ECONOMIC DEVELOPMENT TAX INCENTIVES REVIEW - BACKGROUND MEMORANDUM

INTRODUCTION

North Dakota Century Code Section 54-35-26 (appendix), enacted through the passage of 2015 Senate Bill No. 2057, provides for the review of a specified list of economic development tax incentives and requires each incentive be reviewed at least once every 6 years. The Legislative Management selected the interim Taxation Committee to review tax incentives during the 2017-18 interim.

BACKGROUND

The practice of legislatively mandating the periodic review of economic development tax incentives began to gain popularity following the 2007-09 recession. As states continued to look at austerity options and ways to grow economies, reviewing tax incentives was viewed as sound public policy to ensure state dollars were being spent in a prudent and effective manner. States leading the way in implementing tax incentive review practices included Washington, Oregon, and Iowa.

Washington was one of the first states to enact legislation mandating the review of tax incentives. Legislation enacted in 2006 requires periodic performance audits of tax preferences. Washington's review process requires a showing the tax preference benefits the state's economy and mandates the review of each tax preference at least once every 10 years. The state's Joint Legislative Audit and Review Committee evaluates tax preferences to determine whether each tax preference is meeting its public policy objectives. The committee provides its report and recommendations to a seven-member citizen commission. After incorporating comments from the citizen commission, the committee forwards the final report to the legislature.

Oregon takes a slightly different approach to reviewing incentives. Legislation enacted in 2009 placed sunset dates on 50 of the state's 53 active tax credits thereby prompting a review of each credit prior to renewal. To stagger the sunset dates for purposes of review, credits were divided into three groups, expiring at the end of 2011, 2013, and 2015. The state passed additional legislation in 2013 requiring the preparation of a detailed report on each of the expiring credits. The majority of Oregon's tax credits expire after 6 years.

Iowa established its review process in 2010 through the creation of a Legislative Tax Expenditure Committee. The committee is tasked with reviewing each of the state's tax expenditures at least once every 5 years. The committee's evaluation must contain a statement on the policy goals of the tax expenditure and a return on investment calculation. The return on investment calculation must include a statement identifying whether the benefits of the tax expenditure are worth the costs of providing the tax expenditure.

In 2012 The Pew Charitable Trusts (Pew) began tracking the progress states were making in evaluating tax incentives and published a report entitled *Evidence Counts: Evaluating State Tax Incentives for Jobs and Growth*. The report identified states leading the way in evaluating the effectiveness of tax incentives, states meeting some of the criteria for effective evaluations, and states not meeting any criteria in terms of the scope or quantity of evaluations. Pew's 2017 report, entitled *How States Are Improving Tax Incentives for Jobs and Growth: A National Assessment of Evaluation Practices*, identifies 10 states that are leading the way in evaluating incentives, 18 states that are making progress, and 23 states that are trailing behind. The report describes the leading states as having well-designed plans for regular reviews, experience in producing quality evaluations that measure economic impacts, and a process for applying the results of evaluations to inform policy decisions. North Dakota is identified as a state that is making progress in evaluating incentives.

CREATION OF NORTH DAKOTA'S REVIEW PROCESS

North Dakota joined the ranks of states having instituted a formal incentive review process in 2015 through the passage of Senate Bill No. 2057. The impetus behind the introduction of Senate Bill No. 2057 was a directive by the Chairman of the Legislative Management to the 2013-14 interim Taxation Committee to study state economic development tax exemptions. The study was to include consideration of whether a regular review process should be established to ensure economic development tax incentives are serving the purposes for which the incentives were created.

The 2013-14 interim Taxation Committee received testimony from multiple parties to determine the best practices for evaluating tax incentives. The committee received testimony from a representative of Pew pertaining to methods the organization had observed and analyzed in other states that evaluate tax incentives. The committee also arranged a panel discussion comprised of representatives from Pew, the City of Bismarck, the Economic

Development Association of North Dakota, and the Department of Commerce to gain insight on the best methods to apply when evaluating incentives.

The committee reviewed data provided by representatives of the Tax Department and the Department of Commerce, which detailed the number of claimants and the amounts claimed for various tax incentives. The committee used this information to select the incentives best suited for periodic review. The committee developed a list of considerations to take into account when conducting an evaluation. The committee also determined it was prudent to review the purpose for which an incentive was created to ascertain whether an incentive was generating the intended results.

