

State Tax Expenditures and Incentives



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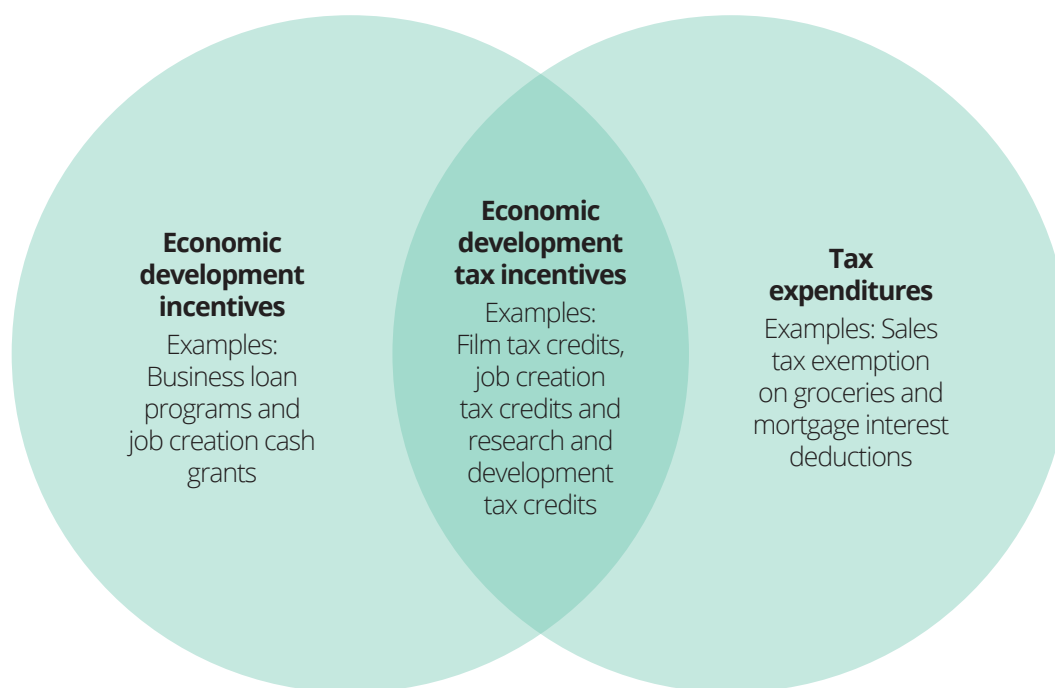
Tax expenditures and incentives play a crucial role in shaping economic growth, business development, social policy goals and the overall fiscal landscape of states. As states strive to attract and retain companies, stimulate job creation, provide for their residents and enhance economic competitiveness, the design and evaluation of these incentives become increasingly important.

This policy brief aims to provide state policymakers with a foundational understanding of tax expenditures and incentives, highlighting the methodologies and criteria used in the evaluation of economic development incentives. It will explore key concepts and definitions, assess state policies through categorization, and discuss the trade-offs involved in designing effective incentive structures. Additionally, the brief will outline best practices for evaluating tax incentives and offer guiding principles for policy development.

Defining Tax Expenditures and Incentives

Structural tax policy refers to the foundational elements of a state's tax system, including tax bases, rates, exemptions and deductions that shape revenue generation and economic behavior. It establishes the framework within which tax expenditures and incentives operate, ensuring stability and consistency. A clear understanding of structural tax policy is essential for differentiating tax expenditures from tax incentives. While structural provisions define the broad contours of a state's tax system, expenditures and incentives function within this framework to influence economic activity and revenue outcomes. The next section delves into these distinctions and explores how they shape fiscal policy decisions.

What Are Economic Development Tax Incentives?



Source: The Pew Charitable Trusts

Differentiating Normal Tax provisions, Tax Expenditures and Tax Incentives

Normal tax provisions refer to deductions or exclusions that determine the correct measure of the tax base. For income taxes, normal tax provisions generally include deductions for ordinary and necessary business expenses. In the case of consumer sales taxes this would generally include business input exemptions. Considerable debate exists within and between states regarding which provisions of a state's tax code constitute tax expenditures and which are integral components of the normal tax structure. In some

states exemptions for food and clothing under the sales tax may be considered normal to reduce the regressivity of the tax, while in others they would be tax expenditures.

