Improving Georgia's Tax Audits and Reviews

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Executive Summary

- Stability and long-term certainty are key to pro-growth economic development climates.
- The State of Georgia is building a process for reviewing tax incentives to ensure taxpayer resources are being used wisely. The current process is flawed but not without merit.
- When measuring the effectiveness of incentives, there are considerations for which measurements and net changes are difficult to assess. Suggestions to improve the process include better defining economic criteria and creating an economic advisory council.
- Additional considerations are included for newly created and renewed tax incentives.

Introduction

Georgia is recognized as the number one state for business for many reasons including its competitive and stable tax environment. Policy makers have equipped communities and economic developers with tools to compete for companies looking to relocate or expand. These tools are often in the form of tax incentives, which Georgia leverages to compete with states, including those which have no gratuities clause. In turn, these private employers bring job creation, innovation, revenue, and prosperity to families.

If a state's tax structure is prone to frequent changes, site selectors and corporate leaders place a lower value on tax benefits offered by the state and perceive a higher level of risk associated with future tax changes. Uncertainty regarding even one tax policy or incentive inevitably leads to heightened concerns about the future of tax provisions, harming a state's reputation for stability both to economic developers and bond rating agencies. The resulting spillover effect can become quite significant to economic growth over time.

In an effort to ensure responsible management of taxpayer dollars, the Georgia legislature has begun reviewing tax incentives. In Senate Bill 6 passed in 2021, the legislature created a process (O.C.G.A. §28-5-41.1) by which ten tax incentives per year would be selected for audit conducted by a third party with oversight from the Department of Audits and Accounting (DOAA). Five incentives are chosen both by the House Ways and Means Committee and the Senate Finance Committee.

This is a largely new endeavor for the State of Georgia, and it will take time to refine the process resulting in reliable and accurate evaluations. When policymakers consider changes to the tax code, it is important to review those changes later and assess their impact on our economy and state revenues.

The first round of tax incentive evaluations was released late in 2022. The evaluations raise concerns that must be carefully weighed before relying on them as the basis for

policy changes, especially concerning incentives that have been key economic development tools. The scope and methodology leave room for improvement, and there are even challenges with the analyses discussed by the staff performing the evaluations (discussed below).

The intent of this report is to elaborate on some of the concerns with the current review process and to raise important points to consider when using IMPLAN, the economic modeling program relied on by the evaluations. Additionally, this report will offer specific ideas and recommendations to improve how Georgia evaluates economic development tax incentives going forward.

Concerns and challenges with the current tax incentive evaluation process

1. There **is a lack of information to replicate the results of the studies**. Showing specific methodology helps analysts and other economists better understand how conclusions were reached. This includes which IMPLAN industry group was used in the economic modeling software to demonstrate the economic and fiscal impact, as this input could be incorrectly selected. For example, there is a substantial difference between the "general manufacturing" IMPLAN industry group and the higher value-added "automotive manufacturing" industry group.
2. There are **no details about the length of time the jobs created are expected to last**. One way to minimize the economic impact is to assume that jobs only last a short period of time, yet most companies that move to Georgia, or expand in this state, stay and those jobs last many years. Analyses should clearly state assumptions and standardize the assumed number of years jobs last. This will give a clearer picture of the evaluation of those jobs, their associated tax revenues, and a more realistic picture of the return on investment. Put simply, assuming a job lasts for five years versus 20 years has a significantly different impact.
3. Some of these studies are highly complex, and the **researchers should be given ample time to perform the studies.** Policymakers could consider funding the more complex incentive studies as Ph.D. dissertations for current Georgia economic graduate students. One of the researchers who conducted some of the audits even told the House Ways and Means Committee, "there are intangibles that input-output models simply do not capture…And in looking at some of the studies that were done in other states that have a longer history of this, their studies tend to look more like a two-year Ph.D. dissertation."
4. The **methodology used in the "but for" examples is not straightforward** and may not be reasonable. Researchers should indicate the methodology used in the papers referred to when using existing "but for" examples. Researchers should also give links to the reports used and other reports that may use alternative "but for" percentages. There is a serious disconnect between the academic estimates and the percentages believed by economic development professionals and businesspeople. Given time constraints, researchers often rely on academic literature to expedite their studies. Generally, such literature could be biased against tax incentives as it is not written by real-world practitioners.

