Avoiding Blank Checks
Creating Fiscally Sound State Tax Incentives
DECEMBER 2012

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## Contents

Overview .................................................. 2

   Graphic: Growing Fiscal Impact ................. 3

   Table 1: Tools to Avoid Blank Checks
      Not Used Consistently. ....................... 5

Reliable Cost Estimates. .................................. 7

Annual Cost Controls ................................. 12

Conclusion .............................................. 17

Endnotes ................................................. 18
Overview

New Mexico’s High-Wage Jobs Tax Credit—an incentive that rewards businesses for creating jobs that pay well—cost the state $9.3 million in fiscal year 2011. A year later, the price tag had more than quintupled to about $48 million. That might have been a positive development if it signaled an economic boom and showed that the credit was working—but there was no matching increase in high-wage jobs. Instead, state officials believed the costs were rising primarily because businesses were learning they could claim credits for jobs they had created years earlier without knowing about the tax credit. While this was permitted under the program’s rules, it meant that some companies were receiving a financial benefit for something they would have done anyway. New Mexico suddenly had a tax incentive on its hands with costs that were growing dramatically without the corresponding economic gains lawmakers had in mind. In recent months, state policy makers have begun studying how to revise the program.¹

In April 2012, the Pew Center on the States released a report, Evidence Counts, that studied whether and how states have evaluated the results of tax incentives. But ensuring effective economic development policy starts when credits, deductions, and exemptions are first proposed. Unless states take steps at the outset, the price tag of these programs can grow unpredictably. Two key things that states should do are:

- Ensure that policy makers understand the budget implications of proposed incentives; and
- Manage the size of tax incentives by setting limits on their annual price tag.

Without taking these steps, states risk creating out-of-balance budgets that may require raising taxes or cutting spending for other priorities. Those are difficult trade-offs, even in cases when an analysis shows that tax incentives are likely to provide a good return on investment.

Unexpected Costs

Tax incentives are unlike most state spending. For priorities such as education and transportation, policy makers determine the specific level of funding they want to commit and review those allotments every one or two years. For tax incentives, however, there often is no limit...
on how much they can cost. Even though tax incentives collectively reduce state tax revenue by billions of dollars a year, they are not usually reviewed alongside other expenditures in the budget process.

Instead, some tax incentives essentially function as entitlement programs. Any business that meets the requirements laid out in law is entitled to the benefit. Other tax incentives give state and local officials considerable discretion on which projects will receive incentives, but likewise do not impose cost limits.

As a result, the financial impact of tax incentives can grow quickly and unexpectedly without any explicit choices by state lawmakers to expand them. For example, a tax exemption for horizontal natural gas drillers in Louisiana grew from just $285,000 in fiscal year 2007 to about $239 million in fiscal year 2010. In Oregon, the state’s Business Energy Tax Credit cost the state about $144 million between July 1, 2007, and June 30, 2009—nearly six times what lawmakers had expected. And in Hawaii, the possibility of unanticipated increases in the state’s renewable energy tax credits was a key reason forecasters downgraded revenue growth projections in May, and downgraded them again in September. The credits cost the state $34.4 million in fiscal year 2010, but are now expected to cost more than $260 million in fiscal year 2013.

**GROWING FISCAL IMPACT**

States’ tax incentive costs can grow quickly and unexpectedly without any explicit choices by policy makers.

