

Economic Development Tax Expenditures

The Commonwealth employs a variety of means to achieve the goals of ‘economic development’ – to promote job creation, attract and retain businesses, and foster economic growth in the state. These include long-term strategies to increase the productivity of our workforce and our economy by investing in education and in infrastructure, as well as short-term strategies to try to attract and subsidize specific businesses and industries.

Though states use a combination of these approaches within their economic development programs, most – including Massachusetts – spend a significant share of their economic development resources on economic development tax expenditures. These tax exemptions, deductions, credits, deferrals and the creation of special tax rules are employed by state governments in an effort to attract new businesses to the state and prevent those already in the state from leaving.¹

The effectiveness of these tax expenditures is rarely examined in any detail and very little data is available to analyze. This brief first examines how much the Commonwealth spends on economic development tax expenditures, how that has changed over time, and how it compares to other elements of state spending both for economic development and other purposes. In addition, this brief outlines improvements that could make it easier to evaluate the effectiveness of tax expenditures.

Each year, the Department of Revenue (DOR) publishes a Tax Expenditure Budget. The Tax Expenditure Budget includes brief descriptions of the state’s tax expenditures along with estimates for the revenue loss associated with each of them. In total, the Tax Expenditure Budget catalogs more than \$20 billion in tax expenditures to the state’s personal income, corporate income and sales taxes. In addition, for each tax expenditure, DOR provides cost estimates for each of the previous two fiscal years (FY) as well. The Tax Expenditure Budget is published with the release of the Governor’s budget recommendations in each fiscal year. It is important to note that the total tax expenditure budget encompasses a much broader range of items beyond those that are intended to foster economic development. Many of these are beneficial to moderate and low-income families, such as personal income tax exemptions for public assistance and social security benefits, deductions for dependent children, and exemptions from the sales tax for food and clothing.

Tax expenditures are in many ways similar to direct appropriations. Both seek to achieve certain policy goals through the use of the state’s economic resources, and both have an effect on the state’s bottom line. A primary difference is that budget appropriations must be reauthorized by the Legislature each year, while tax expenditures remain in effect without the Legislature having to take action.²

¹ A tax credit reduces the amount of tax due by providing a credit that applies to the tax liability. A tax deduction reduces the amount of income that a tax is calculated on. A deferral allows a taxpayer to delay the payment of a tax for a certain period of time, and an exemption excludes the taxpayer from being subject to a certain tax. Tax expenditures are distinct from other policy choices that reduce or increase tax revenues, such as changes to overall tax rates or changes to the basic structure of a tax. For more information, see the FY2009 Tax Expenditure Budget:

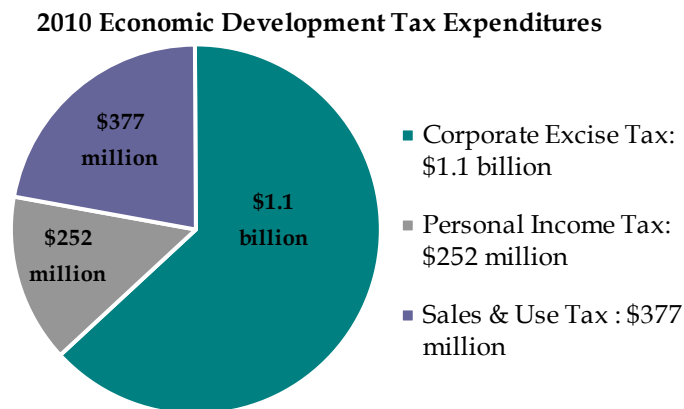
<http://www.mass.gov/Ador/docs/dor/Stats/TEB/TEB2009.pdf>. While many economic development tax expenditures primarily aim at supporting particular businesses or activities, some also serve other goals such as avoiding double taxation or conforming the state tax system to the federal system.

² In addition to the tax expenditure budget and budget appropriations, there is a third way that the Commonwealth spends its resources: through the capital budget. The capital budget includes outlays for long-term investments in infrastructure, such as roads and public transportation. These projects are financed through bonds that the state pays back through line items in the state budget dedicated to debt service on these bonds. Though these are economic development investments, they are not included in the analysis for this report.

