Legislative Council

North Dakota Legislative Council

Prepared for the Taxation Committee
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ECONOMIC DEVELOPMENT TAX INCENTIVES REVIEW - BACKGROUND MEMORANDUM

INTRODUCTION

North Dakota Century Code Section 54-35-26 (appendix), enacted by Senate Bill No. 2057 (2015), provides for the review of a specified list of economic development tax incentives and requires each incentive be reviewed at least once every 6-year period. The Legislative Management selected the interim Taxation Committee to review tax incentives during the 2023-24 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.

Washington was one of the first states to enact legislation mandating the review of tax incentives. Legislation enacted in Washington in 2006 requires periodic performance audits of tax preferences. Washington's review process requires a showing that 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 Fiscal 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 Legislative Assembly.

Oregon takes a slightly different approach to reviewing incentives. Legislation enacted in Oregon in 2009 placed sunset dates on 50 of the state's 53 active tax credits, thereby prompting a review of each credit before renewal. Credits were divided into three groups, expiring at the end of 2011, 2013, and 2015, to stagger the sunset dates for purposes of review. The state passed additional legislation in 2013, which requires 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 continues to publish materials relating to incentive evaluations and provides periodic updates of each state's national rating in evaluating incentives.

In the most recent May 2019 update, Pew identified 16 states leading the way in evaluating incentives, 15 states making progress in evaluating incentives, and 19 states trailing behind in evaluating incentives. Pew classifies leading states as those with well-designed plans to regularly evaluate incentives, experience producing quality evaluations that measure economic impact, and a process for informing policy choices. States classified as making progress are states that have enacted policies that require regular evaluations of major tax incentives. States classified as trailing behind are states that lack a well-designed plan to regularly evaluate incentives.

North Dakota joined the ranks of states identified as leaders in evaluating incentives in Pew's May 2019 state evaluation rating update. Pew credited North Dakota's improved rating to the state's review of the dynamic economic impact of incentives. The dynamic economic impact of incentives was evaluated through the receipt of economic impact reports provided by the Bank of North Dakota. The Bank created the reports using economic modeling software it acquired in 2017.

CREATION OF NORTH DAKOTA'S REVIEW PROCESS

North Dakota instituted a formal economic development tax incentive review process by enacting Senate Bill No. 2057 (2015), which has been codified as Section 54-35-26. Senate Bill No. 2057 was the product of the 2013-14 interim Taxation Committee's completion of a study directed by the Chairman of the Legislative Management. The study directed 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 items to consider when conducting evaluations. The committee also determined it was prudent to review the purpose for which each incentive was created to ascertain whether the incentive was generating the intended results.

STATUTORY PROVISIONS

Section 54-35-26 directs the review of specified economic development tax incentives by an interim committee selected by the Legislative Management. The review entails an assessment of whether each listed incentive is serving the purposes for which it was enacted in a cost-effective and equitable manner. The statute, as originally enacted, included a list of 21 incentives. The statute requires each of the economic development tax incentives listed in Section 54-35-26 to be analyzed within each 6-year period and provides 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 effects 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.

The statute requires the interim committee to identify the list of incentives that will be reviewed each interim before October 1 of each odd-numbered year and provide a plan for reviewing any remaining incentives. The committee is required to 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 its review, the committee is required to 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.

SUMMARY OF THE CURRENT 6-YEAR REVIEW CYCLE AND LEGISLATION

The following table provides an overview of the current 6-year economic development tax incentive review cycle. For purposes of the committee's selection of incentives to review this interim, the table includes a list of the economic development tax incentives in Section 54-35-26 which must be reviewed either in the 2023-24 interim or the 2025-26 interim.