STATUTORY PROVISIONS

Section 54-35-26 directs a review of specified economic development tax incentives by an interim committee selected by the Legislative Management. The review entails an assessment of whether specified economic development tax incentives are serving the purposes for which enacted in a cost-effective and equitable manner. The statute requires each incentive be reviewed at least once every 6 years and lists the following eight items that may be considered when evaluating incentives:

1. The extent of achievement of the goals of the incentive and whether unintended consequences have developed in its application;
2. Whether the design and application of the incentive can be improved;
3. The extent of complementary or duplicative effect of other incentives or governmental programs;
4. Whether the incentive has a positive influence on business behavior or rewards business behavior that is likely to have occurred without the incentive;
5. The effect of the incentive on the state economy, including the extent of primary sector operation of the recipient and any competitive disadvantage imposed or benefit conferred on other state businesses, any benefit or burden created for local government, and the extent of the incentive's benefit that flows to out-of-state concerns;
6. The employment opportunities generated by the incentive and the extent those represent career opportunities;
7. Whether the incentive is the most effective use of state resources to achieve desired goals; and
8. If the committee's analysis of the incentive is constrained by lack of data, whether statutory or administrative changes should be made to improve collection and availability of data.

As enacted by 2015 Senate Bill No. 2057, Section 54-35-26(3) provided the following list of incentives for review.

1. Renaissance zone credits and exemptions.
2. Research expense credit.
3. Agricultural commodity processing facility investment credit.
4. Biodiesel fuel production facility construction or retrofit credit, biodiesel fuel blending credit, and biodiesel fuel equipment credit.
5. Seed capital investment credit.
6. Wage and salary credit.
7. Internship program credit.
8. Microbusiness credit.
9. Angel fund investment credit.
10. Workforce recruitment credit.
11. Soybean or canola crushing facility construction or retrofit credit.
12. Manufacturing automation equipment credit.
13. New or expanding business exemption.
14. Manufacturing and recycling equipment sales tax exemption.
15. Coal severance and conversion tax exemptions.

16. Oil and gas gross production and oil extraction tax exemptions.
17. Fuel tax refunds for certain users.
18. New jobs credit from income tax withholding.
19. Sales and use tax exemption for materials used to construct a fertilizer or chemical processing facility (pursuant to 2015 Senate Bill No. 2035).
20. Sales and use tax exemption for materials used to construct or expand a system for compressing, gathering, collecting, storing, transporting, or injecting carbon dioxide for use in enhanced recovery of oil and natural gas (pursuant to 2015 Senate Bill No. 2318).
21. Sales and use tax exemption for enterprise information technology equipment and computer software purchased for use by a qualifying business in a qualified data center (pursuant to 2015 House Bill No. 1089).

The statute requires the interim committee to identify the list of incentives to be reviewed during an interim on or before October 1 of each odd-numbered year and provide a plan for reviewing any remaining incentives. The committee shall identify the perceived goals of the Legislative Assembly in creating or altering each of the economic development tax incentives selected for review and the data and testimony required to evaluate each incentive. The committee may request data and analysis from state agencies or instrumentalities, including the Department of Commerce, the Tax Commissioner, and the Economic Development Foundation. If the requested data is not available, or is available but cannot be disclosed, the entity receiving the request shall advise the committee on options for obtaining the information or an adequate substitute.

At the conclusion of the committee's review, the committee shall report its findings and recommendations, together with any legislation required to implement those recommendations, to the Legislative Management. In addition to issuing recommendations related to the operation of incentives, the committee's recommendations also may include changes to the list of incentives subject to review and amendments to the substantive provisions of the statute.

2015-16 INTERIM COMMITTEE REVIEW AND LEGISLATION

The Political Subdivision Taxation Committee was the interim committee tasked with reviewing tax incentives during the 2015-16 interim. The committee selected the following 14 incentives from the statutory list provided in Section 54-35-26 for review during the 2015-16 interim.

1. Seed capital investment tax credit.
2. Angel fund investment tax credit.
3. Manufacturing automation equipment tax credit.
4. Wage and salary credit.
5. Microbusiness credit.
6. Soybean or canola crushing facility construction or retrofit credit.
7. Agricultural commodity processing facility investment tax credit.
8. Biodiesel fuel production facility construction or retrofit credit, biodiesel fuel blending credit, and biodiesel fuel equipment credit.
9. Renaissance zone credits and exemptions.
10. Research expense credit.
11. Internship program credit.
12. Workforce recruitment credit.
13. New jobs credit from income tax withholding.
14. New or expanding business exemption.

The committee selected the following four additional incentives not contained in the statutory list.

1. Telecommunications infrastructure sales tax exemption.
2. Electrical generating facilities sales tax exemption.

3. Certified nonprofit development corporation investment tax credit.
4. Geothermal, solar, wind, and biomass energy device tax credit.

The committee received information from representatives of the Department of Commerce and the Tax Department to assist in determining which incentives to review during the 2015-16 interim. The committee elected to review all income tax incentives, incentives scheduled to expire in 2017, incentives seeing little to no use, and the manufacturing automation equipment tax credit. The manufacturing automation equipment tax credit was selected pursuant to the statement of legislative intent in 2015 Senate Bill No. 2340 encouraging the review of this incentive.

