

Memo

To: Senator Louis P. DiPalma, District 12, The State of Rhode Island General Assembly

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Subject: Creating an economic development tax incentive sunrise process in Rhode Island

Introduction

When state legislators consider proposals for new economic development tax incentives, they face hard choices. Subtle differences in the design of business incentives—such as how benefits are structured or how states determine which companies are eligible—can mean the difference between programs that achieve their goals and ones that prove ineffective. Thoughtful design at the outset can avoid creating programs that are unexpectedly costly, not designed to achieve their goals, or that undermine other economic priorities.

This memo and accompanying “Sunrise Analysis” form are designed to help lawmakers in Rhode Island think through important concepts that should be considered when creating new economic development tax incentives. The memo describes the overarching questions lawmakers should ask and corresponding concepts that help answer them. The “Sunrise Analysis” form provides a framework to make note of where an incentive aligns with these practices. The form could be integrated into the existing committee process for considering new tax incentives in the state, thereby instituting a new best practice with minimal investment.

Questions to ask when designing a new economic development tax incentive

1. Is there a clear rationale for the program?

The first step in designing a new tax incentive is to identify the program’s policy goal. A very general goal such as “encouraging economic development” won’t facilitate a conversation about the incentive nor does it provide guidance on how the results of the incentive could be evaluated. In contrast, including a specific, measurable goal carries multiple benefits. First, lawmakers can determine if the new program properly aligns with a state’s current economic development objectives. Second, a clear goal helps lawmakers track progress and is a critical factor in evaluating the program’s effectiveness.

Key Questions

- Does the incentive have a clearly stated goal?

- How does the incentive align with the state’s economic development strategy (if applicable)? Does it complement or duplicate existing programs?
- Does the incentive or supporting documentation point to specific metrics to measure progress towards its goal that will also help evaluate program effectiveness in the future?

2. Is the incentive designed to achieve its stated goal?

Making it clear *how* an incentive will achieve its goal by explaining the logical link between the incentive and its desired economic outcomes is as valuable as the goal itself. One way to do this is by using a logic chain. A logic chain is a flow chart that shows a visual link between the ultimate policy goal of the program, the tool being used to achieve that goal, and the strategy behind it. Once a logic chain has been mapped out, it becomes clear how a program intends to achieve its goal. Logic chains are also useful in identifying the corresponding metrics that might be appropriate for that particular goal.

A key aspect of whether an incentive is designed to achieve its goal is the degree to which the benefits flow to the people, places, and businesses that policymakers intend. Setting clear and thoughtful targeting criteria that are aligned with a program’s goal will prevent the incentive from going to those who lawmakers do not mean to benefit.

A common concern when crafting an incentive is the risk of rewarding beneficiaries for what they would have done in the absence of an incentive. Asking the right questions during the early stages of crafting an incentive can lower the frequency of this outcome, even if lawmakers can never design incentives so that they successfully change behavior 100% of the time.

Key Questions

- Does the incentive (or supporting documentation) describe how it intends to achieve the stated goal?
- Is the incentive structured effectively to benefit target beneficiaries?
- How does the incentive avoid rewarding beneficiaries for what they would do in the absence of the incentive (passes the “but for” test)? Some possible ways to explore this concept include:
 - Does the incentive reduce a business’ costs enough to make it likely that the program will change behavior?
 - Does the award process or timing of the incentive make it more likely to reward businesses for what they would do anyway?
 - Do studies of similar incentives indicate that this is an effective strategy?

3. Does it minimize negative economic impacts?

The effectiveness of an incentive is also impacted by the degree to which it minimizes negative economic impacts and provides benefits to the state’s economy overall. For instance, incentives should encourage new economic activity instead of rewarding business for things that happened in the past or promoting business restructuring to claim tax benefits. An incentive program should also try to avoid helping some state businesses at the expense of others. For this reason, many states target industries where the customers and the competitors of incentive recipients are spread nationally or internationally. Incentive programs can also be designed to minimize the extent to which economic benefits flow outside of the state (known as “leakage”). Factors influencing leakage include whether workers will live out of state, the amount of products or services a beneficiary will purchase from outside the state, and whether

incentivized business activity is located inside the state. Addressing these issues early on will increase the likelihood that the incentive benefits the state overall and not just the businesses that receive the incentive.

Key Questions

- Does the program incentivize new activity? Does it prohibit businesses from restructuring to claim program benefits?
- Does the program target industries or sectors that will grow the state economy overall?
- Does the program limit incentive benefits from going outside of the state?

4. Does it include fiscal protections?

Designing incentives with a sufficient combination of fiscal protections can help lawmakers achieve two goals: keeping the costs of the incentives reasonably predictable from year-to-year and ensuring that the long-term costs of the programs do not become unaffordable. These goals can be achieved through a variety of policy options, such as: capping how much a program costs each year, controlling the timing of when (and for how long) beneficiaries can redeem credits, paying for incentives through budget appropriations, prohibiting beneficiaries from redeeming more credits than they owe in taxes, and requiring businesses to provide notice of program participation. Including a sunset – or an expiration date - on a program is both a fiscal protection and a way to ensure that legislators review the program periodically.