<table>
<tr><th colspan="3">Current 6-Year Review Cycle</th></tr>
<tr><th>2021-22 Interim</th><th>2023-24 Interim</th><th>2025-26 Interim</th></tr>
<tr><td>Research expense credit
Agricultural commodity processing facility investment credit
Seed capital investment credit
Soybean or canola crushing facility construction or retrofit credit
Manufacturing automation equipment credit
New or expanding business exemptions
Manufacturing and recycling equipment sales tax exemption
New jobs credit from income tax withholding</td><td colspan="2"><u>List of incentives for review during the 2023-24 and 2025-26 interims:</u>
Renaissance zone credits and exemptions
Biodiesel fuel production facility construction or retrofit credit, biodiesel fuel blending credit, and biodiesel fuel equipment credit
Internship program credit
Angel fund investment credit
Workforce recruitment credit
Coal severance and conversion tax exemptions
Oil and gas gross production and oil extraction tax exemptions
Fuel tax refunds for certain users
Development or renewal area incentives
Sales and use tax exemption for materials used to construct a fertilizer or chemical processing facility
Sales and use tax exemption for materials used in compressing, gathering, collecting, storing, transporting, or injecting carbon dioxide for use in enhanced recovery of oil or natural gas
Sales and use tax exemption for enterprise information technology equipment and computer software used in a qualified data center
Sales and use tax exemption for raw materials, single-use product contact systems, and reagents used for biologic manufacturing
Sales and use tax exemption for materials used to construct or expand a coal processing facility that utilizes coal as a feedstock</td></tr>
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2017 Legislative Session Legislation

The Political Subdivision Taxation Committee was the interim committee tasked with reviewing tax incentives during the 2015-16 interim. The committee recommended the following eight bills to the Legislative Management 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 enacted all but House Bill Nos. 1046 and 1047, which failed to pass. House Bill No. 1045 and Senate Bill No. 2044 were amended substantially prior to passage. House Bill No. 1045 was modified from a bill that eliminated the angel fund investment tax credit and expanded the seed capital credit to a bill that sunset the angel fund investment 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 analysis 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 was passed by the 2017 Legislative Assembly pertaining to Section 54-35-26. Pertinent legislation included Senate Bill No. 2166, which removed the requirement to study "any economic development tax incentive created by the 64th Legislative Assembly" from the statutory list of incentives designated for review and added the following incentives to the statutory list of incentives designated for review:

- Development or renewal area incentives.
- Sales and use tax exemption for materials used to construct a fertilizer or chemical processing facility.
- Sales and use tax exemption for materials used in compressing, gathering, storing, transporting or injecting carbon dioxide for use in enhanced recovery of oil or natural gas.
- Sales and use tax exemption for enterprise information technology equipment and computer software used in a qualified data center.

2019 Legislative Session Legislation

The Taxation Committee was the interim committee tasked with reviewing tax incentives during the 2017-18 interim. The committee recommended Senate Bill No. 2039 (2019) to create a skilled workforce scholarship program, and House Bill No. 1040 (2019) to create a 21st century manufacturing workforce income tax credit, to the Legislative Management for introduction during the 2019 legislative session.

The 2019 Legislative Assembly enacted House Bill No. 1040 in a form substantially similar to the draft legislation recommended by the committee. The only changes to the 21st century manufacturing workforce income tax credit, as enacted, was the addition of an expiration date and a reduction in the annual available credit amount from $2 million to $1 million. The skilled workforce scholarship program provisions in Senate Bill No. 2039 failed to pass; however, a skilled workforce scholarship program was successfully enacted by House Bill No. 1171 (2019).

2021 Legislative Session Legislation

The Taxation Committee was the interim committee tasked with reviewing tax incentives during the 2019-20 interim. The committee did not recommend any bill drafts to the Legislative Management for introduction during the 2021 legislative session.

2023 Legislative Session Legislation

The Taxation Committee was the interim committee tasked with reviewing tax incentives during the 2021-22 interim. The committee did not recommend any bill drafts to the Legislative Management for introduction during the 2023 legislative session.

Other relevant legislation passed by the 2023 Legislative Assembly pertaining to Section 54-35-26 included:

- House Bill No. 1168 (2023), which updated the name of the manufacturing automation credit in the statutory list of incentives designated for review to accurately reflect legislative changes to the incentive.
- House Bill No. 1455 (2023), which added the sales and use tax exemption for raw materials, single-use product contact systems, and reagents used for biologic manufacturing to the statutory list of incentives designated for review.
- House Bill No. 1511 (2023), which added the sales and use tax exemption for materials used to construct or expand a coal processing facility that utilizes coal as a feedstock to the statutory list of incentives designated for review.

STUDY APPROACH

In determining which incentives to review during the 2023-24 interim and which to carry forward for review during future interims, the committee might find it helpful to assess the proximity of the last review of the incentive and 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; or
7. Relevant to other studies the committee is tasked with completing.

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. The committee also may consider receiving testimony from interested parties utilizing or administering the incentives to determine if any preferences exist among those parties for study selection.

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