- **New Mexico High-Wage Jobs Tax Credit**
  - FY2011: $9.3M
  - FY2012: $48M

- **Louisiana Severance tax exemption for horizontal drilling**
  - FY2007: $285K
  - FY2010: $239M

- **Hawaii Renewable energy tax credits**
  - FY2010: $34M
  - FY2013 (est.): $260M


**What States Should Do**

States have had the most success avoiding these unexpected outcomes when they act up front, using two key tools: reliable cost estimates and annual cost controls. Cost estimates—detailed analyses of the budget implications of proposed tax incentives—give policy makers a sense of the fiscal impact before they vote on the proposals. Cost controls manage the size of tax incentives by setting limits on their annual price tag. Lawmakers can choose to increase a cap if they have reason to believe a bigger program would generate greater economic returns, or they can lower the limit if the incentive is costing too much.
States have often omitted one or both of these protections, as illustrated in our analysis of 16 bills that created, expanded, or extended tax incentives in recent years (Table 1). Of these, four were passed with both meaningful estimates of their fiscal impact and with clear limits on their annual costs. However, eight proposals lacked fiscal impact estimates and nine lacked cost controls, leaving the state more fiscally vulnerable.

When states do not take these steps in advance, remedies can be difficult to implement and slow to take effect. In Oregon, the costs of the Business Energy Tax Credit contributed to the state’s serious budget troubles in 2009 and 2010, prompting policy makers to scale the program back in 2010 and 2011. The Oregon credit, like many other incentive programs, involved agreements with businesses to provide benefits over many years. Even if Oregon lawmakers had allowed the program to expire entirely in 2011, analysts projected that it would have cost $830 million over the next six years because of commitments the state already had made. Similarly, Michigan lawmakers closed one of the state’s largest job creation tax incentives to new businesses as of January 1, 2012, but the costs are likely to continue for many years to come: companies could qualify for these incentives for up to 20 years. Policy makers are sometimes powerless to scale back the costs of incentives immediately without reneging on promises they have already made to businesses.

In contrast, cost estimates and cost controls can give policy makers confidence that the price tag will not grow beyond what they believe the state can afford. Cost estimates for tax incentives are difficult to do, but some states have found promising ways to produce the forecasts, such as projecting the extent to which the incentives will attract more businesses and looking at the price tag of similar programs in other states.

Even the best cost estimate, however, has a margin of error and cannot protect the state budget against unexpected changes in the economy or other factors. For this reason, some states have chosen to safeguard their budgets by appropriating money for incentives in the budget or by setting a cap on the amount that can be spent from year to year. With policies like these, tax incentives function more like regular spending programs, with lawmakers retaining control over the cost, and less like open-ended commitments. When used together, reliable cost estimates and annual cost controls help enable states to seek new jobs and new businesses while avoiding unexpected challenges when the time comes to pay the bill.
To understand whether and how states use cost estimates and controls when making economic development investments, we examined a selection of recently passed tax incentive bills. This review illustrates that policy makers have made major investments without a clear sense of their fiscal impact.