Requiring performance agreements between the state and a business as a condition of receiving an incentive is another way to ensure accountability. To be effective, performance agreements need to be paired with a compliance monitoring system and enforcement mechanisms for times when a company does not achieve its agreed-upon targets. Auditing and regular reporting requirements for beneficiaries also help to flag concerns, collect data to track performance, and estimate costs.

Finally, upfront and ongoing cost forecasts can provide lawmakers with insights into a program’s fiscal impact. This is essential information for lawmakers to have for budgetary purposes.

Key Questions

- Does the incentive include fiscal protection mechanisms?
- For how long can benefits be claimed?
- Does the incentive include a sunset date?
- Will appropriate performance standards be included along with compliance monitoring and enforcement mechanisms?
- Will a fiscal note estimate the anticipated cost of the program? How often are program costs and forecasts provided to the legislature?

5. Is it structured to be adequately and efficiently administered?

Incentive administration should be designed to be efficient, consistent, and transparent. This does not mean trying to achieve the lowest possible administrative cost. Instead, the state’s goal should be to strike a balance between its own interests and that of businesses. For example, while the state should strive to ensure that program administration is efficient for all involved, it must not do so at the expense of its ability to enforce performance standards. Other examples of ways to promote administrative efficiency

include limiting the number of agencies involved in the administration of a program, providing clear definitions of key terms in the enabling legislation, and making compliance resources available to beneficiaries. Not all of these actions are legislative in nature, but lawmakers can work with the administering agency (or agencies) to ensure that a program is implemented in a way that works for the state and for businesses.

Key Questions

- Will clear guidance for program applicants and beneficiaries be included in the legislation or made available by the administering agency?
- How does the program successfully balance business compliance costs with the need to protect the state's investment?
- Is the program designed to be administered efficiently by the state?

6. Is the tax incentive designed to facilitate evaluation?

Under the [Economic Development Tax Incentive Act of 2013](#), newly enacted incentives with “the purpose of recruitment or retention of businesses in the state of Rhode Island” are subject to evaluation. The Office of Revenue Analysis (ORA), which is responsible for evaluations under the law, should be asked to review proposals for new incentives to provide feedback on whether they are designed to facilitate rigorous evaluation. ORA could comment on things like whether the office will have access to the data needed for high-quality analysis, the balance between taxpayer confidentiality and ORA's ability to provide lawmakers with critical information about the performance of the program, and whether the chosen goals lend themselves to evaluation. ORA should also be given the opportunity to provide input on the information businesses will need to report to the state to facilitate the evaluation.

Key Questions

- Is ORA given access to the data necessary for rigorous evaluation?
- Do confidentiality stipulations protect taxpayer information without restricting ORA's ability to publish rigorous program evaluations?
- Do the goals identified for the incentive facilitate evaluation?
- Has ORA reviewed business reporting requirements? Are they designed to provide the data necessary for program evaluation and compliance?

Sunrise Process

The following form provides a framework to answer the above questions for a new tax incentive program. Ideally, this form should be completed before the relevant committees vote on a new incentive bill to encourage discussion of the program. There are several options for who could complete this form:

- The bill's sponsor (with the help of legislative staff),
- Non-partisan legislative fiscal staff,
- The Office of Revenue Analysis, or
- The State Budget Office.

| Question | Addressed? | Explanation |
|--|------------|-------------|
| <p>1. Is there a clear rationale for the program?</p> <ul style="list-style-type: none"> • Does it have a goal(s)? • Is the goal measurable? • Aligned with existing economic strategy? | | |
| <p>2. Is the incentive designed to achieve its stated goal(s)?</p> <ul style="list-style-type: none"> • Does it describe how it intends to achieve the stated goal(s)? • Does it effectively target intended beneficiaries? • Does it pass the “but for” test? | | |
| <p>3. Does it minimize negative economic impacts?</p> <ul style="list-style-type: none"> • Does it incentivize new activity and prohibit restructuring for benefits? • Does it target industries that grow the state economy? • Does it minimize leakage of benefits outside the state? | | |
| <p>4. Does it include fiscal protections?</p> <ul style="list-style-type: none"> • Does it include cost controls? • Does it specify the length of benefits? • Does it include a sunset date? • Does it require performance agreements? • Will there be cost-reporting/forecasting? | | |
| <p>5. Is it structured to be adequately and efficiently administered?</p> <ul style="list-style-type: none"> • Does it include clear guidelines for businesses? • Does it balance compliance and state costs? • Is it designed to be administered efficiently by the state? | | |
| <p>6. Is the tax incentive designed to facilitate evaluation?</p> <ul style="list-style-type: none"> • Does it provide data accessibility for ORA? • Do confidentiality restrictions not impede evaluation? • Do the goals assist evaluation? • Has ORA reviewed the reporting requirements? | | |