**TO: Members of the Tax Expenditure Review Commission**

**FROM: Office of the State Auditor**

**DATE: December 11, 2019**

**RE: To be Considered at Meeting on December 13, 2019**

1. **Determine categories for reviewing expenditures:**

The North American Industry Classification System (NAICS) is the standard used by Federal statistical agencies in classifying business establishments for the purpose of collecting, analyzing, and publishing statistical data related to the U.S. business economy. However, NAICS is frequently used for various administrative, regulatory, contracting, taxation, and other non-statistical purposes. Selecting the North American Industry Classification System’s 20 sector *descriptions* as the review categories is preferred because NAICs codes help make business and product classifications uniform and comparable to simplify market analysis and data resource identification and make them more representative.

North American Industry Classification System’s (NAICS) codes array the economy into 20 sectors, which are separated into 99 3-digit subsectors, which are divided into 311 4-digit industry groups, which are further subdivided into 709 5-digit industries, and finally disaggregated into 1057 6-digit U.S. industries.

The US Bureau of Economic Development, US Department of Labor, Congressional Research Services, The Massachusetts Department of Unemployment, the Massachusetts Office of Travel and Tourism, the Massachusetts Department of Environmental Protection, and the Massachusetts Department of Transportation (to name a few) use and collect NAICs for a variety of purposes; including categorizing products, businesses, registration and licensing, industry job trends, customer market surveys, policy impact studies, etc. By categorizing the tax expenditures by NAICs, we are better equipped to fluidly leverage data that’s been collected by other agencies, and replicate analysis methodologies and assessment criteria that are generally accepted by other public agencies, state peer-groups, industry experts, and professional institutions.

Individuals are generally not assigned a NAICs code so some expenditures will not be simply classified. However, by researching the budget function, claimant/beneficiary, and goals of the expenditure, it should be possible to determine with which NAICs sector (or multiple) to associate the tax expenditure.

\*\*\*Please see the tax expenditure excel document as an example of how these tax expenditures could be categorized in the NAICs sectors.\*\*\*

**North American Industry Classification System (NAICS) 20 Sector Codes:**

**Sector Description**

11 Agriculture, Forestry, Fishing and Hunting

21 Mining, Quarrying, and Oil and Gas Extraction

22 Utilities

23 Construction

31-33 Manufacturing

42 Wholesale Trade

44-45 Retail Trade

48-49 Transportation and Warehousing

51 Information (IT)

52 Finance and Insurance

53 Real Estate and Rental and Leasing

54 Professional, Scientific, and Technical Services

55 Management of Companies and Enterprises

56 Administrative and Support and Waste Management and Remediation Services

61 Educational Services

62 Health Care and Social Assistance

71 Arts, Entertainment, and Recreation

72 Accommodation and Food Services

81 Other Services (except Public Administration)

92 Public Administration

1. **Determine evaluation criteria:**

Evaluation criteria will vary based on the background, intent and goals of each tax expenditure program. The U.S. Government Accountability Office (GAO) often refers to professional judgment when establishing criteria, along with “best practices” for a thorough program evaluation.

The U.S. Government Accountability Office (GAO) offers guidance on tax expenditure evaluations and general program evaluations:

[Tax Expenditures: Background and Evaluation Criteria and Questions](https://www.gao.gov/products/GAO-13-167SP)

[GAO-12-208G, Designing Evaluations: 2012 Revision](https://www.gao.gov/assets/590/588146.pdf)

States across the country are starting to gather data and use evidence to systematically evaluate tax incentives. The National Conference of State Legislatures has a [“State Tax Incentive Evaluation”](http://www.ncsl.org/research/fiscal-policy/state-tax-incentive-evaluations-database.aspx) database. By using the database to assess other State’s reports, evaluation criteria and best practices are easily identified.

High quality tax expenditure evaluation reports usually are designed to contain at least 2 (usually more) performance analyses, including and not limited to:

* *Administration:* Depending on the specifics of the program, administering agencies may be charged with advertising the availability of the incentives, determining which companies are eligible, and monitoring the performance of that benefit. Evaluations often study whether administering agencies are performing these tasks efficiently and effectively and identify potential improvements.
* *Design:* Programs differ in many ways, including which companies are eligible, how the size of the benefits are determined, and whether they take the form of tax breaks, grants, or loans. Even subtle differences in a program’s design can have a large impact on its return on investment. For that reason, many evaluations analyze whether incentives have been well-designed to achieve their intended goals and offer recommendations for improving their effectiveness.
* *Literature Review:* Many evaluations discuss academic literature or other economic research. These literature reviews are often helpful for describing the history, rationale, and effectiveness of particular types of incentives (e.g. film tax credits). Some evaluations have also used academic literature on the responsiveness of businesses to reductions in their taxes as a way to gauge what happened because of the incentive and what would have happened anyway.
* *Economic modeling:* Many evaluations use REMI (Regional Economic Models, Inc.) or IMPLAN to measure the economic impact of tax expenditures. These models are based on a series of equations that represent economic relationships. They can be used to measure how one change in the economy, such as the introduction of a tax incentive, affects other areas of the economy.