<table>
<thead>
<tr>
<th>State</th>
<th>Bill Number</th>
<th>Year</th>
<th>Reliable cost estimates</th>
<th>Annual cost controls</th>
</tr>
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<tbody>
<tr>
<td>Arizona</td>
<td>HB 2001</td>
<td>2011</td>
<td>E</td>
<td>C</td>
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<td></td>
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<td></td>
<td>Legislative analysts used data on historic job growth to estimate the fiscal impact of the new Quality Jobs Tax Credit. The cap on the program starts at $30 million in FY 2013, but grows to $90 million by FY 2015.</td>
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<tr>
<td>California</td>
<td>SBX3-15</td>
<td>2009</td>
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<td>The new Film &amp; Television Tax Credit Program was capped at $100 million per year for five years, and the New Jobs Tax Credit expires once the total amount allocated reaches $400 million.</td>
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<tr>
<td>Florida</td>
<td>S1752</td>
<td>2010</td>
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<td></td>
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<td>The Entertainment Industry Financial Incentive Program was amended with annual caps totaling $242 million over five years. The new Manufacturing and Spaceport Investment Incentive Program included yearly caps that totaled $43 million over two years.</td>
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<tr>
<td>Georgia</td>
<td>HB 234</td>
<td>2011</td>
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<td>Fiscal analysts said they were “unable to give a precise estimate” on the cost of the new Georgia Tourism Development Act, since the program gives the governor final say over which projects qualify.</td>
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<tr>
<td>Illinois</td>
<td>SB 2093</td>
<td>2010</td>
<td>E</td>
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<td>The Department of Revenue said it lacked the information needed to reliably predict the full cost of the new Sales Tax and Revenue (STAR) bond program, which was not capped. Two other programs in the bill (the New Markets Development Credit and the Angel Investment Credit) had annual caps totaling $30 million.</td>
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<td>Louisiana</td>
<td>HB 898</td>
<td>2009</td>
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<td>While the Motion Picture Investor Tax Credit was not capped, the Legislative Fiscal Office estimated that the expansions to the program would cost a total of $100 million over four years.</td>
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<tr>
<td>Massachusetts</td>
<td>H.4829</td>
<td>2008</td>
<td>E</td>
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<td>The Life Sciences Tax Incentive Program was a new 10-year program capped at $25 million a year. As is standard procedure in the state, the program did not receive a formal cost estimate.</td>
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<tr>
<td>Michigan</td>
<td>HB 5841</td>
<td>2008</td>
<td>E</td>
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<td>Legislative analysts were unable to predict the price of the new Michigan Film Production Credit, which ended up costing in excess of $280 million from FY 2009 through FY2011 before being converted to a grant program and scaled back.</td>
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<tr>
<td>Minnesota</td>
<td>HF2695 (SF2568)</td>
<td>2010</td>
<td>E</td>
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<td>While the new Small Business Investment Tax Credit (estimated to cost $59 million over five years) was capped, the expanded Credit for Increasing Research Activities (estimated to cost $31 million over three years) was not.</td>
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</table>
TABLE 1: TOOLS TO AVOID BLANK CHECKS NOT USED CONSISTENTLY (continued)

<table>
<thead>
<tr>
<th>State</th>
<th>Bill Information</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Jersey</td>
<td>S3043 2008</td>
<td>Legislative analysts were unable to estimate the cost of the new Urban Transit Hub Tax Credit because of the program's design.</td>
</tr>
<tr>
<td>New York</td>
<td>A9709-C (2010)</td>
<td>The Excelsior Jobs Program was enacted in 2010 with annual caps totaling $1.25 billion between 2011 and 2019. In 2011, the program was extended to 2024 and a total of $1 billion was added to the annual caps over the life of the program.</td>
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<tr>
<td></td>
<td>S2811C (2011)</td>
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</tr>
<tr>
<td>North Carolina</td>
<td>HB 1973 2010</td>
<td>While the price of the Film Incentive expansion was not capped, legislative analysts estimated the cost would grow by over $50 million per year within three years.</td>
</tr>
<tr>
<td>Ohio</td>
<td>HB 153 2011</td>
<td>The new Small Business Investment Tax Credit, capped at $100 million biennially, did not receive an official fiscal estimate until after the bill was passed. Expansions to the Job Retention Tax Credit and Historical Rehabilitation Tax Credit received fiscal estimates and are capped annually at $25 and $60 million, respectively.</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>SB 97 2007</td>
<td>The Film Production Tax Credit was a new program with annual caps of $75 million. It was estimated to cost just $25 million in the first year.</td>
</tr>
<tr>
<td>Texas</td>
<td>HB 3676 2009</td>
<td>The extension of Texas’ Chapter 313 Economic Development Act did not cap the cost. The bulk of the costs will occur beyond the five years analyzed in the legislature’s fiscal note.</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>Assembly Act 4 2011</td>
<td>The state increased by $25 million the amount available for the state’s Economic Development Tax Credits, but did not place an annual cap on awards.</td>
</tr>
</tbody>
</table>

Out of the hundreds of pieces of legislation states have considered to create or expand tax incentives in recent years (2007 to 2011), we focused on 16 that passed with the potential to be among the costliest nationwide. Because we sought to identify those programs with the highest price tags, each of the 16 states in the selection is among the 20 states with the largest budgets in the country (four of the 20 states with the biggest budgets did not pass major incentive legislation during the period studied). Most states, however, rely heavily on tax incentives to pursue economic development goals, and our review of legislation in states with smaller budgets suggests that many have also used cost estimates and controls inconsistently. As a result, our selection of 16 bills helps illustrate the range of current practices—and options for improvement—in all 50 states.