Massachusetts spends billions of dollars in tax expenditures each year, and those designated for economic development purposes constitute a large sum. As the data below show, the state’s reliance on economic development tax expenditures has been increasing, compared to on-budget appropriations for similar purposes. Given this trend, the Commonwealth should take a closer look at whether or not these expenditures are meeting their intended goals.

TAX EXPENDITURES FOR ECONOMIC DEVELOPMENT ARE PROJECTED TO COST \$1.7 BILLION IN 2010

Economic development tax expenditures are categorized into three types: corporate excise tax, personal income tax, and sales & use tax. The corporate excise tax is levied on the income and property of corporations doing business in Massachusetts. Because some businesses – those that are not organized as corporations – pay taxes through the personal income tax, the cost of some economic development tax expenditures shows up as reduced personal income tax revenue. The sales and use tax is levied on retail sales, including those purchases made by companies for business purposes such as machinery and equipment.



Note: All figures presented in this report have been adjusted for inflation using the Consumer Price Index.

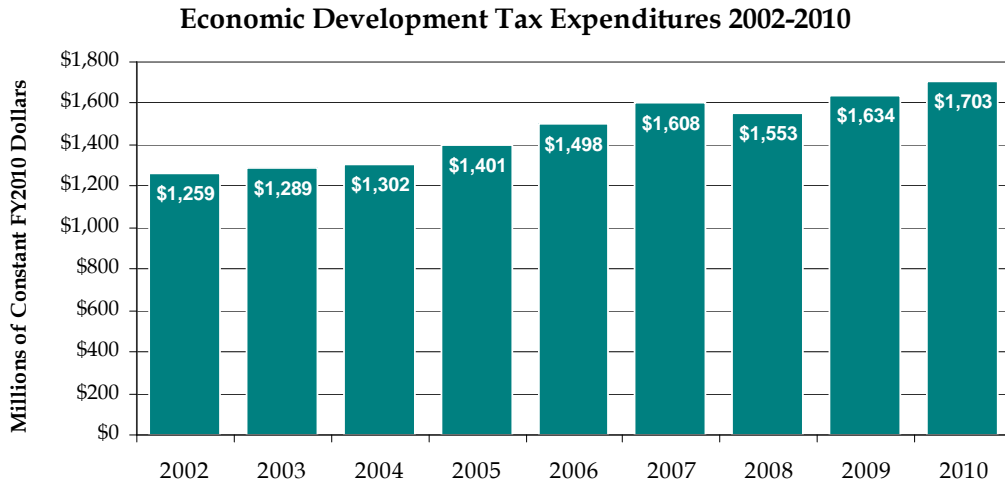
The majority of economic development tax expenditures are concentrated in the corporate excise tax category, which accounts for 63 percent of all economic development tax expenditures. Personal income tax accounted for 15 percent and sales and use tax accounted for 22 percent.

ECONOMIC DEVELOPMENT TAX EXPENDITURES HAVE GROWN SINCE 2002

Overall, tax expenditures for economic development grew 3.8 percent a year from FY2002 to FY 2010. Tax expenditures in the personal income category experienced the largest growth between 2002 and 2010, increasing from \$131 million to \$252 million, after adjusting for inflation. Corporate excise tax expenditures increased by \$242 million, in real terms, and sales and use tax expenditures grew by \$81 million.

Fluctuations in the amount of economic development tax expenditures are a reflection both of changes in the policies that affect how economic development resources are used and by changes in the economy. During economic recessions, tax expenditures tend to decrease as business activity and income decrease; conversely, in periods of growth, tax expenditures tend to increase as businesses and incomes grow. As evident in the chart below, economic development tax expenditures grew between FY2002 and FY2008. In FY2008, there was a drop of about \$55 million in economic development tax expenditures, most likely reflecting the beginning of

the current economic recession.³ Since then, however, economic development tax expenditures have picked back up as a result of policy choices – particularly, increases in incentives to attract the film industry to the state (increasing \$40 million in between FY2009 and FY2010) as well as incentives for the life sciences industry (increasing \$25 million between FY2009 and FY2010) – and have exceeded FY2007 levels.⁴