*Other performance analysis commonly used:*

* + *Multipliers:* The direct economic activity created by incentivized businesses may also produce additional benefits. Economic researchers have developed estimates for these multipliers, which vary based on a variety of factors such as the industry of the company directly receiving incentives. High-quality evaluations are transparent about the multipliers they use and explain the rationale behind them.
  + *Opportunity costs*: When states dedicate revenue to tax expenditures, they lose the ability to spend that revenue on other priorities, such as education, transportation, or broad-based tax cuts. Opportunity costs represent the benefits of those alternatives and provide an important benchmark to compare with the outcomes of incentives to determine their effectiveness.
  + *Leakage:* When incentivized companies produce economic activity in a state, some of the benefits may also flow to others states. High-quality evaluations estimate how much leakage is taking place to help measure the in-state economic impact.
  + *Displacement:* Economic activity created by incentivized businesses can come at the expense of other businesses in the state. To take into account this displacement, evaluations have measured the net effect of incentives on the state economy (rather than merely focusing on the results for the companies that received incentives).
  + *But for:* Incentives are designed to encourage businesses to produce economic activity they would not have otherwise, "but for" the incentive provided by the state. Almost always, however, they at least partially reward businesses for what they would have done anyway. High-quality evaluations estimate the amount of incentivized activity attributable to the incentive.
* *Data:* Where data is estimated, it is important to be transparent. An evaluation may analyze the availability of related data that is needed to evaluate the program’s performance.

In general, the data sources include the following categories:

1. *Federal Agencies*, including the U.S. Census Bureau, the Internal Revenue Service, the U.S. Department of Agriculture, U.S. Energy Information Administration, and the U.S. Bureau of Economic Analysis.
2. *State Agencies*, including, the Department of Agriculture, the Division of Insurance, the Secretary of State’s Office, the Office and Labor and Workforce Development, the Office of Consumer Affairs and Business Regulations, and the Department of Transportation.
3. *Local Governments*, including cities and towns, counties, and special districts.
4. *Research Institutions*, including peer-reviewed professional publications, university publications, and reports published by reputable private research institutions.
5. *Industry and Stakeholder Groups*, including professional associations and other groups that are closely tied to industries relevant to a particular tax expenditure.
6. *Media Sources*, including newspapers and trade publications
7. *Taxpayers*, including surveys and interviews with taxpayers who may benefit from the tax expenditures.
8. **Determine goals for each expenditure:**

The goal of each tax expenditure should reflect the legislative intent, beneficiary, and policy impact initiative that it was designed to effect. The goal should include more information than included in the [DOR TEB database, 2013.](https://www.mass.gov/doc/summary-of-ma-teb-simplified-version/download)

Under the, [“GAO *Executive Guide: Effectively Implementing the Government Performance and Results Act*](https://www.gao.gov/products/GAO/GGD-96-118)*,* “ a key first step of agencies’ performance measurement efforts is establishing strategic goals that explain the purposes of the agencies’ programs and the results they are intended to achieve.

Likewise, identifying the tax expenditure’s purpose is a necessary first step in determining how the tax expenditure’s performance should be assessed. For some tax expenditures, the intended purpose may be clear from the legislative history; for others the purpose may not be clear and may need to be inferred. The Congressional Research Service (CRS) regularly compiles information on tax expenditures, including what is known about their purpose or purposes.

The following are various examples of broad purposes for tax expenditures.

* To encourage taxpayers to engage in particular activities. Some tax expenditures are geared toward encouraging investing in basic research; hiring; saving; or producing or purchasing energy efficient vehicles, housing, or appliances.
* To adjust for differences in individuals’ ability to pay taxes. Taxpayers who had large out-of-pocket medical expenses or theft losses may deduct some of these expenses.
* To adjust for other provisions of the tax code. Advocates of reduced rates on capital gains often explain the special treatment of capital gains income as offsetting, in part, the effect of inflation on the value of capital gains.

**The Goal of this program is to achieve/ eliminate “this/outcome” because…..**

*Intent:*

To enhance

To ensure

To eliminate

To compensate

To promote

To provide

To allow

To attract

To avoid

To assist

To exclude

To exempt

*Claimant/Beneficiary:*

Personal (socio-economic indicators)

Corporate

Sector specific

*Broad Policy Impact: (should be expended based on legislative research, or the “because”)*

National Defense

International Affairs

Research and Development

Energy

Natural Resources and Environment

Agriculture

Commerce

Housing

Transportation

Community Development

Education and Training

Employment and Social Services

Health

Medicare

Income Security

Veterans' Benefits

General Purpose Fiscal Assistance