In five states—California, Florida, Illinois, Ohio, and Minnesota—the selected bill contained multiple tax incentive programs. These bills are indicated above as having cost estimates or annual cost controls only when policy makers used these tools for all tax incentives in the legislation. In the case of New York, we chose a program that was enacted in 2010 and then increased in potential cost by 80 percent one year later. Other than New York, we limited our list to no more than one bill per state, working to identify—as best as possible, given varying or unavailable data on projected costs—the one with the most significant potential budgetary impact. For each bill, researchers examined the design of the program, analyzed legislative fiscal notes and other official documents, and interviewed agency officials. Because states are not always consistent in their use of cost estimates and controls, these bills do not necessarily represent the treatment of all tax incentives within the 16 states.
Reliable Cost Estimates

Reliable cost estimates ensure that policy makers understand the budget implications of proposed incentives. Of the 16 bills reviewed by Pew, eight were accompanied by estimates of their fiscal impact.

The Challenge

Estimating the costs of proposed tax incentives is a challenge, and many states struggle to produce reliable numbers.

One of the biggest hurdles is simply that lawmakers consider so many bills during their legislative sessions. Analysts often have only a few days to write a cost estimate—or a fiscal note, as it is known in many states—for a bill. That can be difficult for any sort of legislation, but it is especially hard for economic development tax incentives. States offer tax breaks to try to nudge businesses to create jobs or make investments that they would not otherwise pursue, but it is difficult to know in advance how many will do so and how much it will cost.

Many incentive laws are written so that the number of businesses that ultimately participate is not even within the state’s control, either because any firm that meets the program’s criteria qualifies or because local jurisdictions decide. In Texas, for instance, the Economic Development Act allows school districts in the state to offer and approve tax incentives for manufacturers and other types of businesses. But the costs fall on the state budget, with no upper limit.

Furthermore, estimates are most useful when they forecast costs on a year-by-year basis, because policy makers write budgets for one or two years at a time. Yet it is often just as hard to figure out when tax incentives will take a bite out of the state budget as it is to estimate how big the bite will be.

Many tax credit programs involve a multi-year, multi-step process. Companies sign up to participate, then engage in the activity the program requires, such as creating jobs or making investments. Only then are they awarded their tax credits, and it could be years before they actually use the credits to lower their taxes, costing the state money at that later date. “Let’s say we knew for a fact that we were going to
have one new firm a year brought into this new program,” says Greg Albrecht, chief economist in Louisiana’s Legislative Fiscal Office. “We don’t know how much eligible activity they’ll engage in. When will they engage in it? When will we hand them their benefit paper? When will they hand it back to the state? We don’t know.”

What States Should Do

Some states have found ways to ensure that policy makers have the information they need or, at the very least, that they understand the risks involved before they vote on legislation creating tax incentives. Specifically, states can:

- Project the economic impact
- Warn about uncertainty
- Link cost estimates to policy making
- Make the process professional and transparent

Project the economic impact

To make informed decisions, policy makers need reliable data, including estimates of how attractive incentives will be to businesses and how much they will cost the state each year. For instance, when North Carolina lawmakers considered expanding the state’s film tax credit in 2010, legislative analysts took into account how many additional films were forecast to be produced in the state as a result of the expansion. The difference was significant. If lawmakers approved the more generous incentives, the state expected two additional major films the next year (beyond what the existing incentives would attract), with even more films to come. The analysts were able to project that the legislation would raise the costs of the film tax credit by more than $50 million a year.