ECONOMIC DEVELOPMENT TAX EXPENDITURES FAR OUTWEIGH ECONOMIC DEVELOPMENT BUDGET APPROPRIATIONS

Estimates for tax expenditures for economic development in FY 2010 far exceed budget appropriations for similar purposes, which only amount to \$138 million. Budget appropriations for economic development were defined as those funds allocated for workforce training programs, job placement services, providing technical and financial assistance to businesses, aid to small businesses, tourism, infrastructure, and research. This includes programs within state and community colleges that are geared toward workforce or economic development, but does not include all of the higher education spending included in the budget.⁵ General higher education spending is another way that the state uses resources that contribute to the economy, as are funding for elementary education, public safety, and health care – and many other core government services that make Massachusetts a good place to live and do business. Because these are not solely aimed at generating economic development, they are not included in this analysis. However, a discussion of higher education spending is included in the following section.

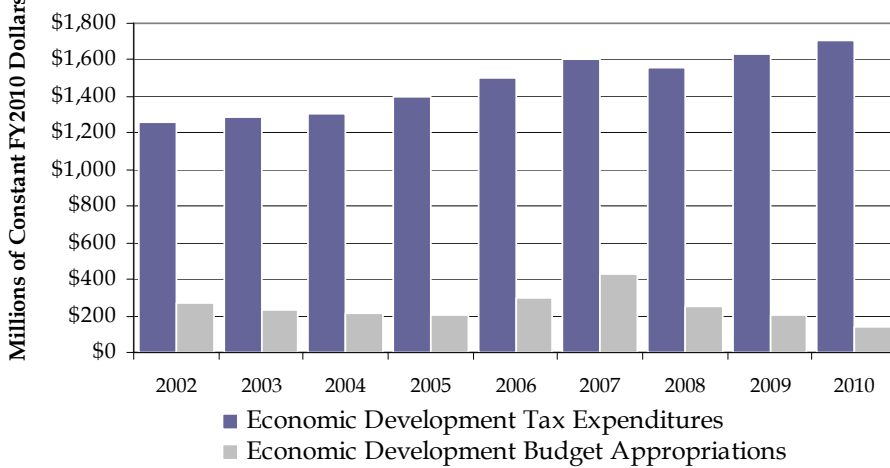
The gap between tax expenditures and budget appropriations for economic development has widened over the years. As tax expenditures grew, economic development budget appropriations actually declined by an average of 8.2 percent annually, pointing to the growing prominence of tax expenditures over budget appropriations toward achieving economic development goals.

³ The economic development tax expenditures that decreased the most between FY2007 and FY2008 were the deductions allowed for the depreciation of certain business assets purchased within the prior tax year (-\$12.5 million), lowered tax rates for certain small businesses (-\$9.1 million), tax credits to corporations for research and development expenditures (-\$7.1 million), and the unequal weighting of sales, payroll and property taxes in the formula used to calculate tax liability for business operating in more than one state (-\$6.6 million). As businesses reduce spending in a recession, deductions and credits associated with various types of spending decline.

⁴ It is also possible that the final figures for FY2010 tax expenditures and budget appropriations could end up lower than current estimates, due to the economic climate. Further budget cuts and a slow recovery could mean that the current estimates are higher than what will actually be spent this year.

⁵ MassBudget, "Tax Expenditures and Economic Development," April 2004, http://www.massbudget.org/file_storage/documents/econdev.pdf.

Economic Development Tax Expenditures Increase as Economic Development Budget Appropriations Decrease, 2002-2010

