic development tax incentives if they are intended to achieve an economic goal by encouraging people or businesses to do something that they otherwise would not have done (e.g., locate a company in a certain area, create or retain jobs, or invest in equipment and facilities).

**Fiscal costs (or simply "costs"):** The reduction in state tax revenue as a result of providing incentives.

**Issue:** When a state agency determines that a company has satisfied all necessary eligibility and performance requirements, the agency will issue the company a tax credit, which it can use to reduce its taxes.

**Redeem:** State revenue is reduced when a company redeems a tax credit on its tax returns. The tax credit reduces the amount of taxes the company owes and thus reduces state revenue the year the credit is redeemed. In some cases, a tax credit can be redeemed years after the credit is issued.

**Refundable:** Sometimes companies earn more in credits than they owe in taxes. If the incentive program is refundable, the company is allowed to redeem more than it owes, and the state pays the company the difference in a refund check.

Continued on the next page

**Revenue forecasts:** To write state budgets, lawmakers rely on regular estimates of how much money the state will collect from taxes, fees, the federal government, and other sources.

**Targeted:** To try to ensure that the incentives will efficiently achieve their specific goals, the laws creating incentives limit which companies will be able to use them. Some incentives are targeted by activity (e.g., only businesses that create jobs are eligible); some are targeted by location (e.g., only businesses in distressed areas are eligible); some are targeted by economic sector or industry (e.g., only manufacturers are eligible); and some are targeted in multiple ways.

**Transferable:** Some incentive programs are transferable, allowing companies to sell credits to other businesses or individuals, who can then use the credits to reduce their own tax bills.

## How incentives can cause fiscal risk

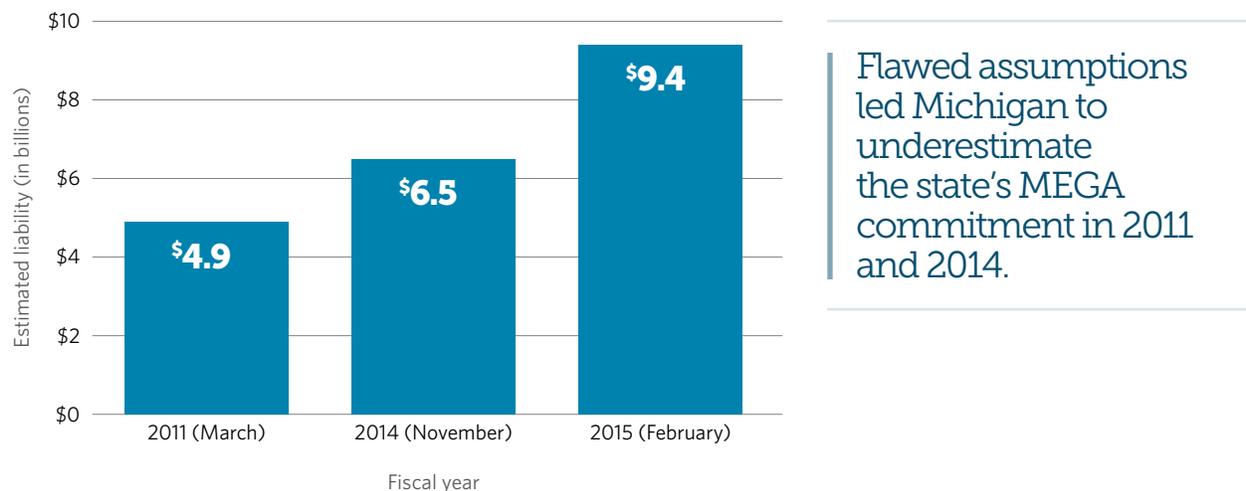
The experiences of several states help illustrate how incentives can cause budget challenges.

For example, when Michigan lawmakers passed the fiscal year 2015 budget, they believed, based on the data available at the time, that revenue would be enough to cover spending. But less than four months into the year, it became clear that the cost of Michigan Economic Growth Authority (MEGA) tax credits—one of the state's incentives—was going to be much higher than expected, throwing the budget out of balance by hundreds of millions of dollars.<sup>3</sup>

Although lawmakers closed the budget gap with spending cuts, officials remained concerned.<sup>4</sup> MEGA is expected to cost billions of dollars in coming years.<sup>5</sup> Many of the credits causing fiscal challenges were authorized in 2010 as part of long-term deals with distressed automakers, without protections to limit the program's cost.<sup>6</sup> The state badly underestimated the number of jobs the companies would create and the salaries they would pay because of flawed wage growth assumptions that state officials had used and the surprisingly strong recovery of the auto industry. Since the companies were paying more in wages to their workers, they earned more tax credits.<sup>7</sup>

Figure 1

### Michigan's Estimates of Its MEGA Tax Credit Liability, FY 2015-32



Note: The increased estimates were primarily a result of refinements to the state's forecasting methods, although new tax credit authorizations and revisions to existing authorizations also increased the state's liability.