Changes to tax incentives affect not only the businesses that receive the incentives, but their competitors as well. Some states have taken this into consideration. In 2009, Illinois policy makers considered creating the Sales Tax and Revenue (STAR) bond program, which was designed to spur a new billion-dollar retail and entertainment complex. The incentive sought to achieve that goal through, in effect, a sales tax exemption: at the new complex, sales tax collections would be used to pay off bonds for the construction of the development itself, instead of going into the state’s general fund.

The state’s Department of Revenue pointed out that the true price tag was not just the reallocated sales tax revenue. Some of
the consumers at the new development would have otherwise shopped—and paid sales tax—elsewhere in the state. For the 2010 version of the bill—Governor Pat Quinn (D) had vetoed the 2009 version—the department estimated that the shift in consumer activity away from existing stores would add tens of millions of dollars to the state’s cost.10

In the end, Illinois did enact an amended STAR bond program in 2010. It included protections that showed legislators were responding to the state’s analysis. For example, the law requires the Department of Revenue to hire an independent economist to study the effects of any proposed STAR bond district, including the extent to which it would cause displacement. “It was the most influence we’ve had on a piece of legislation,” says Natalie Davila, director of the department’s research division.11

Warn about uncertainty

Sometimes the design of an incentive makes it difficult to pin down precise fiscal estimates. Even in those cases, analysts can provide lawmakers with valuable information on the program’s potential costs and make policy makers aware of the unknowns.

In Georgia, for example, a bill proposed incentives to develop new tourist attractions in the state, but gave the governor final say on which projects to approve. Analysts at the Fiscal Research Center at Georgia State University, which provides fiscal notes to the state, acknowledged they could not know which projects future governors would want to support.

Nonetheless, they pointed out that Georgia’s incentive was modeled on one in Kentucky that cost the state $7 million in fiscal year 2012. Since Georgia has more than twice the population of Kentucky, that would suggest a cost of $16 million—but they also noted that Georgia’s program was less generous than Kentucky’s, which might mean it would cost less. Next, they produced a list of proposed tourist attractions in the state that might qualify and estimated how much in incentives each would receive. That offered a different picture. They explained that if one particular proposed project—a billion-dollar sports complex—was approved for the benefits, the cost to the state would be $25 million a year for that development alone.12

Likewise, when New Jersey was considering a bill in 2011 to both modify an existing tax incentive to encourage development near transit stations and to establish a new tax incentive to create and retain jobs, the state’s Office of Legislative Services declared that it could “determine neither the direction nor the magnitude of the bill’s fiscal net impact on the State and affected local governments.”13 One key challenge, the analysis noted, was that an accurate cost estimate depended on
knowing not only what would happen if the bill was enacted, but also what would happen if it was not. Would businesses claim more dollars in tax credits under the new version of the program than they would if the old one was left in place? Would companies have made the same investments even without the incentives? Rather than offer incentives, if New Jersey decided to use the money for some other purpose such as road construction, would that put the state in a better revenue position or a worse one?

While the bill passed without answers to these questions, the analysis provided helpful context. “I don’t know what this is going to cost,” says Thomas Koenig, the analyst who wrote the estimate, “but I can still provide some useful information. I’m trying to provide an analytic framework or a way to think about the issue.”

**Link cost estimates to policy making**

Ideally, cost estimates help legislators decide which incentives to enact and how generous they should be. Some states have adopted policies that incorporate these forecasts in lawmakers’ deliberations.

Minnesota, for example, has taken two noteworthy steps. First, every bill that impacts the state’s tax collections receives a cost estimate on its final version. In many other states, there is no guarantee that estimates will be updated when bills are amended—meaning legislators may have to vote on a proposal without knowing how much the latest version will cost. Second—and even more unusually—if Minnesota’s final estimates show the state will collect less in taxes to the point that it would throw the state’s budget out of balance, lawmakers are required to increase revenue or reduce spending elsewhere to make up the difference. In this way, Minnesota’s cost estimates link directly to its budget process. In most states, cost estimates are only advisory.