5. **Alternative "but for" percentages should be used to calculate economic impacts**. Instead of using one "but for" percentage, the readers should be given a wide range so they can match their subjective probabilities of the number projects that were due to the incentive.
6. **Sensitivity analyses should be performed on "but for" analyses to show a "break even" percentage**, the point at which the return on investment "breaks even" at zero. This would indicate how close the "break even" percentage is to the researcher's chosen "but for" percentage. For example, an incentive with a "but for" percentage of 5% could have a negative 25% return compared to a 7% "but for" which yields a "break even" percentage of zero. The difference in ROI between the two "but for" percentages is significant and could prove consequential to decision-making.
7. **Benefits of creating jobs for Georgians will not appear in a simple economic model like IMPLAN, the economic modeling program relied on by the evaluations**. Therefore, analyses do not adequately capture what investment in a community and individual lives means.
    a. There are substantial benefits when a person outside the workforce returns to work when a job is created in Georgia. Considering those workers who were previously receiving government benefits then become taxpayers, research from the Federal Reserve Bank of Atlanta shows that the value of each one of those transformations can be worth more than $100,000 in terms of the reduction of government benefits and the gains in tax revenues.
    b. Companies invest in their communities, not only in education but also in quality-of-life elements for the communities in which they locate. These investments are not counted nor acknowledged in the reports.
    c. Company announcements for relocations or expansions in Georgia are "news events" that may have impacts on other companies contemplating moves to Georgia. These announcements signal the market that the state is ready for business and provide added endorsement. This has value and is not counted in IMPLAN nor acknowledged in the reports.
    d. Research indicates that around 70 percent of manufacturing research and development becomes a public good, given that only around 30 percent is captured by the "inventing" company. This public good has a substantial economic benefit to other companies and the state.
    e. Training offered by companies and the state of Georgia, including internships and apprenticeships, benefits not only the individuals and their companies but also other companies in those industries in the state. These are not counted in IMPLAN nor acknowledged in the reports.
8. **Return on public investment calculations may be flawed**. These are used as a comparison, as in "what if the government spent the money on something other than incentives". First, there is no spending on incentives without performance by the company. The company has to create jobs and those jobs generate tax revenues every year for multiple years. Most jobs created in Georgia, according to IMPLAN, yield thousands of dollars per job per year in state tax revenues. Those jobs typically last multiple years, yet the incentives are paid only for a limited time. Therefore, a comparable "return on public investment" is only a reasonable

comparison if that alternative government spending also creates sustainable state tax revenues over multiple years.

A Note on IMPLAN

IMPLAN is the economic modeling program relied on by the state tax incentive auditors. It is a tool widely used by both academics and economic development professionals around the country for economic impact analysis. The output it provides is a simple representation of the economy and since it is a partial equilibrium model, all the effects of job creation cannot be modeled. It is reasonable for the Georgia legislature to continue to use IMPLAN for the purpose of analyzing the economic and fiscal impacts, but understanding limitations of using a model like IMPLAN is critical before making policy decisions. For examples, see appendix 1.

Suggestions for Improving Georgia Tax Incentive Evaluation Process

When reviewing state tax incentives already in place, Georgia relies on the process as described in Senate Bill 6 passed in 2021 (O.C.G.A. §28-5-41.1). The stated parameters for measuring the incentives are:

> "An economic analysis shall include, but not be limited to, a good faith estimate as a result of the law or proposed law, on an annual basis for five years thereafter, of the following, on both a direct and indirect basis:
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> (1) Net change in state revenue;
> (2) Net change in state expenditures, which shall include, but not be limited to, costs of administering the bill;
> (3) Net change in economic activity; and
> (4) If applicable, any net change in public benefit."

These parameters are reasonable but may not be specific enough to create a complete analysis of any tax credit. When measuring the effectiveness of incentives, there are considerations for which measurements and net changes are difficult to assess. For example, one of the most important considerations left out is "what economic value does the State of Georgia apply to the diversification of its economy?" There may be instances where an industry has a lower return on fiscal investment than others, but there is substantial and unquantifiable value to the state of diversifying the economy. Georgia benefitted in terms of recovery from the COVID-19 pandemic due to the diversification of its economy. Indeed, even the Georgia Department of Audits and Accounts acknowledges, that:

> "Measuring performance based only on the factors shown here may not be appropriate. While this summary report includes only the business tax incentives reviewed, the incentives may have purposes beyond economic growth, jobs, and the generation of new state revenue."[1]

To improve this process, the following changes should be considered.

