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New Disclosure Rules and the Future of Incentives

By Ellen Harpel

PREPARING FOR TRANSPARENCY AS THE NEW NORM

Elected officials and community groups are demanding better data on incentive costs and benefits. New tax abatement disclosure rules are one manifestation of this trend toward greater transparency and accountability in incentive use. While compliance will come with challenges, the disclosures also create an opportunity for economic developers to tell their story: why incentive programs are in place, the ways in which they are managed responsibly, and how they are designed to accomplish shared economic development objectives to improve the well-being of communities.

new disclosure rules

AND THE FUTURE OF INCENTIVES

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During an IEDC webinar in 2013 the speakers and participants agreed it was time to prepare for a future of greater transparency and accountability in incentive use. The Governmental Accounting Standards Board (GASB) tax abatement disclosure rules now in effect indicate that this future has arrived. In fact, these rules represent just one aspect of the trend toward greater transparency in the use of incentives and reflect the growing interest in quantifying the impact of economic development incentives on government budgets and on the well being of our communities.

This article explains why there is demand for greater transparency related to incentives, discusses the specifics of the tax abatement disclosure rules, and provides suggestions for how economic developers can respond. The article concludes with observations on how transparency may change the way incentives are used.

WHY THE FOCUS ON INCENTIVES? WHY NOW?

It is easy to peg the current interest in incentives to the 2012 New York Times series, "United States of Subsidies," but three more fundamental dynamics underlie today's concern.

First, there is a disconnect between what economic developers believe they do and what others think they do. Elected leaders, reporters, and even some academic researchers equate economic development as practiced in the US today with incentives for business attraction. An excerpt from a recent report from The Brookings Institution, Remaking Economic Development[1], encapsulates this perspective:

> "Yet, conventional economic development remains largely misaligned to what matters. It favors recruiting new firms over helping existing firms become more productive and expand. It relies too often on taxpayer-funded incentives geared to one-time job creation, rather than positioning industries and assets for long-term growth. And . . . conventional economic development remains largely reactive, driven by deals in the pipeline." (p 5)

The paper recommends setting the right long-term goals (focused on prosperity and inclusion as well as growth), growing from within by working with clusters and existing businesses, supporting trade, investing in people and skills, and focusing on place within a regional context. These are all things that good economic developers have always done. In fact, many incentive programs exist to serve these ends. Workforce programs, industry- or cluster-specific incentives, and capital access for entrepreneurs account for a sizeable proportion of all finance and incentive programs. And yet the perception lingers that economic development is just about closing a deal with a relocating company.

The broader trend toward greater transparency will have more lasting consequences than the specifics of the GASB disclosure rules. Still, the new disclosure rules will change the public discourse around incentives.

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Elected officials and community groups are demanding better data on incentive costs and benefits. New tax abatement disclosure rules are one manifestation of this trend toward greater transparency and accountability in incentive use. While compliance will come with challenges, the disclosures also create an opportunity for economic developers to tell their story: why incentive programs are in place, the ways in which they are managed responsibly, and how they are designed to accomplish shared economic development objectives to improve the well-being of communities.

WHY THE FOCUS NOW ON INCENTIVES

Three fundamental dynamics underlie today's concern with incentives:

- A disconnect between what economic developers believe they do and what others think they do
- Incentives are big business
- Open data and transparency in government are the new norms

One reason this perception gap exists is that inclusion and prosperity represent long-term ideals that can be difficult to quantify for a community let alone measure in the context of day-to-day economic development activities. Growth is more easily measured and explained. Further, stung by comments that economic developers shoot everything that flies and count everything that falls, many conscientious organizations have worked to report only on activities that they have influenced, not just broad economic indicators – in other words, the "deals".

That said, we can and should do more as economic developers to share with our communities how our work and well-run incentive programs can help us accomplish our shared economic development objectives.

Second, incentives are big business. Incentive use has increased and tax based incentives are a significant portion of the total. There are more programs, we are spending more money, and we are using incentives for more projects and types of businesses, so this has naturally led to calls for more information on projects and outcomes. A few examples:

- The C2ER State Business Incentives Database shows that the number of state business incentive programs expanded from 940 in 1999 to over 1,900 in 2015.[2]
- Over 95 percent (1,145 of 1,201) of local governments use business incentives and roughly 60 percent of those use tax abatements and tax increment financing, according to a 2014 ICMA economic development survey.[3]
- 49 of 50 states have tax increment financing (TIF) or TIF-like statutes, and nearly 50 percent of community development finance agencies use tax abatements according to the Council of Development Finance Agencies.[4]
- Good Jobs First reported 23 "megadeals" completed in 2015 with an estimated total value (costs incurred over time, not just in 2015) of $4.8 billion.[5]
- IEDC's report on the current state of incentives cites research estimating the annual cost of incentives at between $30 billion and $80 billion.[6] Regardless of the right number, the costs are eye-catching and necessitate explanation.