Tax expenditures refer to tax benefits that allow individuals or companies to reduce their tax liabilities. These include exemptions, deductions, credits and preferential rates that deviate from a state's normal tax structure. **Tax incentives**, on the other hand, are a specific type of tax expenditure explicitly designed to encourage behaviors or investments, either by individuals or companies. While both tax expenditures and incentives reduce government revenues, incentives are proactive policy tools intended to influence taxpayer decisions toward economic or social objectives. Not every tax expenditure serves as an incentive, but every tax incentive qualifies as a tax expenditure.

States may analyze tax expenditure budgets and tax incentive programs separately to enhance transparency and policy effectiveness. The former provides an accounting of revenue lost due to exemptions, deductions and credits without measurable outcomes, while the latter represents strategic economic development tools with measurable outcomes.

State tax expenditures and incentives take various forms, including:

- **Tax Credits:** Direct reductions in the amount of tax owed, such as credits for renewable-energy investments or for earned income.
- **Tax Exemptions:** Relief from specific taxes, such as sales tax exemptions for purchases in economic development zones or, in some states, groceries.
- **Tax Deductions:** Reductions in taxable income, such as immediately expensing research and development expenses or personal medical expenses.

Different states employ distinct definitions and approaches to tax incentives and expenditures, influenced by their structural tax policy, unique economic contexts, legislative priorities and political landscapes. Deductions for ordinary and necessary business expenses to determine income and sales tax exemptions for business inputs are typically considered part of the normal tax structure. The absence of a clearly defined distinction between the normal tax code and tax expenditures can create challenges for consistent policy-making and evaluation. It has also made state-to-state comparisons exceedingly difficult. Therefore, establishing clear definitions and consistent terminology is essential for effective communication among policymakers, stakeholders and the public.

Understanding tax expenditures and incentives is increasingly critical as policymakers seek to assess their effectiveness. A number of states, such as California and New York, started preparing Tax Expenditure Reports in the late 1980s after federal tax reform. However, over the past 15 years, there has been a notable surge in interest among policymakers and the public for comprehensive information on the performance of tax incentives. Currently there are more than 30 states, along with New York City, Washington, D.C., and Philadelphia, adopting processes for regular and rigorous evaluations of their tax expenditures and incentives. The concerted efforts of state analysts have resulted in a [substantial catalogue](#) of evaluations, providing valuable insights into the effects of these incentives and highlighting the need for effective communication and consistent terminology in this evolving landscape.

Tax Expenditure Reporting: Previous SALT Taskforce Findings

The SALT Taskforce has previously addressed tax expenditures in the paper [Tax Expenditure Budgets and Reports: Best Practices](#). This paper defined tax expenditures as exemptions, deductions and credits that deviate from the normal tax structure to benefit taxpayers or incentivize specific behaviors. These expenditures were historically unreported and lacked transparency. Policymakers now recognize the importance of regular accounting and review as part of effective budgeting practices.

Each state needs to determine what provisions of the tax code are foundational elements of the tax system and not deviations from it, and this requires judgment calls by policymakers.

To improve evaluations of tax expenditures, the taskforce recommended integrating these assessments into state budgeting processes. This included establishing responsibilities for reviews, setting goals and ensuring that evaluations inform decisions about the continuation or modification of tax expenditures. The Executive Task Force on State and Local Taxation adopted the paper on Jan. 14, 2017.

Tax Incentive Evaluations: Types of Accountability Tools

Tax incentive evaluations differ from other [types of transparency and accountability tools](#) such as performance monitoring, transparency portals or compliance audits.

Performance monitoring tracks progress toward agreement milestones for a company. These milestones are company-specific, often tied to incentive payments and used internally by state agencies responsible for administering incentive programs.

Transparency portals are databases that make company-specific agreement metrics available to the public. For instance, these portals might list a company's name, location, maximum incentive amount, the type and amount of activity the company has promised in exchange for the incentive, and how much progress has been made toward those goals.

