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Memo

To: Kirk Fulford, deputy director, Alabama Legislative Services Agency – Fiscal Division

From: Khara Boender, The Pew Charitable Trusts

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Subject: Resources on improving incentive design and administration, particularly through evaluation findings and associated study committees/commissions

It was great to reconnect with you and discuss the upcoming work of the Joint Legislative Study Commission on Renewing Economic Development Incentives. As discussed during our April 19 call, below are some additional resources and examples of ways states have created committees and commissions to study evaluation findings, as well as information about managing the potential costs and budget implications of incentives.

Study committees and commissions in other states

Colorado

Under Colorado's 2016 law, the Office of the State Auditor (OSA) is required to evaluate economic development tax incentives and other tax credits, exemptions, and deductions on a five-year cycle. Since 2018, OSA has released evaluations of the state's tax expenditures. OSA is also required to submit the report to the joint budget and finance committees of each legislative chamber, but until more recently, there was not a standing requirement for the legislature to study evaluation findings.

To address this, the General Assembly adopted a resolution to establish the Tax Expenditure Evaluation Interim Study Committee. The committee was asked to review OSA's tax expenditure evaluation findings and policy considerations, and then recommend up to five bills to repeal, clarify, or amend current tax expenditures. As part of their work, the committee heard testimony from experts about evaluation processes, methodology, and findings. A summary report of the interim committee's work can be found here.

The impact of the interim study committee persisted into the following years. Nine bills were introduced during the 2020 legislative session that reflected evaluation recommendations and best practices shared by experts. A total of six bills were enacted, including bills to clarify eligibility requirements for the long-term lodging sales tax exemption, modifications to the net operating loss deduction, a measure that establishes tax expenditure bill requirements for newly enacted expenditures (including expanding and clarifying requirements for purpose statements and sunset dates), and legislation to repeal three expenditures that OSA found to be seldom-used or obsolete: the residents of bordering states sales tax exemption, the nonprofit transit authority agency fuel tax, and the pre-1987 net operating loss deduction.

During the 2021 legislative session, HB 1077 created a legislative oversight committee concerning tax policy and an associated task force which helps ensure that policymakers can regularly dedicate time to review evaluation findings. This legislation was also informed by the 2019 interim committee's work – similar legislation was introduced during the 2020 legislative session but failed to make it across the finish line. The enactment of this legislation helps to ensure that policymakers can regularly dedicate time to review evaluation findings. A summary of the oversight committee's work can be found here.

The oversight committee's work informed the introduction of several bills during the 2021 legislative session. These include the alternative transportation options credit, the farm close-out exemption exclude motor vehicles, the repeal of several infrequently used expenditures, the sales and use tax exemption for public school construction. And based on the 2020 legislation referenced above establishing bill requirements for newly enacted tax expenditures, a recent homeless contribution income tax credit proposal includes a legislative declaration for the expenditure's policy goal.

Oklahoma

Legislation in Oklahoma created an Incentive Evaluation Commission (IEC) responsible for setting a review schedule for incentives, identifying goals for each incentive, and developing criteria for determining whether those goals have been achieved. The members of the commission are:

1. The Director of the Office of Management and Enterprise Services or his or her designee;
2. The Secretary of Commerce or his or her designee;
3. The Chairman of the Oklahoma Tax Commission or his or her designee;
4. An individual appointed by the President Pro Tempore of the Senate who is an economist representing an institution of higher education in this state;
5. An individual appointed by the Speaker of the House of Representatives who is a layperson holding no elective office;
6. An auditor who is employed as an internal auditor by a company or who is employed by a private auditing firm appointed by the Governor;
7. The president of the Oklahoma Professional Economic Development Council or his or her designee; and
8. A certified public accountant appointed by the Oklahoma Accountancy Board.

The composition of the IEC represents a wide range of perspectives. People who are generally supportive of incentives, such as the president of the Oklahoma Professional Economic Development Council, are included, but so are other viewpoints. There's a mix of public members, executive branch officials who administer incentives (Commerce and the Tax Commission), and officials who have general budget and policymaking responsibility (the Director of the Office of Management and Enterprise Services). One advantage to including these executive branch officials is that they're experts on what data is available on incentives.

The IEC's work has resulted in various modifications to incentives. For example, in 2019, three bills implemented recommendations from a 2018 evaluation: HB 1411 eliminated a population restriction on the municipalities eligible for the state's Affordable Housing Tax Credit, expanding the number of housing units eligible for the credit; SB 840 required that new jobs eligible for incentives under the Oklahoma Quick Action Closing Fund exceed the average county wage to better target the incentive to higher-quality jobs; and SB 485 reformed the Small Business Incubators Incentives Act, disallowing incentives for incubator sponsors but retaining incentives for incubator tenants, because the former had been found ineffective. In 2021, the state enacted a new law that requires the state's Department of Commerce to implement reporting requirements for beneficiaries of the Oklahoma Local Development and Enterprise Zone Incentive Act; the new reporting provisions require beneficiaries to submit data on employment, capital investment, and information on project changes as directly recommended by the evaluation. As part of that new law, the Tax Commission was asked to prepare an annual report using data from these new requirements for the governor and the legislature. This law follows recommendations from a 2019 evaluation that cited difficulties in reviewing the program due to a lack of data. For more information about the IEC's work, you may refer to a Smart Incentives publication called "Incentive evaluations lead to statutory changes."