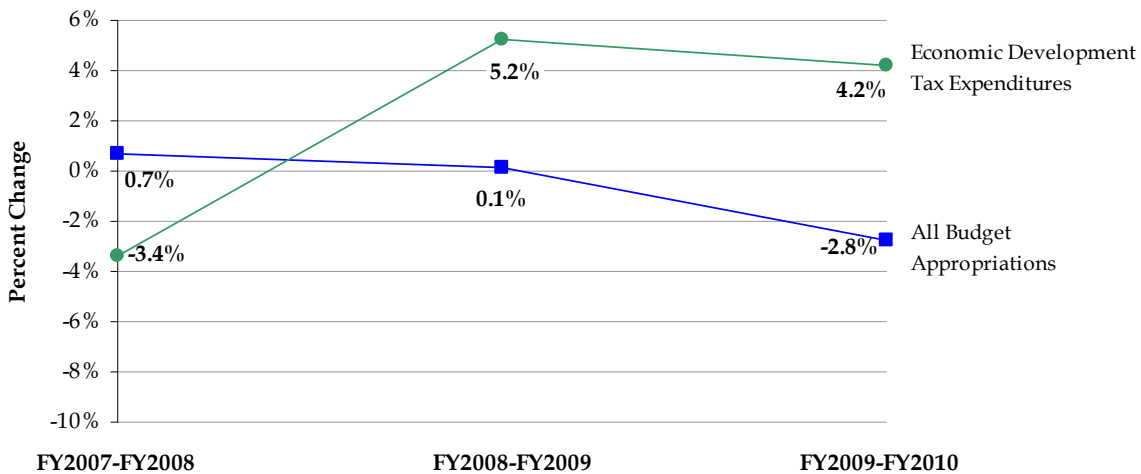


Economic Development Budget Appropriations

Category	FY2010 Appropriation
Workforce Training & Employment Services	\$98.5 million
Other	\$23.1 million
Tourism & Recreation	\$9.5 million
Technical & Financial Assistance	\$6.2 million
Research	\$210,000

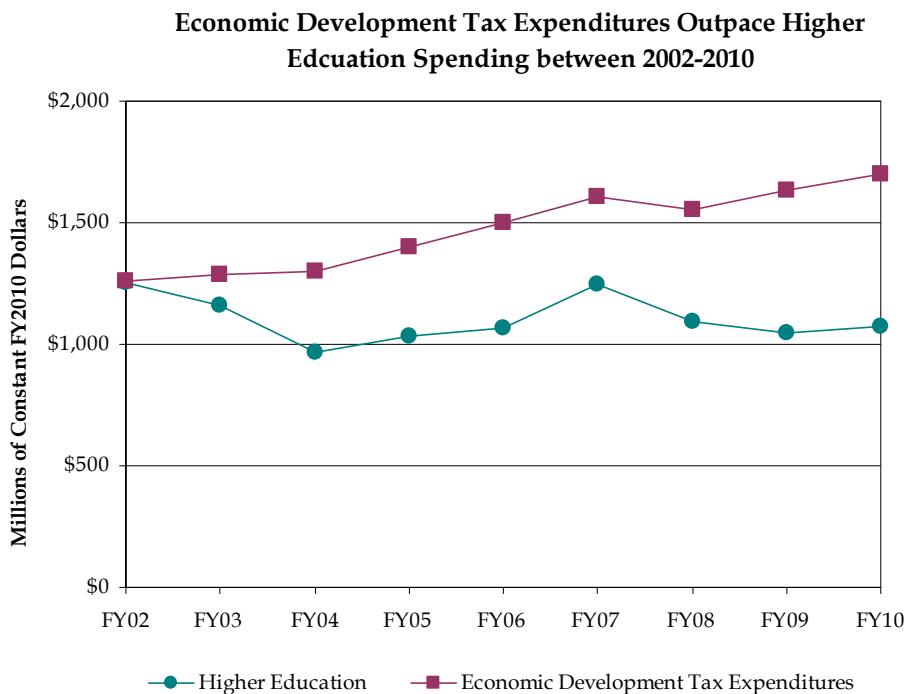
The growth of tax expenditures for economic development has also outpaced the growth of budget appropriations overall. Between 2002 and 2010, as economic development tax expenditures grew at an average of 3.8 percent yearly, the overall budget only increased at an average of 0.9 percent annually. Even with significant budget cuts in the last year -- from FY2009 to FY2010 total budget appropriations fell by 2.8 percent and budget appropriations for economic development dropped by 34 percent-- tax expenditures for economic development have still grown, with an increase of 4.2 percent. One reason for this is that tax expenditures do not need annual reauthorization by the Legislature, while budget appropriations do. Particularly in economic recessions, budget appropriations are cut back to accommodate budget shortfalls.