Compliance audits are used to determine whether a company or an administering agency is following statute and administrative rules. A company may be audited to ensure that it has submitted proper documentation with sufficient evidence to justify a claim and complied with all stipulations of its incentive agreement. An administering agency may be audited to ensure its processes and procedures for awarding and monitoring incentives adhere to the law, safeguard public funds and follow best practices.

[Incentive evaluations](#), in contrast, look at the overall performance of a program versus individual company deals and whether the program is making progress toward its stated goals. Analysts also consider the influence of the incentive to change business behavior, effectiveness of program administration and its alignment with the state's economic development strategy.

Establishing an Evaluation Process for Economic Development Incentives

To ensure that tax incentives are working as they should, states should consider establishing plans to evaluate them regularly and rigorously.

[Research](#) by The Pew Charitable Trusts highlights some of the key questions that officials should ask when designing processes for ongoing incentive evaluations, such as which programs to evaluate; who will conduct the work; how often the evaluations will take place; how to access needed data; the type of information that will be covered in reports; and how the results will be used to improve policy.

Which programs will be evaluated? States often base this decision on the number and magnitude of programs in their portfolios and staff capacity to conduct the reviews. At a minimum, states should evaluate all major economic development tax incentives.

Who will conduct the evaluations? Ideally, the evaluator—whether a state office, legislative staff, an outside contractor, or other arrangement—would have several key traits: experience at program evaluation; experience measuring fiscal and economic impact; an impartial, nonpartisan perspective; and an ability to draw policy-relevant conclusions.

When and how often will programs be evaluated? States should evaluate their tax incentives frequently enough that policymakers have up-to-date information but also give time to analysts to produce rigorous, detailed studies. Several states time their evaluations to inform program sunset conversations.

How will evaluators access the necessary data? Unless the selected evaluator has access to relevant data, plans will usually include provisions that ensure access while acknowledging the importance of protecting sensitive or confidential data. Evaluation laws in several states include data-sharing provisions that balance these priorities.

What should the analysis include? To guide evaluators, evaluation plans list criteria that should be used when studying tax incentives. High-quality reports include a description of the incentive, its history and goals; an assessment of the program’s design and administration; an estimate of the incentive’s economic and fiscal impacts; and policy recommendations.

How will the results be used to improve policy? When states evaluate incentives, policymakers should incorporate opportunities to use the results. That way, the evidence provided is translated into policy improvements. Lawmakers should consider holding hearings in designated committees to review evaluation recommendations or when programs are approaching their sunset dates to increase the likelihood that they will be used in policymaking.

Approaches to Evaluating Tax Incentive Effectiveness

To determine whether a program is effective, analysts should first identify its goal(s) and the metrics needed to measure progress. Unfortunately, many tax incentives lack a clearly stated goal in their enabling statute. It then falls to state legislators or evaluators to [define it after the fact](#).

In general, high-quality evaluations include an analysis of the fiscal and economic impacts of an incentive and take into account the degree of influence an incentive had on business decisions—also known as “[but for](#).” They should also describe the incentive (including its history and goals), an assessment of the program’s design and administration and policy recommendations. Evaluations may cover [many other elements](#) that help in [estimating their impact](#) and providing policymakers with [information](#) to inform policy decisions.

Access to Data

Evaluators across the country report that data limitations and accessibility are some of the biggest challenges they face in their work. These can take several forms:

- Confidentiality restrictions on accessing data or publishing analysis results;
- Incomplete administrative records or reports submitted by program participants;
- Data is collected for administrative/compliance purposes and is not what evaluators needs for analysis;
- No data is collected (such as with sales tax exemptions).

But states have found [numerous ways](#) to safely gain or share access to confidential information, supplement administrative data with secondary data sources, improve incentive governance through enhanced data collection and storage practices, all while protecting taxpayer information.

Putting Evaluations to Work

When states evaluate incentives, it’s important to provide opportunities for policymakers to translate the results into action [to improve policy](#).