While Minnesota ensures that lawmakers have estimates for the final version of bills, Wisconsin makes sure they have them at the start—for the first version. Any bill in Wisconsin that will affect state revenue must have a cost estimate before committees hold hearings and before lawmakers can take any action on them. Estimates are required by law, unlike in some states, where lawmakers receive them only when a legislator requests one.

**Make the process professional and transparent**

Forecasting the costs of tax incentives can be difficult even for highly trained analysts. In some states, though, there is no guarantee that official cost estimates will be conducted. When legislators in New York sponsor bills, they may request estimates from state agencies such as the Department of Taxation and Finance. But they also can simply identify a projected cost themselves.
In Massachusetts, the Department of Revenue often provides fiscal estimates for bills under consideration, but lawmakers and their staffs have final say over what price tag to use.

Even for states where nonpartisan analysts produce detailed estimates, the information can be hard to find. Illinois’ longest fiscal note for the sales tax and revenue bond program ran 15 pages, but only a short summary appeared on the legislature’s website, with few methodological details. Georgia’s fiscal notes were not available online as of October 2012.

Florida’s system is more consistent and transparent. The numbers are put together by a committee known as a consensus estimating conference. Four members of the conference—one each from the House, the Senate, the governor’s policy staff, and the legislature’s economic and demographic research arm—gather at public meetings where they discuss data and methods, and they can invite others to speak about their own data and estimates. All four must come to a unanimous decision about the likely price tag of the bill. Once they reach a decision, their estimate is published online, accompanied by backup data sources and methodology.
Annual Cost Controls

The Challenge

Even the best estimates cannot guarantee that policy makers will have a good sense of what tax incentives will cost over time. After all, most estimates do not look beyond a few years in the future. For example, Louisiana enacted its horizontal drilling tax exemption in 1994, but its costs ballooned only after a natural gas deposit was discovered in 2008 and energy companies commonly began using horizontal drilling.18

Even in the short term, some tax incentives can prove unexpectedly popular. After Oregon’s Business Energy Tax Credit was expanded in 2007, the state estimated the program would cost $25 million from July 2007 to June 2009. But there were far more projects approved than expected, pushing the bill up to $144 million in that period.19

What States Should Do

Up-front decisions often can help states avoid such situations. In particular, states can:

- Regularly budget for tax incentives
- Set annual caps
- Ensure that incentives are reconsidered in future years

Regularly budget for tax incentives

When Michigan lawmakers were considering creating one of the nation’s most generous film tax credits in 2008—production companies could claim benefits worth roughly 40 percent of their costs in the state—legislative analysts declared the program would decrease state revenue “by an unknown and potentially significant amount.” There were no limits on how many films could qualify or how much the incentives could cost; analysts said they could not forecast how attractive the incentive would be.

The legislature passed the bill without knowing the cost. From April 2008 through the end of 2010, the state’s film office approved more than $360 million
in tax credits.\textsuperscript{20} “With the film incentives, I kept telling people that if they went out and incentivized $1 billion in films, they would say, ‘What a resounding success,’” says John Nixon, Michigan’s budget director. However, he adds, “I would have to find $400 million to pay the bill.”\textsuperscript{21}

In 2011, Michigan lawmakers, including Governor Rick Snyder (R), decided they wanted more control and a lower price tag. The state changed the incentive from an uncapped tax credit to a direct grant program in the budget. The limit was $25 million for fiscal year 2012 and doubled to $50 million for fiscal year 2013. Now, Nixon says, the program is much more transparent and accountable.