At the conclusion of its study, the committee declined to recommend any changes to the soybean, canola, biodiesel, or agricultural commodity processing facility credits. The committee refrained from recommending legislation to extend or eliminate the sunset date on the sales tax exemption for wind-powered electrical generating facilities as the interim Energy Development and Transmission Committee recommended House Bill No. 1028 to eliminate the sunset date. House Bill No. 1028 failed to pass during the 2017 legislative session. The committee did not have adequate time to review the geothermal, solar, wind, and biomass energy device tax credit; research expense credit; internship program credit; workforce recruitment credit; new jobs credit from income tax withholding; new or expanding business exemption; or renaissance zone credits and exemptions. The committee recommended a future interim committee review these incentives.

In regard to the remaining incentives selected by the committee, the following eight bills were recommended for introduction during the 2017 legislative session.

1. House Bill No. 1044, to provide a uniform definition of "primary sector business."
2. House Bill No. 1045, to increase allowable credit amounts and carryforward periods related to the seed capital investment tax credit and sunset the availability of the angel fund investment tax credit for investments made after December 31, 2017.
3. House Bill No. 1046, to eliminate the sunset date of June 30, 2017, on the telecommunications infrastructure sales tax exemption.
4. House Bill No. 1047, to eliminate the sunset date of December 31, 2017, on the manufacturing automation equipment income tax credit.
5. House Bill No. 1048, to repeal the certified nonprofit development corporation income tax credit.
6. House Bill No. 1049, to repeal the wage and salary income tax credit.
7. House Bill No. 1050, to repeal the microbusiness income tax credit.
8. Senate Bill No. 2044, to allow the interim committee selected to review economic development tax incentives during the 2017-18 interim to obtain software capable of generating dynamic fiscal impact statements for incentives selected for review.

The 2017 Legislative Assembly adopted all but House Bill Nos. 1046 and 1047, which failed to pass. House Bill No. 1045 and Senate Bill No. 2044 were substantially amended prior to passage. House Bill No. 1045 was modified from a bill that eliminated the angel fund credit and expanded the seed capital credit to a bill that sunset the angel fund tax credit and created a new angel investor tax credit. Senate Bill No. 2044 was modified from a bill that allowed the interim committee studying incentives to obtain fiscal impact software for use during the 2017-18 interim to a bill that allowed the committee to receive dynamic fiscal impact analysis from the Bank of North Dakota during the 2017-18 interim.

In addition to the bills recommended by the interim committee, other relevant legislation pertaining to Section 54-35-26 included Senate Bill No. 2166, which added development or renewal area incentives to the statutory list of incentives slated for review.

2017-18 INTERIM COMMITTEE REVIEW

The Taxation Committee is the interim committee tasked with reviewing tax incentives during the 2017-18 interim. Taking into account incentives selected during the 2015-16 interim, but not fully reviewed due to time constraints, Section 54-35-26 requires a review of the following 13 incentives before the conclusion of the 2019-20 interim:

1. Renaissance zone credits and exemptions;

2. Research expense credit;
3. Internship program credit;
4. Workforce recruitment credit;
5. New or expanding business exemption;
6. New jobs credit from income tax withholding;
7. Manufacturing and recycling equipment sales tax exemption;
8. Sales and use tax exemption for materials used to construct a fertilizer or chemical processing facility;
9. Sales and use tax exemption for materials used to construct or expand a system for compressing, gathering, collecting, storing, transporting, or injecting carbon dioxide for use in enhanced recovery of oil and natural gas;
10. Sales and use tax exemption for enterprise information technology equipment and computer software purchased for use by a qualifying business in a qualified data center;
11. Fuel tax refunds for certain users;
12. Coal severance and conversion tax exemptions; and
13. Oil and gas gross production and oil extraction tax exemptions.

Development or renewal area incentives, added pursuant to 2017 Senate Bill No. 2166, also must be reviewed before the end of the 2021-22 interim.

STUDY APPROACH

In determining which incentives to review during the 2017-18 interim, and which to carry forward for review during the 2019-20 interim, the committee might find it helpful to assess whether any of the listed incentives are:

1. Nearing expiration;
2. Too recently enacted to contain adequate data for review;
3. Potentially outdated in light of changed circumstances;
4. Similar, or pertain to the same tax type;
5. Underutilized;
6. Historically contentious;
7. Relevant to other studies the committee is tasked with completing; or
8. A priority for review using dynamic fiscal impact modeling software, as the software is only available for use during the 2017-18 interim.

In determining the number of incentives to select for review, the committee may wish to consider the level of complexity associated with each incentive and the volume of data and information required to complete a thorough review.

ATTACH:1