Most states that regularly evaluate incentives have designated a specific legislative committee to hold hearings to discuss their results, receive input from stakeholders (including the businesses receiving the incentives and the agencies administering them), and consider whether policy changes are needed. Some states have simply mandated that relevant existing committees hold periodic hearings on evaluations, while others have created panels specifically for this purpose. To put the evaluation results to use, policymakers could discuss topics like:

■ Is there a clear rationale for the program?

- Does the incentive have a clearly stated goal? Are the metrics used to measure progress sufficient?
- How does the incentive align with the state’s economic development strategy?
- Does it complement or duplicate programs?
- Could other policy mechanisms achieve this goal?



■ **Is the incentive designed to achieve its goals?**

- How has the incentive's performance evolved?
- Is the incentive reaching its target beneficiaries?
- Does the incentive aim to avoid rewarding businesses for what they would do in its absence?

■ **Does it minimize negative economic impacts?**

- Does the program incentivize new activity?
- Does it prohibit businesses from restructuring to claim benefits?
- Does the program target industries or sectors that will grow the state's economy overall?

■ **Does it include fiscal protections?**

- Does the incentive include fiscal protections?
- How long can benefits be claimed?
- Does the incentive have a sunset date?
- Are performance standards, compliance monitoring and enforcement mechanisms sufficient?

■ **Is it structured to be adequately and efficiently administered?**

- Is clear guidance made available to businesses by the administering agency?
- Is the program designed to be administered efficiently by the state?

■ **What changes could be made to improve future analysis?**

- Do key terms need clarification?
- Do evaluators have access to the data they need?

States have had success designating a committee to consider the findings of evaluations and place statutory expiration dates on tax incentives. These “sunsets” encourage legislators to carefully consider the findings, since lawmakers must decide whether the programs should be extended, altered or allowed to end.

Not all improvements to incentives require legislation. In many cases, evaluations have made a difference by identifying subtle changes that would improve the administration of incentives. If an evaluation showed that a state economic development agency was not adequately monitoring the performance of companies receiving incentives, for example, the agency could act on its own to improve its monitoring.

Some states have ensured that executive branch agencies consider the findings of evaluations so that administrative changes are more likely. Audit offices have had success in this regard, by allowing executive agencies to respond in writing to findings and recommendations. The audit offices then monitor whether their recommendations have been implemented, often writing follow-up reports.

Understanding Trade-offs in Designing Incentives

Designing incentives is challenging and involves making a series of trade-offs in policy decisions. Over time, evaluations have pointed out these trade-offs, helping policymakers understand how they affect outcomes.

Embedded in these elements is also a spectrum of administrative complexity for government and businesses. A program with more steps, qualifying criteria, complex rules and cumbersome reporting requirements may make for a well-targeted program, but could be costly, time-consuming and difficult to administer. Thus, state policymakers and agencies administering the program may work toward a mix of efficiency, accountability and effectiveness.

Design Characteristics and Best Practices for Tax Incentives

The table below describes various incentive characteristics and how they may translate when implemented. Several organizations have published resources on best practices for designing tax incentives:

- [Establishing an Economic Development Incentive](#)—Government Finance Officers Association
- [Improving Economic Development Incentives](#)—The W.E. Upjohn Institute for Employment Research
- [Pew Questions for Lawmakers to Ask When Designing New Tax Incentives](#)—The Pew Charitable Trusts
- [How States Can Consider and Design Effective Tax Incentives](#)—The Pew Charitable Trusts
- [Repositioning Economic Development Incentives](#)— Center for Regional Economic Competitiveness

Application Process	
Design Element	Description
Competitive (or discretionary) vs. entitlement	<p>Under the competitive model, officials or appointed boards assess applications and offer incentives to businesses viewed as most promising, based on criteria such as expected economic impact. With the entitlement approach, a state offers incentives to all qualifying applicants. If there is a cap on an entitlement program, it is usually first-come, first served.</p> <p>Discretionary programs require clear processes and strong internal capacity for determining awards. This type of process may help direct incentives to businesses that offer a stronger return on investment, but only if the state can make impartial decisions about which companies to choose. Entitlement programs can be easier to administer because they require less involvement by administrators. However, they may not effectively target the strongest applicants and can instead reward those with the most capacity to submit applications quickly.</p>