This approach, appropriating money for incentives through the budget process, is how states commonly control the costs of grants and other direct economic development investments. Some lawmakers have argued that tax incentives should work the same way. Missouri State Senator Jason Crowell (R), for example, proposed legislation this year to require all tax credits to be appropriated. “Budgets, in my mind, are supposed to be value decisions,” Crowell says. “You have limited resources, you only have one dollar, and where you choose to spend that dollar you don’t have [it] to spend somewhere else. The place you make those decisions is in an appropriations process.”\textsuperscript{22} To date, states have rarely adopted this strategy, however, so its results remain to be seen.

**Set annual caps**

While tax incentives are rarely appropriated, a more common practice is placing statutory limits on the cost. For example, when Pennsylvania revised its film tax credit in 2007, it capped program spending at $75 million a year. While the staff of the Pennsylvania House Appropriations Committee often performs complex analysis to estimate the costs of proposed legislation, the limit on the film tax credit made it much easier to project the long-term price tag. “The bill sets the maximum,” says Miriam Fox, executive director of the committee’s Democratic staff, “so any reasonable person could calculate that.”\textsuperscript{23} Besides providing cost certainty, the cap also has offered policy makers flexibility, because the state can always change the upper limit from year to year. Pennsylvania

\begin{quote}
You have limited resources, you only have one dollar, and where you choose to spend that dollar you don’t have [it] to spend somewhere else. The place you make those decisions is in an appropriations process.”

—Missouri State Senator Jason Crowell (R)
\end{quote}
cut its film tax credit to $42 million in fiscal year 2010 and then raised it to $60 million the following year.

Caps work well in tandem with specific forecasts of how much incentives will cost in coming years. These cost estimates provide important information for policy makers: when incentives do not reach their cap, states may have dollars left over that could be spent on other priorities. In Pennsylvania, legislative analysts said that the state’s film tax credit was unlikely to reach its $75 million cap during the first fiscal year of implementation. They used data from the state Department of Revenue to project that the credit would cost only $25 million. Likewise, Missouri capped its Historic Preservation Tax Credit—a major urban redevelopment incentive—at $140 million a year during the 2009 legislative session, but the state offered about $80 million in the credits in fiscal year 2011, when the weak economy limited demand.24

Not all types of caps provide the same level of budget protection. The strongest

HOW CAPS WORK FOR TWO PROGRAMS

Minnesota’s Small Business Investment Tax Credit provides incentives to angel investors on a first-come, first-served basis. When individuals or investment funds plan to contribute money to start-up companies, they apply to the state’s Department of Employment and Economic Development for the tax credit, worth 25 percent of their contributions. The program is capped at $12 million per calendar year. The department approves every application that meets the criteria written into the law until it hits the cap. In 2012, that limit was reached in July, barely halfway through the year.

In Massachusetts, the board of directors for the state’s Life Sciences Center has discretion to determine which companies qualify for its tax incentives and how much they receive. Each year, life sciences companies fill out detailed applications by a specific deadline. With all applications in hand at once, the board chooses projects for state aid that seem most likely to create jobs—among other criteria—while ensuring that the money it awards does not exceed the program’s $25 million-a-year cap. The selected companies enter into formal agreements with the Life Sciences Center, specifying how many people they will hire, which of the program’s 10 tax credits they will claim, how much money they will claim for each credit, and how many years they will receive it. The Department of Revenue monitors companies’ compliance with the agreements.
Caps control states’ costs each year. Other incentives cap only the size of the benefits a company can receive, but not the number of companies—leaving the overall price tag uncertain. Other programs limit spending over the life of the program, not for the one- or two-year periods for which states write their budgets—potentially leaving policy makers unsure of when the costs will arrive.

Most states apply caps only to particular incentive programs, but Iowa takes a broader approach. The state’s economic development agency can award up to a specified amount of money each year—the cap is currently set at $120 million—for many major tax credits it administers. Lawmakers installed the cap in 2009 because the recession was forcing them to cut other state budget priorities, and they did not think economic development should be exempt, says Iowa State Senator Joe Bolkcom (D), who chairs the Senate’s Ways and Means Committee. “Caps are really an effective approach to limiting the costs of these tax credits,” Bolkcom says. “When we hand out public money to bring jobs or to keep jobs, we want to drive a hard bargain. We don’t want to put a dollar more on the table than we need to make the deal.”