Third, open data and transparency in government are the new norms. There is also an expectation for data-driven, performance-based activity and metric-based accountability in government. Economic development is no exception, no matter how the organization is actually structured. Economic development groups are being asked to contribute information for various open data and transparency portals or to create their own online dashboards to allow more insight into their activities and accomplishments. It is no longer an option *not* to report on spending and program activity, especially on a controversial topic like incentives.

STATEMENT NO. 77, TAX ABATEMENT DISCLOSURES

GASB's Statement 77 requiring disclosure of financial information about tax abatements in state and local government financial reports is one manifestation of these trends.

As background, the Governmental Accounting Standards Board (GASB) last year approved *Statement No. 77, Tax Abatement Disclosures*, which establishes guidance requiring state and local governments to disclose certain information about tax abatement agreements for periods beginning after December 15, 2015. The full statement and summary materials are available for download on the GASB website.[7]

The guidelines are important because GASB is the official source of generally accepted accounting principles (GAAP) for state and local governments. Its principles or standards are intended to improve financial reporting so that users of financial statements (bond holders, citizens, elected leaders, oversight bodies) have the information they need to make decisions about how well a government is managing its resources. Compliance with GAAP can also lower the cost of borrowing. GASB has no enforcement authority, but individual state laws and audits that assess conformity with GAAP tend to compel compliance with GASB standards in government accounting and financial reporting. The Financial Accounting Foundation reports that every state follows GAAP and approximately half of states require their counties or localities to follow GAAP.[8]

GASB began considering tax abatement disclosure in 2008. The rationale is that governments do not always provide information on how tax abatements affect their financial position, including their ability to raise revenue in the future. Tax abatements can limit revenue-raising ability because a government has agreed not to collect taxes to which it would otherwise be entitled. GASB seeks "to make the financial impact of these transactions readily transparent" to users of financial statements. After an extensive research phase, GASB added the topic to its

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technical agenda in 2013, began deliberations in 2014 and issued an Exposure Draft that same year. After reviewing nearly 300 comments, the Board issued its final statement and guidance in August 2015.

> As a result [of disclosure], users will be better equipped to understand (1) how tax abatements affect a government's future ability to raise resources and meet its financial obligations and (2) the impact those abatements have on a government's financial position and economic condition.
>
> *Summary, Statement No. 77 of the Governmental Accounting Standards Board on Tax Abatement Disclosures*

It is useful to remember that GASB is not directly concerned with the effect of tax abatements on economic development outcomes. GASB cares about how tax abatements affect government finances. Our concern, by contrast, is effective and responsible use of economic development incentives to accomplish community objectives.

Disclosure guidance

Tax abatements are defined by GASB as:

> A reduction in tax revenues that results from an agreement between one or more governments and an individual or entity in which (a) one or more governments promise to forgo tax revenues to which they are otherwise entitled and (b) the individual or entity promises to take a specific action after the agreement has been entered into that contributes to economic development or otherwise benefits the governments or the citizens of those governments.[9]

The statement is clear that a transaction's substance, rather than its form or title, is the determining factor in whether a transaction meets this definition.

Information that must be disclosed in notes to the government's financial statements includes:

- Brief descriptive information
  - o names of tax abatement programs
  - o the taxes being abated
  - o authority under which abatements are provided
  - o eligibility criteria
  - o mechanism by which taxes are abated, including how the taxes are reduced and how the amount of the abatement is determined
  - o provisions for recapture, and
  - o types of commitments made by recipients
- Dollar amount of taxes abated during the reporting period (calculated on an accrual not cash basis)
- Other commitments made by a government (such as providing infrastructure) as part of the agreement
- Tax abatements entered into by other governments that reduce the reporting entity's tax revenues, such as when a local government provides an abatement that reduces the tax revenue of a school district.
  - o Names of the governments that entered into the agreement
  - o The taxes being abated
  - o Dollar amount of taxes abated during the reporting period
  - o Amounts received from other governments in association with the lost tax revenue (payments made to mitigate the loss of tax revenue)

Information that does *not* need to be disclosed includes:

- Individual tax abatement agreements, unless the individual agreements meet or exceed a threshold established by the government
- Future amounts to be abated or the duration of the tax abatement
- Number of agreements entered into and in effect during the reporting period (a change from the draft statement)
- Information the government is legally prohibited from disclosing - but the general nature of the information omitted and the source of the legal prohibition must be provided

A few points for economic development organizations to remember:

- Disclosure should begin in the period in which the agreement is entered and continue until the agreement expires.
- The guidance for disclosure is limited to tax abatements. It does not include all tax expenditures (only the subset that fit the definition) and it does not include many other forms of assistance to businesses, such as grants, loans or transfers of capital assets.
- The disclosure rules are not limited to tax abatements for business attraction. Tax incentives designed to support economic development objectives such as historic preservation, brownfield cleanup or housing construction are also covered if they meet the criteria.
- An agreement is a critical element of the tax abatement triggering disclosure.