Sources: Michigan Economic Development Corp.; Michigan Senate Fiscal Agency

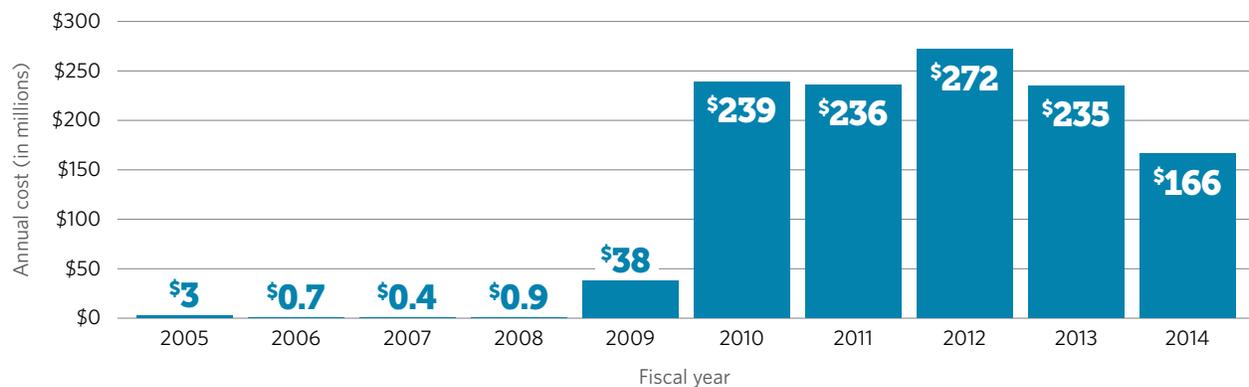
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"I would still admit very publicly that there's still volatility in the numbers," state budget director John Roberts said in February 2015, "so more predictability would be a great thing for us."<sup>8</sup> To better prepare for the future, the Michigan Legislature is working with executive branch agencies to develop better forecasts.<sup>9</sup>

Michigan is not the only state where economic changes have led to a sharp increase in incentive costs. Louisiana enacted a tax exemption for horizontal natural gas drilling in 1994, but the costs ballooned only after energy companies discovered a sizable deposit of extractable natural gas in 2008 and began using horizontal drilling regularly. The program grew from costing \$285,000 in fiscal 2007 to about \$239 million in fiscal 2010.<sup>10</sup>

The Louisiana and Michigan situations contributed to fiscal challenges, but at least the desired economic activities were increasing quickly along with the costs. Yet quite often that is not the case. New York’s “brownfields” tax credits—which lawmakers created to encourage cleanup and development of contaminated sites—have cost far more than anticipated since the program opened in 2005.<sup>11</sup> State officials estimated that the brownfields program cost more than \$500 million in 2013, making it New York’s costliest business tax credit.<sup>12</sup> One reason the program has proved expensive is that the state has awarded credits to projects that had little to do with its environmental goals. One hotel project received more than \$100 million in credits without reporting any environmental remediation work.<sup>13</sup> Because of concerns that the program was poorly targeted, New York lawmakers revised it in 2015 to more closely link the size of the awards to the amount of environmental remediation.<sup>14</sup>

Figure 2  
**Cost of Louisiana’s Tax Exemptions for Horizontal Oil and Natural Gas Drilling**



Sources: Louisiana Department of Revenue; Louisiana Legislative Auditor

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As New York’s experience shows, broad or unclear eligibility rules often contribute to fiscal risk. When states are unsure how many projects or companies will qualify for an incentive, officials often struggle to predict how much it will cost. Oregon’s Business Energy Tax Credit (BETC), a program for renewable energy projects such as wind and solar farms, cost hundreds of millions of dollars more than anticipated after lawmakers expanded it in 2007. The cost increases were as much due to accounting maneuvers by program participants as they were a result of a genuine increase in renewable energy production: The program’s rules included a limit on how much any one project could receive in incentives, but some applicants simply divided projects to evade these limits. If a development that might have applied as one wind farm applied as four adjacent ones instead, it could quadruple its benefits. The program exacerbated Oregon’s budget challenges during the economic downturn, when state lawmakers approved both significant tax increases and budget cuts.<sup>15</sup>

As the BETC situation reflects, unexpected costs are often a sign that the programs are not well-designed or well-targeted to achieve their intended goals. Making the costs of the incentives more predictable can make the programs more economically effective, too.

In the 2011 fiscal year, New Mexico’s High-Wage Jobs Tax Credit cost the state \$9.3 million. The next year, the cost increased to approximately \$48 million, with no corresponding increase in jobs.<sup>16</sup> The program was intended to encourage hiring that otherwise wouldn’t happen, but there was no time limit for applying for the credit. As a

result, some of the cost increase went to reward companies after the fact for hiring decisions made as far back as 2004, the year the program was created.<sup>17</sup> In addition, a technicality allowed some national retailers to claim the credit, potentially putting New Mexico businesses at a disadvantage.<sup>18</sup> Finally, the rules of the program also allowed companies to count jobs they acquired through mergers and acquisitions as new, even if the businesses had not boosted net employment in New Mexico.<sup>19</sup>

As these flaws became clear, even some of the program's biggest supporters agreed that changes were needed. "It is an extremely beneficial refundable tax credit," said Debra Inman, a vice president of the nonprofit Albuquerque Economic Development, "but if you're going to have companies that were never intended to qualify for the credit using it, you're not going to have it around." In response, New Mexico policymakers worked with tax and economic development experts to design reforms, which lawmakers approved in 2013.<sup>20</sup>

## Uncertainty about the timing of costs

Along with increasing the predictability of the long-term costs of incentives, officials need to be able to anticipate how much the programs will cost from year to year. That is difficult, because many programs are designed in such a way that years can pass between when companies apply for incentives and when they claim the benefits on their tax returns. Many tax credits involve a multistep process, with the exact steps varying from state to state and program to program.