Economic Development Tax Expenditures Increase as All Budget Appropriations Decrease



ECONOMIC DEVELOPMENT TAX EXPENDITURES OUTPACE SPENDING ON HIGHER EDUCATION

As mentioned above, in addition to devoting resources to tax expenditures and budget appropriations targeted for economic development, the state also spends resources in other areas that contribute to the Commonwealth’s economy. Education, which is critical in building up a strong and competitive workforce, is one important long-term state investment. In 2002, the state spent roughly the same amount on economic development tax expenditures and higher education. Since then, spending on economic development tax expenditures has increased by \$444 million while higher education funding has decreased by \$176 million.⁶ The state now spends \$628 million more on economic development tax expenditures than on higher education. This is an example of the state decreasing resources for more long-term investments while at the same time increasing spending on short-term solutions, such as the tax breaks and incentives included within economic development tax expenditures.



ECONOMIC DEVELOPMENT TAX EXPENDITURES ARE SUBJECT TO LITTLE PUBLIC SCRUTINY

As mentioned above, tax expenditures occur automatically – meaning that they do not require the Legislature to take action for them to remain in effect. When the Legislature and Governor elect to create a new program, or expand an existing one, the funding for these programs must be approved year after year, no matter how dire the need they meet or how popular they may prove with the public. The merits for sustaining the programs are weighed carefully in light of the overall budget priorities and incoming revenue for that year. In contrast, when a new tax expenditure is created, it generally remains in effect year after year – regardless of

⁶ Between FY2009 and FY2010, higher education funding would have decreased by 19 percent, but was backfilled with \$230 million in federal stimulus funding for FY2010.

changing economic or fiscal conditions, or broader consideration of the relevance of the tax expenditure. Thus, tax expenditures can continue without consideration of possible merits, faults, or need.

SHOULD TAX EXPENDITURES FOR ECONOMIC DEVELOPMENT BE SUBJECT TO THE SAME SCRUTINY AS BUDGET APPROPRIATIONS?

Tax expenditures represent a growing share of our economic development resources. These tax expenditures represent a trade-off – for every dollar the state fails to collect due to a tax break, it has one fewer dollar to devote to another priority. Nearly \$1.7 billion will be spent on economic development tax expenditures in fiscal year FY2010 alone. And because most of these tax breaks continue year to year, the cumulative cost over the lifetime of these tax breaks is much greater. As the state budget shrinks, economic development tax expenditures continue to grow at an average of almost 4 percent between FY2002 and FY2010.

Consequently, the question must be asked: are these tax expenditures the most effective means of promoting economic growth? The costs and benefits of tax expenditures for economic development must be weighed against the costs and benefits of other strategies for generating economic growth. Especially in the current economic climate, it is imperative that our state adopt a comprehensive and cost-effective strategy for economic development that employs a range of policies, with a clear and transparent mechanism for evaluating these programs.

HOW CAN POLICYMAKERS, RESEARCHERS AND ACTIVE CITIZENS EVALUATE TAX EXPENDITURES?

In order to judge whether or not a tax expenditure is effective, it is important to consider the policy goal of that tax expenditure, the cost and the behavior or actions the tax expenditure has brought about. In addition, the ability to compare the initial estimates of the cost of a tax expenditure to the actual cost would provide important information on cost control and effectiveness. Unfortunately, a great deal of information about tax expenditures is not available to policymakers, researchers or the public -- making informed evaluations of tax expenditures difficult. However, some specific changes to the Tax Expenditure Budget could be made to allow for far more informed discussions of tax expenditure policy:

1. *Provide information on the purpose and effectiveness of each tax expenditure.* While the Tax Expenditure Budget describes what each tax expenditure is, it does not describe the purpose of each tax expenditure or analyze whether or not the tax expenditure is achieving its stated goal. In order to make a judgment on the effectiveness of this type of tax expenditure, it is important to know why this tax expenditure was created and whether the tax expenditure has had its intended effect. Among other states that do provide this information in their Tax Expenditure Budget, The Delaware Tax Preference Report provides a good example of how this type of information can be presented: http://finance.delaware.gov/publications/2007_tax_prefer/2007_report.pdf
2. *Provide disaggregated information for tax expenditures.* In order to gauge the success of most corporate tax expenditure, it is important to know how many firms it applied to, estimate how many jobs were created, and the cost of the tax expenditure per job created. Each year the state spends more than \$1 billion on economic development tax expenditures, and yet little information on how this spending has improved the economic climate in Massachusetts is available. Providing information on

the corporations that use different tax credits and the number of jobs that the credits create would make it easier to analyze the efficacy of many corporate tax expenditures.