DISCLOSURE GUIDANCE

Information on tax abatements that must be disclosed includes:

- Brief descriptive information on tax abatement programs
- Dollar amount of taxes abated during the reporting period
- Other commitments made by a government as part of the agreement
- Tax abatements entered into by other governments that reduce the reporting entity's tax revenues

- o An agreement includes "a promise by the government to reduce the individual's or entity's taxes and a promise from the individual or entity to subsequently perform a certain beneficial action." A key point is that the agreement precedes the tax reduction and the beneficial action.[10]
- o Disclosure does not depend on the existence of a written, legally enforceable agreement. Abatements must be disclosed even if the government's agreement to reduce the tax liability and the taxpayer's agreement to perform a "certain beneficial action" is implicit.

- Expected benefits from tax abatements are not part of the disclosure. Therefore, the disclosures will be useful for financial transparency, but not for economic development compliance, evaluation or accountability. GASB explained, "(I)t was not an objective of the Statement to provide information needed to evaluate the effectiveness of tax abatement programs."[11] Further, the Board noted that information on compliance may not be readily available for reporting purposes and information on recipient compliance is not required.
- Governments must use their professional judgment to determine how tax abatements related to component units – such as "a separate legal entity established . . . for the purpose of deploying economic development strategies" should be disclosed, whether presented as their own or as another government entity.[12]

WHAT SHOULD ECONOMIC DEVELOPERS DO?

Economic developers are not responsible for preparing government financial statements, but they are likely to be asked for information to enable the required disclosures. It is also likely that the disclosure will raise additional questions about how and why incentives are being used. Economic development organizations should consider taking the following three steps to help their communities comply with disclosure rules and convey how the tax abatements are intended to help achieve the community's economic development goals.

1. Understand which tax incentives meet the GASB criteria for disclosure

The first step is to understand which tax incentives meet the criteria and must be disclosed. The substance of the transaction rather than the name or description determines whether the abatement must be disclosed. In other words, it doesn't matter what it's called or the form that the tax break takes: if it fits the criteria, it needs to be disclosed. A critical element is the existence of an agreement that precedes the reduction in taxes and the promised beneficial action. Now is the time to review your tax incentive programs to determine which fit the definition.

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THREE STEPS ECONOMIC DEVELOPERS SHOULD TAKE

- Understand which tax incentives meet the GASB criteria for disclosure
- Communicate with government finance staff
- Determine how to supplement the financial disclosure

2. Communicate with government finance staff

Compliance with GASB 77 will require cooperation between the economic development organization and the government's finance staff because, in many cases, neither will have all the information necessary to determine the financial disclosure.

The Government Finance Officers Association (GFOA) has similarly recommended that, "finance staff initiate communication and develop/maintain relationships with its entity's economic development partners and/or budgetary officials charged with initiating, developing and affirming tax abatement to ensure the proper flow of information."[13] GFOA also recommends creating a timeline for sharing information to prevent reporting delays.

3. Determine how to supplement the financial disclosure

The disclosure rules focus on the costs, but not the expected benefits, of tax abatements. Accordingly, it will become important for economic developers to use other outlets to provide context and detail on the reasons for the tax abatement agreements and the anticipated outcomes. At a minimum, economic development organizations should prepare to respond to questions post-disclosure about how and why incentives were used. A better strategy would be to develop additional reports or material to be reviewed alongside the financial disclosures to convey how those funds are designed to achieve the community's economic development goals. There are several options for doing so:

a. Letter of transmittal with the financial report

GFOA, in its best practice statement on Enhancing Tax Abatement Transparency, recommends that governments disclose additional tax abatement information in their letter of transmittal. The letter of transmittal accompanies the comprehensive annual financial report, which will include the financial note providing the tax abatement disclosure. GFOA suggests that this letter include:

- a reference to other documents where a complete cost/benefit analysis can be found;
- an explanation of how tax abatements are accounted for and incorporated into the budget;
- a description of policies governing tax abatements, including what the government is hoping to achieve and methods used to determine the return on investment;
- an identification of those responsible for monitoring compliance with abatement agreements;
- an explanation of the relationship between tax abatements and the government's goals as set forth in its strategic plan; and
- a five-year chart of benefits anticipated and received.

b. Annual report

Most economic development organizations already prepare some type of annual report. During the preparation of this report it would be beneficial to review its content and consider how it would be viewed in the context of the financial disclosures. Will the information in your annual report answer questions that are likely to arise about how and why tax abatements were provided? Does it convey project benefits – and distinguish between actual and forecasted returns? Does it clearly connect projects and incentive programs to the community's overall economic development strategy so citizens and stakeholders can be confident that resources are being used in a manner consistent with community values?