[1] https://www.audits2.ga.gov/reports/summaries/business-tax-incentives/

Economic Criteria

Additional criteria should be included to more thoroughly and properly evaluate the economic implications of an incentive. A narrow focus on "direct" impacts of a credit measured against the direct cost of the credit leaves out the indirect and downstream effects of each credit. When considering direct impact, some incentives will have a negative fiscal impact but are spurring economic growth and job creation.

Simplified studies and economic analysis software account for limited downstream economic impact and largely ignore supplier-related activity (the cluster effect) and related consumer spending. However, if analyses continue to study "return on investment," the definition should be more thoroughly and accurately defined.

- When measuring "direct return on investment," the definition should specifically include elements like state tax collections, local tax collections, full-time jobs, part-time or partially allocated jobs, and wage increases significantly supported by a tax provision.
- "Indirect return on investment" captures many more elements. Some aspects to consider include residential housing, local education facilities, commercial businesses, community financial support, public safety, and works facilities, and commercially insured patients.
- Incentives are intended to encourage or discourage a particular activity. Capturing return on investment should include the "incentive effect" to determine the degree to which the desired activity is encouraged due to the incentive.
- Significant amounts of infrastructure are put into place by companies newly operating or expanding in an area. Including and defining "infrastructure" in the definition would capture components needed not only for the company driving the infrastructure but also for future companies, organizations, schools, residential communities, etc. These include roads, bridges, telecommunications networks, fiber, energy generation and transmission capacity, rail lines, airports, and water supply and treatment facilities.

In recognition of the fact that these items are often difficult to quantify or require significantly more time, personnel, data, and study, auditors should be required to state what they are unable to capture in their findings. Additionally, final reports should include the methods attempted to quantify these items.

Economic Advisory Council

The tax incentive review process should take input from relevant regulatory agencies and third-party organizations or businesses. Modeled after the 2010 Special Council on Tax Reform and Fairness for Georgians, the legislature could create an advisory council to include experts and practitioners to ensure thorough tax incentive evaluations and vet recommendations for improving incentives. Such a body could create standardized criteria and methodology on which all tax incentive evaluations would rely.

A standing group, called the "Tax Economic Advisory Council" for example, should consist of:

- Six economists, two each appointed by the Governor, Lieutenant Governor, and the Speaker of the House of Representatives;
- The Governor or a designee;
- A nonpartisan fiscal expert jointly agreed to by the minority leaders of the House of Representatives and the Senate;
- Two members appointed by the Lieutenant Governor and two members appointed by the Speaker of the House of Representatives;
- The commissioner of the Department of Economic Development, or a designee;
- The commissioner of the Department of Community Affairs, or a designee;
- The state director for the National Federation of Independent Business, or a designee;
- The presidents of the Metro Atlanta Chamber and Georgia Chamber of Commerce, or their designees; and
- A professional site selector and an economic development professional chosen by the appointed members listed above.

The members of the council would not receive compensation, except members who are state officers or employees who may be reimbursed for expenses incurred in the performance of their duties by the agency or department in which they serve.

Suggestions for Future and/or Renewed Tax Incentives

As new tax incentives are created or existing ones are amended or renewed, new language should be considered to improve the audit process and provide long-term planning support and predictability for users of the incentive. These recommendations would also support policymakers and auditors over time and by providing stability and best practices as staff and policymakers turn over.

- Language should define the purpose of the incentive, such as which industry is the target of growth or attraction or what behavior the incentive is attempting to influence, such as driving taxpayers to make certain purchases or contributions. For incentives passed years ago, the original goal is often forgotten over time as original proponents leave the industry and/or legislature.
- Instead of a sunset, proposals should build a timeline for evaluating the incentive. This could be a standard number, such as five years, or other timeline based on how the incentive functions. This provides companies with greater long-term stability while also protecting the review process.
- Quantifiable goals for determining whether the incentive meets its goal, such as growth by a specified percent or specified number of jobs, would help entities know from the outset what the expectations are. These goals could be scaled over time through a series of benchmarks.