Year-round vs. Scheduled Application Dates	Some programs accept applications year-round, and others accept them only at select times. The challenge with the latter is that restricted timing may not meet a company’s schedule. Some programs hold multiple rounds each year, with a separate cap on the value of credits awarded to make sure the program does not cost more than intended.
Upfront “But For” Requirements	<p>Governments may not be able to eliminate instances of rewarding businesses for what they would have done without the incentive, but they can reduce these occurrences. One step could be to exclude activity that is already planned or underway. Doing so would indicate that the business has already chosen a location and therefore does not need the incentive to aid in its choice.</p> <p>Another alternative incorporates a “but for” estimate into the up-front project assessment process. Instead of assuming 100% of the proposed business investment is a result of the incentive, states could score proposals using a predetermined rubric and discount the investment by the corresponding “but for” amount. The hope is to get a more accurate cost-benefit analysis and whether support is likely to induce new behavior.</p>

Incentive Claims

Design Element	Description
Performance-based programs vs. Upfront awards with clawbacks	<p>Requiring businesses to meet performance standards to receive incentives can help protect states from paying for activity that never occurs. States have also linked incentives to company performance through “clawbacks,” in which a business receives incentive dollars upfront, but the state reclaims the money if the company does not meet required performance standards.</p> <p>Although paying incentives upfront may be more valuable to the companies, designing programs with clawbacks has a downside. Businesses may have understandable reasons for not growing as they intended, such as changes in economic conditions, and states can be reluctant to take money away from companies that are already struggling.</p>
Carryforwards, Prorating, Transferability, or Refundability	<p>Carryforwards are specified time limits for businesses to claim credits. Carryforwards can make it hard for officials to anticipate how much a program will cost from year to year because years can pass between when companies apply for incentives and when they claim the benefits on their tax returns.</p> <p>Some states opt to prorate incentive payments, such that every eligible business receives the incentive, but the value of each incentive is prorated to stay under an overall program cap. This approach provides certainty for states about cost but uncertainty for businesses. The amount of their incentive will change depending on the number of qualifying businesses because the value will get evenly divided among participants.</p> <p>Refundable credits allow a company to redeem more in incentives than it owes in taxes with the state paying the difference in a refund check. Transferable credits allow a company to sell its excess credits to another taxpayer that owes the state taxes.</p> <p>However, if policymakers pursue these options, it is important that they incorporate cost controls, such as program spending caps, recognize the economic loss associated with transferable credits sold between businesses and institute tracking systems for credits transferred between businesses.</p> <p>Despite the fiscal risks, states have a rationale for using refundable or transferable tax credits: The programs help businesses with little state tax liability. This group often includes startups, which may owe little because they are not yet turning a profit.</p>

Incentive Targeting

Design Element	Description
<p>Targeting locally serving businesses vs. businesses that export goods/services</p>	<p>Giving incentives to companies that sell their goods locally, such as retailers, will tend to harm other businesses in the community and undermine the program’s potential economic benefits because sales and jobs at the new firm will come at the expense of existing companies.</p> <p>In contrast, incentives given to exporters—businesses such as manufacturers that primarily sell their products outside the state or community—are more likely to deliver local economic benefits because those firms bring in new dollars and jobs. Some companies may do both, selling a portion of their goods locally and exporting the rest.</p>
<p>Incentivizing businesses in tight labor markets vs. in those with a lower employment to population ratio</p>	<p>Incentives may have larger benefits when a local economy is struggling. When unemployment is high, there is an increased likelihood that new jobs created will be filled by the large pool of unemployed local workers rather than by workers moving between communities, boosting local workers’ earnings and increasing tax revenue.</p> <p>However, when unemployment is low, fewer local workers are available, and more of the new jobs will be filled by people moving from outside the area. Moreover, this increased population leads to higher government spending due to greater demand for local services such as schools, housing and infrastructure.</p>