You mentioned that you have previously contacted Randy Bauer of PFM Consulting, Inc. We would also suggest reaching out to Jon Chiappe, director, Research & Economic Analysis Services at the Oklahoma Department of Commerce. Jon might be able to provide insightful context about the evolution of Oklahoma's evaluation process, including the impact of the IEC.

Limiting Fiscal Risk Associated with Incentive Programs

Included below are some resources that describe how states can increase the effectiveness of economic development incentives while minimizing fiscal risk:

- How States Can Avoid Costly Pitfalls While Rebuilding Their Economies. This report features a discussion about the Michigan Economic Growth Authority (MEGA) program. Because the program did not include fiscal protections, Michigan was later forced to close a multi-million-dollar budget gap with spending cuts. More details about MEGA can be found here: Faulty Forecasts: Michigan's MEGA Tax Credit.

- How States Use Annual Caps to Control Tax Incentive Costs. This Q&A discusses the benefits of including caps to reduce fiscal risk and highlights the different ways in which caps can be used. For example, the Q&A mentions that combining caps on *authorizations* with caps on *redemptions* can produce greater short- and long-term cost certainty. "By capping the authorizations, states limit their overall financial commitments. Caps on redemptions, on the other hand, control what incentives can cost each year." More information on authorizations and redemptions is included in the section below.

Caps on authorizations vs. redemptions

Caps can apply to incentive "authorizations," or "redemptions"— steps at different stages of the incentive lifecycle. Occasionally, caps also apply to "issuances." Not every economic development program includes discrete authorization, issuance, and redemption steps, but many do—especially programs that offer tax credits to businesses and developments.

Authorizations occur when a company applies for incentives and receives approval from a state agency to participate in the program. For example, a state could authorize a company to receive $1,000 in tax credits for every job it creates up to 500 jobs, which would amount to an authorization of $500,000 in credits.

But an authorization doesn't guarantee the company will end up getting credits—it must first fulfill its performance obligations first to receive a credit issuance. In the example above, if the company ended up creating 400 jobs instead of 500, the state would issue $400,000 in credits. At this point, the company can begin “redeeming” its credits—using them to reduce what it pays when filing tax returns. But the company may not redeem them all upon issuance, either because program rules dictate the timing of redemptions or because the company lacks sufficient tax liability to fully use the credits immediately.

Programmatic caps on authorizations limit the state’s total commitment—the total amount of credits the state could approve for all companies within a specified time period. Programs with authorization caps should not cost more than the amount authorized over the long-term – in fact, usually they will cost less because not all businesses end up fulfilling their obligations. Caps on authorizations also provide the most certainty for businesses because, once their initial application is approved, they know the precise value of credits they’re eligible to receive.

However, caps on authorizations don’t control the timing of incentive costs to the state. Instead, years often pass between credit authorizations and credit redemptions. Programs often allow companies to take years to meet performance standards, such as creating required jobs. Then, they often also allow businesses to take years to redeem them. Missouri’s low-income housing tax credit (LIHTC) illustrates this concept. The state didn’t authorize any LIHTC credits in fiscal years 2018, 2019, or 2020, yet paid $132 million for redeemed credits in fiscal year 2020 because of credits authorized before the program was closed to new applicants.

This timing disconnect is one of the reasons states sometimes choose to cap credit redemptions. By capping redemptions, states know how much to budget each year to cover this cost and avoid surprises. The potential tradeoff 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.

Given this trade-off, instituting caps on redemptions on at least some programs— especially those that seem prone to temporary spikes in redemptions – is one option. Another strategy to control the timing of incentive costs is requiring beneficiaries to redeem their credits in equal installments over a set number of years. This approach provides more certainty for the state on year-to-year costs, while also providing certainty to program beneficiaries who know the value of the credits they will be allowed to use each year. For example, under Maine’s credit for rehabilitation of historic properties after 2007, projects must redeem credits in equal installments over four years. And 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. These specific limits can help policymakers know how much the program will cost, so long as state officials are tracking how many projects they have approved and when recipients are scheduled to redeem their incentives. More about transferability and refundability is detailed below.

Transferability and Refundability

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.

In its first series of evaluations, Pennsylvania’s Independent Fiscal Office (IFO) recommends making the state’s New Jobs, Historic Preservation, and Film Production credits refundable to improve their economic impact. That way more of the credit incentivizes activities that the state wants to encourage, rather than losing value when a credit is sold.

Policymakers also need to keep in mind the broader fiscal implications of refundability, such as the potential for runaway program costs. To its credit, Pennsylvania includes caps on these programs, which balance the benefits of refundability while controlling for potential revenue implications.

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.

Under Utah’s Economic Development Tax Increment Finance (EDTIF) program, businesses that create at least 50 new jobs are eligible to receive tax credits. The credits are refundable, which allows businesses to use credits quickly and provides the state with more predictability as to when companies will use incentives. These programs sometimes cause budget challenges because of the speed with which companies can use their credits. However, EDTIF includes a range of fiscal protections designed to make that less likely. For example, GOED negotiates company-specific caps on the value of the credits as part of each agreement.

We hope these resources are helpful; please don’t hesitate to reach out if you have any additional questions.