### Life Cycle of a Tax Credit

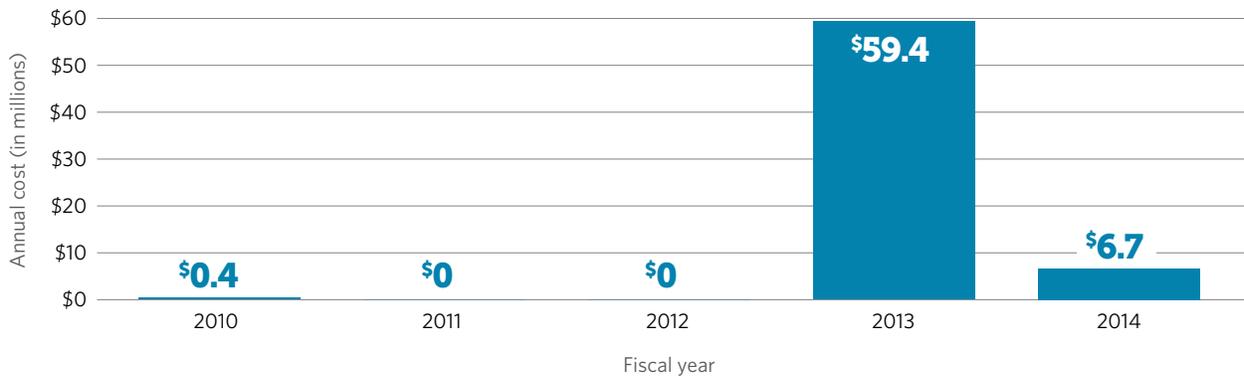
For some programs, a state agency will *authorize* incentives after companies or projects apply. This initial authorization means the company is eligible to participate in the program but does not necessarily guarantee that it will receive the incentives. Instead, the company may have to meet performance standards, such as creating a set number of jobs. Then, the state will *issue* the credits, allowing the company to begin using them to reduce its taxes. For other programs, there is no authorization step; the first interaction between the state and the company is when credits are issued.

Even after credits are issued, years could pass before the credits affect the state's bottom line, because some programs allow issued credits to be carried forward to future years. State revenue is reduced when the credits are *redeemed* on a company's returns. (Each state has its own terminology to describe the life cycle of a tax credit; for the sake of clarity, this report uses *authorize*, *issue*, and *redeem*.)

These complexities can lead to volatile claims. Virginia's Coal Employment and Production Incentive Tax Credit cost the state \$59 million in fiscal 2013 after two cost-free years—the result of rules that allow businesses to carry forward credits for up to 10 years without using them on their tax returns.<sup>21</sup> Under one Oklahoma tax credit program, businesses can carry incentives forward indefinitely, and these taxpayers currently hold \$250 million to \$300 million in credits.<sup>22</sup> That number is expected to rise in coming years, but policymakers lack good information on when or whether companies will ultimately redeem the credits.<sup>23</sup>

Figure 3

## Annual Cost of Virginia's Coal Employment and Production Incentive Tax Credit



Source: Virginia Department of Taxation

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Because incentive programs often involve such long-term commitments, states can have difficulty changing course if programs cost more than expected or if policymakers conclude that they are not effective economic development tools. In fact, several states have continued to spend huge amounts of money on programs that policymakers had ended for new applicants years earlier.

That was the case with Michigan's MEGA tax credit program, which was closed to new participants at the end of 2011 as the state shifted away from credits and toward cash incentives. Cash programs provide much more fiscal certainty because they are limited by the amount of money that lawmakers appropriate to them in the annual budget process, but the costs of MEGA are still expected to continue through at least 2032.<sup>24</sup> The Michigan Economic Development Corp. estimated in February that the state's future liability could be as much as \$9.4 billion.<sup>25</sup> Likewise, New York replaced its Empire Zone program with a new incentive in 2010 after a series of reports documented flaws in the program's design. Yet in 2013, the old program still cost New York \$374 million, and the state must continue to pay out benefits until 2020.<sup>26</sup> When Hawaii ended its High Technology Business Investment Tax Credit in 2010, the state still faced a fiscal obligation of more than \$800 million, according to a 2012 audit.<sup>27</sup>