3. ***Provide tax expenditure information for all sources of tax revenue.*** The Tax Expenditure Budget only includes information for tax expenditures related to personal income, corporate income and sales taxes. For example, insurance taxes are not included in the Tax Expenditure Budget. This change, while potentially minor, would again provide a more complete picture of where the costs of our tax system are located. The Connecticut Tax Expenditure Budget provides more complete information on other state taxes, providing a more complete picture of tax expenditures in the state.
4. ***Provide projections for the cost of tax expenditures when they are created and then compare these projections to actual cost in later years.*** At present, it is difficult to know how the actual cost of tax expenditures compares to the initial projections. By making projected costs for tax expenditures available when they are created, it would be possible in future years to know which tax expenditures had a different cost than initially anticipated.
5. ***Provide cost estimates for every tax expenditure.*** In the FY 2009 tax expenditure budget no cost estimates are given for 51 different tax expenditures. In fact, for each of the three major revenue categories, 20 percent or more of tax expenditures have no associated cost estimate. For example, there is a sales tax exemption on various tools used in manufacturing. Up until FY 2004, federal data allowed DOR to calculate the cost of this exemption, which as more than \$200 million annually. However, due to a change in federal data collection, DOR no longer provides a cost estimate for this item. In order to get a true sense of the cost of tax expenditures, DOR should be given the capacity and responsibility to collect data that allows a cost estimate to be calculated for each item.
6. ***Provide information on local tax expenditures.*** States like New York track the cost of property tax exemptions and other local tax incentives offered by municipalities, often for the purpose of attracting business. The Massachusetts Department of Revenue collects some of this information by town, but does not make it available through the tax expenditure budget. By collecting this information and making it easily available, town residents, researchers and local policymakers can see more clearly the actual cost of local economic development tax initiatives and compare this cost with the value the town has received.

A NOTE ON METHODOLOGY

Most of the tax expenditure data for FY2002 through FY2009 used for this report was obtained from the annual Tax Expenditure Budgets published by the Department of Revenue. Tax expenditure estimates for FY2010 were obtained from the Governor's budget recommendations. Revised estimates for the Film Tax Credit for FY2007 through FY2010 were obtained from the Department of Revenue based on more up to date information and are greater than the estimates found in the Tax Expenditure Budgets for each year. The Film Tax Credit falls within both the corporate and personal income tax categories. Because estimates of the breakdown of the Film Tax Credit within these categories were not available, the proportions in the FY 2009 Tax Expenditure Budget were used to estimate the breakdown between the two categories.

As defined by the Council on State Governments (CSG), economic development tax expenditures are tax expenditures used for the purposes of creating, retaining, or attracting business and development to the state. These include a variety of tax incentives including sales and use tax exemptions for new equipment, materials

used in manufacturing, tax incentives for creating new jobs, for encouraging research and development, for development in designated areas, and tax expenditures related to workforce development, such as credits for tuition and student loans.⁷ This paper follows the methodology established by the CSG.

Tax expenditures for which there were not consistent data available for the years between FY2002 and FY2010 were not included. Most significantly, the exemption for materials, tools, fuels, and machinery used in manufacturing was removed from our analysis, as the data source for this tax expenditure became unavailable after 2004. In addition, tax expenditures that were reported as 'negligible' were not included in this analysis. In cases where the state used money previously appropriated in trust funds for other purposes, particularly in the past two years, the amount of the reduction was applied to the amount for the year that the budget appropriation for the fund was made.