- Codified metrics and/or methodology to measure growth, jobs, ROI, etc. would provide additional clarity regarding expectations. Once again, this would help entities understand expectations and how they will be determined from the outset.
- If the incentive's goals are unmet, a codified plan to phase out the incentive or reevaluate effectiveness would help with long-term planning. Any plan to phase out an incentive should include a gradual step-down or reasonably long sunset instead of an immediate end to so companies relying on those incentives to expand in or move to Georgia understand the environment and would be more protected. Additionally, the state would not receive the negative reputation that incentives will not be available due to a sudden change in the actions of the legislature.
    - If an incentive has no sunset, a sunset two to three years out would provide sufficient notice.
    - If an incentive does have a sunset, leaving the sunset in place upholds the stability Georgia has historically signaled to investors.

Conclusion

Georgia is the number one state for business thanks in part to its competitive and stable tax environment and the tools created by the state and leveraged for economic developers. Georgia's ongoing conversations about tax incentives would better signal stability to site selectors and external audiences, given well-defined parameters and established processes. The legislature is to be applauded for attempting to do this work during the 2024 session, and this report attempts to support that effort.

Appendix 1: Understanding IMPLAN

IMPLAN is the economic modeling program relied on by the state tax incentive auditors. It is a tool widely used by both academics and economic development professionals around the country for economic impact analysis. The output it provides is a simple representation of the economy and since it is a partial equilibrium model, all the effects of job creation cannot be modeled. A general equilibrium model would give better results, but those are expensive to build and not widely accessible. It is reasonable for the Georgia legislature to continue to use IMPLAN for the purpose of analyzing the economic and fiscal impacts, but understanding limitations of using a model like IMPLAN is critical before making policy decisions. For examples, see appendix 1.

1. IMPLAN is a static model. Although it does account for indirect impacts (those created in the supply chain) and induced impacts (those created due to the spending of salaries of workers in the direct and indirect jobs), IMPLAN is unable to account for the "cluster effect". One example of this is that IMPLAN cannot predict how many suppliers will move to a state as an industry expands. To consider the "cluster effect" one would have to use a dynamic model, not a static one like IMPLAN.
    - The 2022 Tax Incentive Evaluation of the Georgia Research and Development Tax Credit acknowledges this challenge:

"While traditional economic impact modeling is designed to capture the effect of increased employment, spending, and taxation within a region, it may fail to fully account for the clustering effect of businesses, suppliers, and customers. For example, one major user of the Georgia R&D credit… cited two significant suppliers of R&D-derived intermediate inputs that have relocated to facilitate closer collaboration. These suppliers, who in turn conduct their own research and development, create additional jobs and economic impact that may not be captured by a static economic impact model due to the simple fact that such relocations typically occur over a fairly long time horizon. These relocations may also add to the state's reputation as a good place to conduct business, another intangible that cannot be captured by a traditional quantitative impact analysis."[2]

2. The production function underlying IMPLAN is a "constant returns to scale" function. In other words, the results can be thought of as "linear." An example would be that adding 1,000 jobs in an industry yields a result that is simply 10 times adding 100 jobs. Economic theory and real-world observations suggest that clustering of jobs often yields substantially higher multipliers due to the clustering effect.
3. Industries have different multipliers depending upon where they are located in the state. The economic impact at the state level may be higher or lower than that same job in a specific location because IMPLAN will use the state average or the county average.
4. IMPLAN would be unable to analyze bringing a totally new industry to Georgia. If the industry does not currently exist in a specific county or in the state of Georgia, there would be no information in the input-output model to show the supplier connections and other information needed to calculate its impact. IMPLAN does a better job of calculating impacts for industries that are already well-established, assuming the correct IMPLAN industry is chosen by the modeler.
5. The specific industry needed to give an accurate economic impact may not be included in IMPLAN. There are only 546 available industries in IMPLAN, and often multiple NAICS codes map to a more general industry in IMPLAN that is available. In other words, a more general industry is used as a substitute for the actual industry. In some cases, the IMPLAN industry would have smaller multipliers associated with them than would the original industry, especially if the new industry is one with a high level of value-add.

[2] Page 22 - https://www.audits.ga.gov/ReportSearch/download/28912