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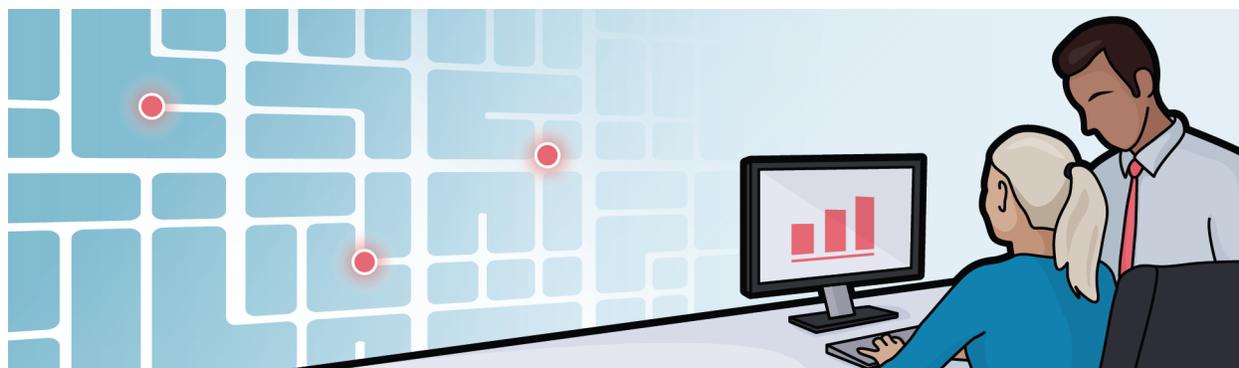
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One state that is beginning to face these challenges is New Jersey, where the Office of Legislative Services reported in March 2015 that tax credits authorized annually by the state's Economic Development Authority had grown from \$147 million in 2010 to more than \$1.7 billion in 2014.<sup>28</sup> That increase reflects a political consensus: An expansion of incentives in 2013 was supported by both Governor Chris Christie (R) and state Democratic legislative leaders. Knowing that the budget impact of today's agreements with companies will last for a decade or more, policymakers are now beginning to focus on ensuring that the state isn't surprised by the costs. "We're going to have to pay more attention to it," said David Rosen, who until recently served as New Jersey's legislative budget and finance officer, "because the numbers really start to balloon going forward."<sup>29</sup>

## Strategies

Pew's research identified two strategies for states to employ for effective use of economic development incentives while avoiding unpleasant budgetary surprises.



### Strategy No. 1: Gather and share high-quality data on the costs of incentives

States often do not realize until after budget problems emerge that the costs of incentives are increasing quickly. At that point, lawmakers are forced to make difficult choices between raising taxes and cutting spending. If they had more warning, policymakers could either prepare for the cost increases or prevent them by changing the design of the incentives.

To help avert these challenges, states can:

- Regularly forecast the cost.
- Monitor costs and commitments of large and high-risk programs.
- Share timely information on incentives across relevant agencies.

#### Regularly forecast the cost

Many states lack a consistent process for forecasting the fiscal impact of their incentives. The absence of such a process is a major reason that cost increases often surprise policymakers.

Most states do regularly publish tax expenditure reports that compile the historical costs of tax incentives. However, many of these reports do not include projected costs.<sup>30</sup> Often, those that do are not updated frequently enough—once every year or two is typical—to provide timely information to state budget officials.

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The lack of data on the future costs of incentives creates challenges for state officials when they try to forecast overall revenue collections. Revenue forecasting is a vital part of every state's budget process: Policymakers rely on the forecasts to tell them how much money will be available to spend. When states collect less revenue than predicted, they often experience a budget crisis.

To develop revenue forecasts, states project the economic outlook for the period that the budget will cover—one year or two, depending on the state. Officials then use computer models to estimate how much revenue the state will bring in, based on historical information about how economic and demographic conditions have translated into revenue collections.

Lacking forecasts of the future costs of incentives, most states simply assume that the models will capture the effects of long-standing incentives, even without specific estimates. In most states, revenue forecasters make explicit adjustments only for incentives that are new or have recently changed, because their costs would not be part of the historical data the models use. This approach, however, is not always adequate. If older incentives suddenly start costing far more—as they have in Louisiana, Michigan, New Mexico, Virginia, and other states in recent years—revenue forecasts are less likely to be accurate, putting states at risk of budget shortfalls.

One option is for states to regularly project the costs of each economic incentive. For example, Iowa's Department of Revenue forecasts the costs of each tax credit for five years, with the numbers updated three times a year, and these projections are incorporated into the revenue forecasts.<sup>31</sup> Iowa develops its credit forecasts based on historical data from tax returns that reveal how the value of credits the state issues typically translates into redemptions for each program. Amy Harris, chief economist and Research and Analysis Division administrator for the Department of Revenue, says her department might know for a particular credit that, historically, only 80 percent is typically ever redeemed, with 20 percent redeemed in the first year, 20 percent in the second year, and so forth. From that, Department of Revenue staff can take the aggregate amount authorized from each year and forecast the amount of tax credits that will be redeemed in future years.<sup>32</sup>

Iowa also regularly monitors the accuracy of its projections.<sup>33</sup> If a state makes its best effort to forecast the cost of an incentive and cannot come up with reliable numbers, that could be an indication that the design of the program needs to be adjusted to create more predictability.