⁷ Council on State Governments. "State Business Incentives: Trends and Options for the Future." 2000.
<http://www.csg.org/knowledgecenter/docs/Misc00BusinessIncentives.pdf>

Appendix: All Economic Development Tax Expenditures, FY2010

Category	Item Number	Economic Development Tax Expenditure	FY2010 Expenditure Amount (millions)
Personal Income Tax	1.203	Excess Natural Resource Depletion Allowance	\$ 0.6
	1.204	Abandoned Building Renovation Deduction	\$ 3.9
	1.301	Accelerated Depreciation on Rental Housing	\$ 31.4
	1.303	Accelerated Depreciation on Buildings (other than Rental Housing)	\$ 5.5
	1.304	Accelerated Cost Recovery System (ACRS) for Equipment	\$ 62.5
	1.305	Deduction for Excess First-Year Depreciation	\$ 17.8
	1.306	Five-Year Amortization of Start-Up Cost	\$ 4.5
	1.307	Five-Year Amortization of Certain Operating Rights	-
	1.308	Expensing of Exploration and Development Costs	-
	1.309	Expensing of Research and Development Expenditures in One Year	\$ 1.2
	1.312	Expensing of Certain Capital Outlays of Farmers	\$ 0.3
	1.413	Exemption of Interest on Savings in Massachusetts Banks	\$ 6.9
	1.414	Tuition and Student Loan Interest Deduction	\$ 34.8
	1.501	Preferential Treatment of Interest on Savings Massachusetts Banks	-
	1.603	Economic Opportunity Area Credit	\$ 3.5
	1.604	Credit for Employing Former Full-Employment Program Participants	\$ 0.1
	1.608	Brownfields Credit	\$ 1.1
1.611	Film Tax Credit	\$ 78.0	
1.613	Medical Device Credit	\$ 0.3	
Corporate Excise Tax	2.001	Small Business Corporations	\$ 70.7
	2.101	Deferral of Tax on Certain Shipping Companies	\$ 0.1
	2.202	Additional Deduction for Certain Businesses in a Poverty Area (UJIP)	-
	2.203	Net Operating Loss (NOL) Carryover	\$ 96.0
	2.204	Excess Natural Resource Depletion Allowance	-
	2.206	Abandoned Building Renovation Deduction	\$ 0.9
	2.301	Accelerated Depreciation on Rental Housing	\$ 3.3
	2.304	Five-Year Amortization of Start-Up Cost	\$ 0.3
	2.305	Accelerated Cost Recovery System (ACRS) for Equipment	\$ 214.6
	2.306	Deduction for Excess First-Year Depreciation	\$ 3.1
	2.307	Accelerated Depreciation on Buildings (other than Rental Housing)	\$ 11.2
	2.308	Expensing of Research and Development Expenditures in One Year	\$ 98.3
	2.309	Expensing of Exploration and Development Costs	\$ 1.2
	2.401	Unequal Weighting of Sales, Payroll, and Property in Apportionment Formula	\$ 301.9
	2.601	Tax Credit for Building in a Poverty Area (UJIP)	\$ -
	2.602	Investment Tax Credit	\$ 58.5
	2.604	Research Credit	\$ 91.2
	2.605	Economic Opportunity Area Credit	\$ 20.0
	2.607	Credit for Harbor Maintenance Taxes Paid	\$ 0.8
2.608	Brownfields Credit	\$ 2.1	
2.611	Jobs Incentive Payment for Biotechnology and Medical Device Companies	\$ 2.5	
2.614	Film Tax Credit	\$ 72.0	
2.617	Life Sciences Tax Incentive Program	\$ 25.0	
Sales & Use Tax	3.112	Exemption for Aircraft and Aircraft Parts	\$ 8.3
	3.303	Exemption for MTFM Used in Research and Development	\$ 60.5
	3.304	Exemption for MTFM Used in Furnishing Power (to Consumers?)	\$ 118.5
	3.305	Exemption for MTFM Used in Furnishing Power to an Industrial Mfg. Plant	\$ -
	3.306	Exemption for MTFM Used in Newspaper Printing	\$ 49.9
	3.308	Exemption for MTFM Used in Agricultural Production	\$ 7.9
	3.309	Exemption for MTFM Used in Commercial Fishing	\$ 7.9
	3.410	Exemption for Containers	\$ 123.1
3.418	Exemption for Fuels, Supplies and Repairs for Vessels Engaged in Interstate or Foreign Commerce	\$ 0.5	