Ensure that incentives are reconsidered in future years

Lawmakers have also fixed sunset dates at the outset to control tax incentives’ long-term costs. Sunsets cut off new applications after a specified number of years, effectively limiting the duration of the costs, unless lawmakers act to extend them.

For example, under a new law in Oregon, tax credit programs expire every six years. In 2011, when the first group of incentives was set to expire, lawmakers studied their costs and economic benefits. They found that extending all the credits intact would have cost the state $40 million more over the next two years. They decided to limit the cost to $10 million by changing some...
Most of the anticipated savings came from a major overhaul of the Business Energy Tax Credit—the incentive that was costing the state much more than expected. Similarly, Virginia approved a law in early 2012 requiring sunsets of five years or less for all newly enacted tax credits, but not existing ones.

As Pew’s report, *Evidence Counts*, showed, states sometimes evaluate incentives after they have been in place to ensure that policy makers have information not only on their costs, but also on their economic results. On occasion, states have ensured up front that this analysis will take place in the future. In laws creating tax incentives they have included requirements to evaluate the programs later. For example, the 2010 law creating Minnesota’s Small Business Investment Tax Credit also appropriated $100,000 to hire an independent economist to evaluate the program by 2014.
Conclusion

When policy makers consider proposals to create or expand tax incentives for economic development, there are significant implications. While these investments are a leading tool states use to encourage businesses to create jobs and invest in the local economy, they cost taxpayer dollars. The price of these programs can rise unexpectedly, putting pressure on state budgets. Effective fiscal stewardship can help avoid that outcome. Reliable estimates of how much tax incentives will cost will allow policy makers to make better decisions regarding the design, size, and scope of incentives. Limiting the amount that can be spent each year will allow policy makers to directly manage the price tag with flexibility to raise or lower the cap as needed.
Endnotes


3 Pew Center on the States interview with Chris Allanach, senior economist, Legislative Revenue Office, State of Oregon, via e-mail, August 7, 2012.


10 Illinois Department of Revenue. “Fiscal Note; Senate Bill 2093, HAM 002, Executive Summary.” February 5, 2010. This fiscal note was provided to Pew by Andy Chupick, a research analyst for the Illinois Department of Revenue. Illinois’ fiscal notes are available upon request from the Illinois Department of Revenue.

11 Illinois Department of Revenue. “Fiscal Note; Senate Bill 2093 as Amended by House Amendment 4.” May 7, 2010. In 2010, when Illinois lawmakers began considering a new version of the STAR bond program that changed the region of the state it targeted, the Department of Revenue explained that it lacked key data. In the old location, analysts possessed an economic impact study that the developers of the project had
commissioned; but for the new one the department didn’t even know precisely where the development would be located. “We are charged with providing sound information on which policy makers can make decisions,” the analysts wrote. “Without more information, we cannot provide a comprehensive analysis to assist policy makers in determining whether they wish to commit limited state resources to this project.”


15 Pew Center on the States interview with Rod Hoheisel, assistant director, Tax Research Division, Minnesota Department of Revenue, May 21, 2012.


19 Pew Center on the States interview with Chris Allanach, senior economist, Legislative Revenue Office, State of Oregon, via e-mail, August 7, 2012.


24 Pew Center on the States interview with Angela Burke, assistant general counsel, Missouri Department of Economic Development, August 15, 2012.


26 State of Oregon Interim Joint Committee on Tax Credits. “2011 Tax Credit Sunset Process: Review and Results.” October 11, 2011. This report was provided to Pew by Paul Warner, the Legislative Revenue Officer for the State of Oregon.