A 2015 Louisiana law requires state revenue forecasters to project the costs of tax incentives.<sup>34</sup> The sponsor of the legislation, state Senator Jack Donahue, chairman of the Senate Finance Committee, thinks this approach will help the state better understand how the programs fit in the overall budget picture. "I understand the business perspective of incentives and their value," Donahue said. "I've been a businessman for a long time. But there are also priorities of state to be careful of, like education and roads. So we need to keep better track of [tax incentives.]"<sup>35</sup>

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**At a minimum, states should monitor their largest incentives—those that could cause significant budget problems if they cost more than expected—and those that lack clear protections to prevent them from costing more than anticipated.**

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### Monitor costs and commitments of large and high-risk programs

Some state officials make the case that forecasting the cost of every incentive is not necessary, because some programs are small and are designed or targeted in such a way that they are likely to remain small. At a minimum, states should monitor their largest incentives—those that could cause significant budget problems if they cost more than expected—and those that lack clear protections to prevent them from costing more than anticipated.

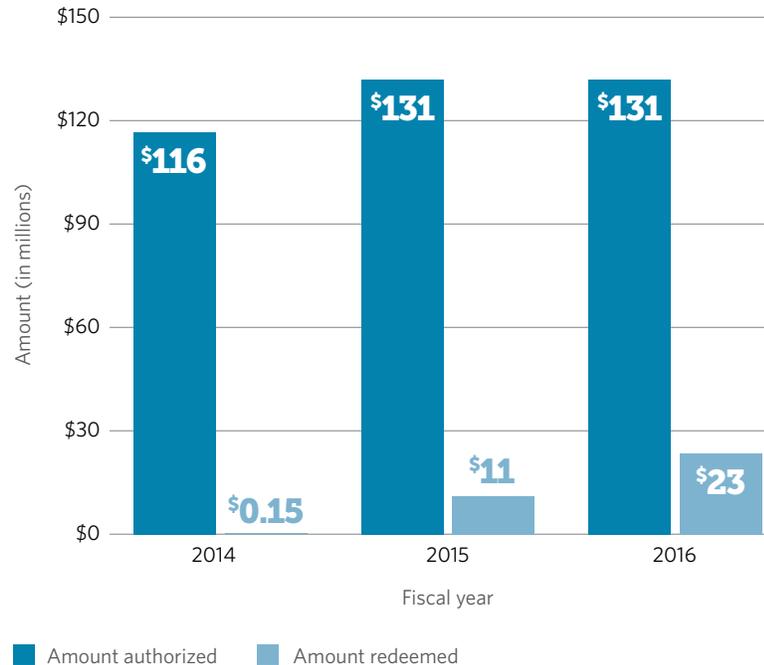
For example, the Nebraska Department of Revenue produces 11-year projections of the fiscal impact of the state's largest incentive program, the Nebraska Advantage Act.<sup>36</sup> Similarly, in Michigan, after the surprise increase in the costs of the state's MEGA credits in early 2015, staff analysts from across the legislative and executive branches have focused on improving estimates of the state's MEGA liability, which is regularly projected as part of the revenue forecasting process.<sup>37</sup>

In addition to forecasting how much incentives will cost in any given year, states should track the total value of their obligations. When they agree to provide incentives, they are making a financial commitment that might last five, 10, or even 20 years. By monitoring long-term obligations, policymakers can have confidence that the state is not making promises that will cause budget problems down the road.

Missouri, for example, provides information on future tax credit commitments in a report that is published each year. Missouri Works, a new incentive the state created in 2013, helps illustrate why this information is valuable. This program cost the state less than \$150,000 in fiscal 2014. In some states, that figure would be the only one reported, and the program would not appear to be a significant commitment. In Missouri, however, the Department of Economic Development lists the value of credits that the state has authorized but not yet issued. The report shows that the department authorized \$116 million in Missouri Works incentives in fiscal 2014.<sup>38</sup> These costs will affect Missouri's budget gradually, because companies that qualify for the program have to meet job creation standards and then can redeem the credits for up to six years.

Figure 4

## Value of Tax Credits Authorized and Redeemed Under the Missouri Works Program



Missouri produces detailed forecasts of the costs of the state's tax credits. These forecasts show that the Missouri Works program is not costing much yet, but the state is authorizing incentives today that are likely to increase costs in the future.

Note: Fiscal year 2015 and 2016 data are projections.

Source: Missouri Department of Economic Development

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The Department of Economic Development also provides data on when the costs might arrive and how the state's commitments could grow. For each program, the department forecasts the value of credits that will be authorized, issued, and redeemed in both the current year and the next budget year.<sup>39</sup>

One reason some incentives can have a long and uncertain fiscal impact is that the programs include carryforward provisions, which allow companies to save up tax credits after they are issued and redeem them years later. Virginia has a well-established process to monitor carryforwards. Whenever a state agency issues a credit, staff from the Virginia Department of Taxation enters the information into the state's tax processing system. When companies or individuals redeem the incentives, the amount is subtracted from the taxpayer's credit balance. This approach allows the Department of Taxation to keep a running tally of the value of credits that taxpayers have redeemed, as well as credits they are carrying forward to future years. These data are not just valuable for understanding the long-term fiscal impact of these programs; they also help the department to ensure that businesses are redeeming only the credits that state officials have issued to them.<sup>40</sup> Ohio's Department of Taxation has implemented a similar system.<sup>41</sup>

### Share timely information on incentives across relevant agencies

Many parts of state government have a role in administering and overseeing incentives. Economic development agencies often determine which companies receive incentives, and revenue agencies process the tax returns when companies redeem them. Various officials in both the legislative and executive branches also need to take incentives into account as they develop revenue forecasts and state budgets.