Fiscal Protections

Design Element	Description
<p>Caps vs. no caps</p>	<p>Research shows that caps, or limits on spending or commitments, are among the most effective tools for governments to guarantee that incentives do not cost more than expected or intended. In some cases, the revenue reductions from incentives are predictable. However, if more companies qualify for the programs than anticipated or if they qualify for unexpectedly large incentives, state budgets can be caught off guard. Incentives have caused short-term budget challenges when payments spike by tens of millions of dollars from year to year or longer-term budget difficulties when incentive payments increase year over year beyond state’s budget capacity.</p> <p>States have numerous options when designing caps. Policymakers need to consider the mechanics of their state’s specific programs to determine the best approach.</p> <ul style="list-style-type: none"> • Caps on authorizations limit a state’s overall financial commitments. • Caps on redemptions control what incentives can cost each year. • Caps on issuances: when businesses that have met performance requirements are provided with incentives but allowed to redeem them later. • Aggregate caps: While states usually place caps on individual tax incentive programs, in rare instances they create caps that apply to multiple programs.

<p>Paying for incentives through tax increases vs. spending cuts</p>	<p>When an incentive spurs new business activity, it can have budget implications that go beyond the initial cost of the program. On the positive side, increased economic activity results in additional tax revenue. But government spending will also grow as new job opportunities draw in additional population, boosting demand for government services such as transportation and public safety. The net budget cost—the incentive’s initial cost, plus the increased spending needs, less the increased revenue—depends on the relative strength of these three effects.</p> <p>In many cases the revenue and spending increases will largely offset each other, and the program’s net budget impact will be approximately equal to its initial cost. Because government budgets must be balanced in the long term, that cost must be paid for by increasing tax rates, cutting spending, or both. Each of these approaches can have negative economic consequences that offset some benefits of the incentive programs.</p> <p>Tax increases can have negative effects by reducing how much money people must spend and by discouraging business activity.</p> <p>Government spending cuts can result in fewer jobs and less economic activity, and reductions to long-term government investments can be damaging to future economic prosperity. For example, cuts to education can harm students’ job prospects and wage potential for many years to come. And spending money on one incentive program means a state or city might have to forgo other potentially productive economic development strategies.</p>
<p>Incentives through the tax code (tax credits, etc.) vs. state budget (grants, loans, etc.)</p>	<p>If incentives are funded by appropriations, like most government programs, lawmakers are in control of their costs and have an impetus to reconsider their effectiveness. Spending through the tax code can inject more uncertainty for state budgets unless they are coupled with things like caps or controls on the timing of distributions. Although an appropriations process is far more common for cash incentives than it is for tax incentives, it can be used to set annual caps for tax incentives as well.</p>
<p>Other</p>	
<p>Design Element</p>	<p>Description</p>
<p>Data reporting requirements as a condition of receiving incentives</p>	<p>States can ensure that policymakers, evaluators and compliance monitors have access to the data necessary for them to carry out their duties. Ways to do this include contractual obligations by the incentive recipient to submit data (sometimes paired with penalties for non-compliance); waivers to confidentiality; publication of taxpayer information as a condition of receiving an incentive; or special arrangements like memoranda of understanding or liaisons to facilitate the exchange of relevant project data with administrators and evaluators. Some governments require formalized data sharing agreements between agencies, while others have developed technology solutions to share unified databases with incentive information.</p> <p>In addition to compliance, states should consider designing data reporting requirements with an eye toward evaluation. Doing so can ensure that data would provide useful information for analysts and avoid unnecessarily burdening businesses.</p>
<p>Sunset provisions</p>	<p>“Sunsets” are statutory expiration dates on tax incentives. They encourage legislators to consider the findings of evaluations, since lawmakers must decide whether the programs should be extended, altered or allowed to end. Sunsets work best when paired with evaluations. Otherwise, lawmakers may lack the information they need to determine whether incentives should continue and, if so, in what form.</p>

NCSL's State and Local Taxation Task Force

This policy brief was developed by NCSL's State and Local Taxation (SALT) Task Force. The Task Force was created to analyze emerging tax issues and provide guidance to state legislators confronting the complexities of the 21st century economy and consists of legislators, legislative staff, and NCSL Foundation members.

Acting in a bipartisan and balanced manner, the task force identifies critical issues legislatures need to address and provides practical guidance to states by developing principles and best practices for tax reform and modernization.

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