These offices and agencies do not always communicate and share data effectively, however. For example, governments sometimes treat certain information—such as the plans of specific businesses or how much they pay in taxes—as confidential, so agencies are reluctant to share it with one another. Technology also can be a challenge. Many incentive programs use paper application processes, and even when information is in computer databases, different agencies' systems often are not well-integrated.

The states that have made progress forecasting and monitoring the costs of incentives are working hard to overcome these challenges. In Missouri, Ohio, and Virginia, agencies that issue credits communicate the information to the revenue or tax department.<sup>42</sup> Other states base their information on the costs of incentives primarily on tax returns, which might not be filed until years after the credits are issued.

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### In Missouri, Ohio, and Virginia, agencies that issue credits communicate the information to the revenue or tax department.

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Missouri's Department of Revenue and Department of Economic Development share a unified database with tax credit information. Besides allowing data to pass quickly between the two departments, the database balances confidentiality concerns with the need to share information. Department of Revenue officials have access, within the database, to credit redemptions for specific taxpayers, but Department of Economic Development staff members are able to see only redemption data that are aggregated by program.<sup>43</sup>

Iowa has relied primarily on data from tax returns to develop its forecasts of tax credit costs, but the state is now in the process of implementing a unified database similar to Missouri's. The Iowa Economic Development Authority and the Department of Revenue will track the issuing and redemption of tax credits. The database will also incorporate tax credits authorized by other state agencies.<sup>44</sup>



## Strategy No. 2: Design incentives in ways that reduce fiscal risk

States can structure incentives so that officials can more easily forecast how and when the programs will affect their budgets. When creating new incentives or revisiting existing ones, lawmakers should carefully consider how to design programs that will both achieve economic goals and avoid undue fiscal risk. There are several options that policymakers should consider. States can:

- Cap how much programs can cost each year.
- Control the timing of incentive redemptions.
- Require lawmakers to pay for incentives through budget appropriations.
- Restrict the ability of companies to redeem more in credits than they owe in taxes.
- Link incentives to company performance.
- Require businesses to provide advance notice of program participation.

### Cap how much programs can cost each year

One of the strongest protections against surprise increases in tax incentive costs is an annual limit, or cap, on program costs. Caps can work in different ways. In some cases, businesses qualify for incentives on a first-come, first-served basis until the money for the year runs out. In other cases, all businesses apply for the incentives at the same time; then state officials choose which ones will receive them. In still others, every eligible business receives the incentive, but the value of each incentive is prorated to stay under the overall cap.

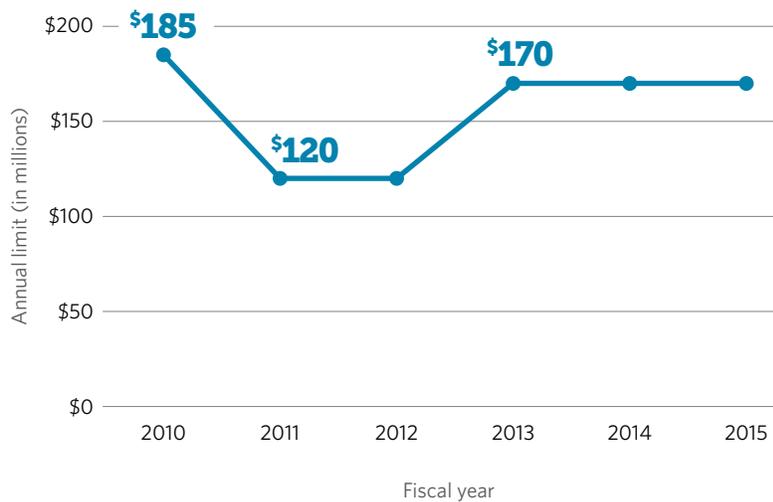
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Most states have placed caps on at least some specific incentive programs, but few have systematically applied this protection. One exception is Iowa, which installed an aggregate limit across many economic development tax credits in 2009.<sup>45</sup> This cap provides flexibility to both economic development officials and legislators. Officials have discretion to spend more or less on specific programs from year to year, so long as they abide by the aggregate limit. Lawmakers can adjust the cap from year to year depending on their priorities and the state's budget situation, in the same way that they can adjust spending levels in other policy areas such as education or transportation. Iowa legislators lowered the cap for fiscal 2011 when the economic downturn was straining the state's budget, then raised it for fiscal 2013.<sup>46</sup>

Figure 5  
Size of Iowa's Aggregate Tax Credit Cap



Iowa has placed a combined cap on many of the state's economic development tax credits. Lawmakers have adjusted the limit depending on their priorities and the state's budget situation.

Sources: Iowa Code; *Des Moines Register*

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Policymakers intend for some incentive programs to benefit all eligible businesses, so a cap could be seen as inconsistent with that goal. But California has implemented caps in an innovative way to overcome this concern.

In 2013, the state created a sales tax exemption for equipment purchased by manufacturers and research and development firms, with the intent of providing the exemption for all qualifying purchases by all eligible companies. Before the state's fiscal year begins each July 1, the California Department of Finance estimates the cost of the sales tax exemption and two other incentives—the California Competes Tax Credit and a credit to encourage hiring in distressed areas. If the cost of the three programs is expected to exceed \$750 million, the dollars available for California Competes are reduced. With California Competes, no company is automatically entitled to benefits; a competitive application process determines eligibility. By combining the caps, every eligible business still receives the sales tax exemption, but policymakers can have confidence that in the aggregate, the three programs will not cost more than intended.<sup>47</sup>

The cap on the California Competes Tax Credit is innovative in another way. California stages multiple competitions a year, rather than just one, for the tax credits. The idea, said William Koch, deputy director of the Governor's Office of Business and Economic Development, is to control the program's costs while still having incentives available whenever businesses are ready to grow.<sup>48</sup>

### Control the timing of incentive redemptions

Some incentives allow businesses flexibility around the timing of when they can earn incentives over years or even decades. Michigan was surprised by the costs of the MEGA program in 2015, in part because businesses were receiving incentives on an unclear schedule over 20 years.<sup>49</sup>

Similarly, programs may permit companies to carry forward credits that have been issued to them, allowing businesses to redeem these credits years later. Generally, the longer a business can carry forward an incentive, the harder it will be for state officials to predict the timing of the costs to the state.

Even caps do not necessarily make the timing of costs predictable. Many states apply caps to the value of incentives that are authorized or issued, but not to incentive redemptions, which affect state budgets directly. Capping redemptions provides states with the most certainty about the timing of costs, but the potential trade-off is that businesses may have less certainty about when they will be able to take advantage of the programs. For example, under Florida law, the value of tax incentives that businesses can redeem under two programs is limited to \$35 million combined. If the cap is reached in one year, businesses can redeem them the next year.<sup>50</sup>

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States can also ensure that each specific project or business that benefits from a program will redeem incentives on a predictable schedule. For example, projects that receive tax credits for rehabilitating historic properties in Maine are required to redeem the credits in equal installments over four years. Each project knows that it will be able to redeem the full installment each year because the credits are refundable. If their value exceeds the taxpayer's liability, the state pays the difference in a refund check.<sup>51</sup> These project-specific limits can help policymakers know how much the program as a whole will cost, so long as state officials are tracking how many projects they have approved and when recipients are scheduled to redeem their incentives.

### Require lawmakers to pay for incentives through budget appropriations

States can also set annual limits on incentive programs by requiring that incentives be funded by appropriations, like most government programs. As a result, lawmakers are in control of their costs and have an impetus to reconsider their effectiveness.

In Minnesota, one of the state's major tax incentives, the Job Opportunity Building Zones program, is being phased out. Rather than renew the program, lawmakers in 2013 decided to replace it with a new cash grant known as the Job Creation Fund.<sup>52</sup> "When there are tax credits, you don't know how much is actually being claimed," said Kevin McKinnon, deputy commissioner of the Minnesota Department of Employment and Economic Development (DEED). "It really depends on the tax situations of the businesses." In contrast, the Job Creation Fund provides fiscal certainty: Lawmakers appropriated \$24 million for the program for its first two years.<sup>53</sup>

Being subject to the appropriations process doesn't mean that participating businesses have to be left unsure about whether they will receive benefits. When a company is approved for the Job Creation Fund through DEED's competitive selection process, the department and business enter into an agreement in which DEED guarantees the incentives so long as the company meets required job creation or investment thresholds. DEED can hold on to the money to ensure that it will be able to pay for the incentives for the life of the agreements because it does not have to spend money that lawmakers appropriate to the Job Creation Fund in the same budget period in which it is appropriated. In some cases, businesses are allowed to receive benefits each year for seven years.<sup>54</sup>

Although an appropriations process is far more common for cash incentives than it is for tax incentives, it can work for tax incentives, too. In Florida's budget each year, lawmakers set how much money will be available for several of the state's programs, including cash and tax incentives. This approach has encouraged policymakers to scrutinize the programs in more depth, with the governor and legislators debating the right level of funding for the programs and how their effectiveness can be improved.<sup>55</sup>

## Restrict the ability of companies to redeem more in credits than they owe in taxes

Many of the incentives whose costs have rapidly increased in recent years have been either “refundable” or “transferable” tax credits. With refundable credits, if a company redeems more in incentives than it owes in taxes, the state pays the difference in a refund check. With transferable credits, the company can sell its excess credits to another taxpayer that owes the state taxes. Either way, companies’ tax liability can, in effect, be a negative number; they end up receiving more in benefits from incentives than they owe in taxes.

That level of generosity can allow the programs to grow quickly. For example, in New York, business tax credits rose from \$673 million in 2005 to \$1.7 billion in 2013, with refundable programs representing most of the increase.<sup>56</sup>

Officials in some states are considering making incentives nonrefundable or nontransferable as a way to keep costs under control. Louisiana, for example, faced a \$1.6 billion budget shortfall in 2015, so one way lawmakers closed the gap was by eliminating or limiting refundability for a few of the state’s major incentives. Those changes are expected to boost state revenue by \$129 million in the first year and \$735 million over five years.<sup>57</sup>

Despite the fiscal risks, states have a rationale for using refundable or transferable tax credits: The programs help businesses with little state tax liability. This group often includes startups, which may owe little because they are not yet turning a profit, and temporary projects such as film productions. Other tax incentives reduce only a portion of a company’s liability, which is not of much value to a company that does not owe much. If policymakers choose to make tax incentives refundable or transferable, though, it is even more important that the programs include other cost controls such as caps.

## Link incentives to company performance

The worst-case scenario for states occurs when incentives both prove expensive and fail to achieve their economic development goals. In 2010, Rhode Island made a \$75 million loan guarantee to a startup video game company known as 38 Studios. By 2012, 38 Studios had collapsed—leaving the state to pay the bill to bondholders, more than \$100 million with interest.<sup>58</sup> Requiring businesses to meet performance standards in order to receive incentives can help prevent such a situation.

For example, in 2011, New Jersey authorized \$261 million in incentives for Revel, an Atlantic City casino. In 2014, after two bankruptcies, Revel closed its doors. But like many New Jersey incentives, the award for Revel was contingent on the project’s performance: Under the terms of the deal, the casino had to start paying taxes before it could begin receiving the benefits. The state never had to pay any of the \$261 million.<sup>59</sup> “We think the performance-based structure is extraordinarily important,” said Timothy Lizura, president and chief operating officer of the New Jersey Economic Development Authority.<sup>60</sup>

States have also linked incentives to company performance through “clawbacks,” in which a business receives incentives upfront but the state reclaims the money if the company does not meet required performance standards. Although paying incentives to businesses before they perform the required activities may be more valuable to the companies, designing programs with clawbacks has a downside for businesses and government. Businesses may have understandable reasons for not growing as they intended, such as changes in economic conditions, and economic development officials can be reluctant to take money away from companies that are already struggling.

For that reason, many states are opting for an approach like New Jersey’s, in which incentives are not provided until after companies perform. Missouri Works and the Minnesota Job Creation Fund follow that model.<sup>61</sup>

## Require businesses to provide advance notice of program participation

Sometimes policymakers are surprised by the costs of incentives because state officials do not have any warning of how broadly the programs are being utilized until the bill comes due. Such situations are less likely when state agencies share data effectively, but incentive program design also plays a role.

Some programs allow businesses simply to claim the incentives on their tax returns, with no prior interaction with the state. For example, under one Oklahoma incentive, manufacturers are entitled to exemptions on local property taxes for five years when they build or expand facilities; the state then reimburses local governments for the lost tax revenue. The state does not have a role in the program until after localities request reimbursements.<sup>62</sup> In 2014, the program's cost to the state increased to more than \$60 million—nearly double what it had been three years earlier—leading Oklahoma lawmakers to reduce spending in other areas.<sup>63</sup>

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**If projections show that the costs of incentives will increase beyond the state's means or expectations, policymakers may be able to intervene before the budget challenges become severe.**

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Other programs require companies to apply in advance, providing state officials with an opportunity to collect data that will help them anticipate the costs at the same time that they determine which businesses are eligible. For example, under Utah's Economic Development Tax Increment Financing (EDTIF) program, companies enter into long-term incentive contracts with the state's economic development office before they begin receiving incentives. In 2014, the state auditor's office used these contracts to project that the state's EDTIF commitment would double to \$1.3 billion over the next 10 years.<sup>64</sup>

If projections show that the costs of incentives will increase beyond the state's means or expectations, policymakers may be able to intervene before the budget challenges become severe. When Wisconsin opened an expanded version of its Historic Preservation Tax Credit in 2014, officials recognized within months that they were approving incentives worth far more than anticipated. In response, the state imposed a moratorium on new applications to the program so that policymakers could reassess what changes might be necessary.<sup>65</sup> Within weeks, the state reopened a more carefully targeted version of the program, with an ongoing moratorium on the part of the program that had allowed any property dated before 1936 to qualify. Properties with an official "historic" designation are still allowed to receive credits.<sup>66</sup>

## Conclusion

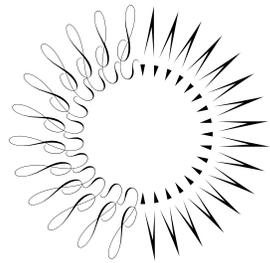
The fiscal challenges that many states have experienced as a result of economic development incentives are avoidable. Numerous states are beginning to implement policies to make the costs of incentives more predictable. State officials are gathering high-quality data to help them understand the future costs of incentives and are designing incentives in ways that reduce fiscal risk. By adopting these practices more consistently, states will be able to invest in programs that work, at a price they can afford.

## Endnotes

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