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c. Other government transparency or open data sites in your community

Governments are sharing more data than ever, and the open government movement has already altered expectations for data transparency from economic development organizations. Some economic development data may already be incorporated into state or local government data portals. These portals and other transparency initiatives may provide another opportunity to share information related to incentive benefits as well as costs with members of your community who are interested in economic development.

d. Outreach

One of the biggest challenges for economic developers is figuring out how to talk about incentives to people outside the economic development community. The disclosures are an opportunity to engage in a better conversation on this difficult topic. Incentive queries often start with a negative or accusatory tone, making economic developers understandably reluctant to initiate a dialogue. However, economic developers are the best resource for quality information on incentives because they have the experience with the projects and the expertise to make sense of complex program information. This fact, combined with the new norm of transparency in government, means that economic developers can't be on the sidelines during the incentives conversation.

Some steps that may help in preparing to talk about incentives with media, citizen groups, elected leaders and other stakeholders are:

- **Connect incentive use to your community's economic development objectives.** Articulate those objectives and explain how incentives are designed to support an overall strategy to improve economic opportunities in your community – not just win a deal.
- **Provide context.** Standalone project or financial information is often not very meaningful. Context that demonstrates the relative impact of a project or program and how it fits into the community can be extremely helpful.
- **Consider your audience.** Different audiences want different information. Many community members simply want basic data on what was done, with whom and at what cost. A much smaller, but typically important, group of stakeholders will want detailed insight on process, verification of outcomes, and program evaluation.
- **Engage and be a good resource.** It's not time to hide. Economic developers should consider engaging external audiences more actively if the goal is to improve the quality of the policy conversation around incentives. If incentives are discussed only when forced to address a problem, we will be stuck where we are, with all parties distrustful and frustrated.

WILL DISCLOSURE CHANGE INCENTIVE USE?

The broader trend toward greater transparency will have more lasting consequences than the specifics of the GASB disclosure rules. Still, the new disclosure rules will change the public discourse around incentives. The expectation is that GASB could have the following effects for economic developers:

- **Some of the most expensive, lowest performing or poorly designed tax abatement programs will be repealed or modified by putting in place caps or limits on use or tightening eligibility rules.** While there may be more restrictions to avoid runaway costs, we do not foresee a significant decline in overall use of tax abatement programs.
- **Organizations will focus on streamlining and standardizing reporting procedures to better answer questions on incentive use.** Economic

development groups may also find it useful to document their decision-making process leading up to the provision of tax abatements. By conducting due diligence, completing a cost-benefit analysis, and monitoring compliance with agreements, economic development organizations will have the information they need to answer calls for greater transparency in incentive programs.

- **An unintended but possibly beneficial consequence will be more insight into how other governments are using incentives and how much they are spending.** Economic developers often complain about information asymmetry in the incentives negotiation process, and the financial disclosures will add a meaningful category of information to the market. Other incentive data sets are frequently used for benchmarking and market research. This new cross-government information has the potential to alter the market as much as the disclosures themselves.

CONCLUSION

Elected officials and community groups are demanding better data on incentive costs and benefits. The GASB disclosure rules are just one manifestation of the trend toward greater transparency. Even though many government organizations opposed details of the GASB standard, nearly every comment letter began by stating that there should be greater transparency and accountability in incentive use. This standard is a useful step in that direction even though it will not answer many of the most important questions about total costs and benefits. This creates an opportunity. The disclosures give economic development organizations a new platform to tell their story: why incentive programs are in place, the ways in which they are managed carefully and responsibly, and how they are helping us accomplish our shared economic development objectives to improve the well-being of our communities.

A Sample Financial Disclosure

GASB Statement No. 77 provides two examples of how the reporting might look. Replicated below is a portion of one of the examples, which GASB states "are illustrative only." This example is a financial disclosure, which would follow the brief descriptive information by program type. Please refer to the full set of examples in the GASB statement for more detail.

Note Y. Tax Abatements

As of December 31, 20X1, the County provides tax abatements through six programs—the Residential Improvement Program, Film and Television Production Incentives, the Economic Assistance Initiative, the High-Tech Investment Program, the Competitive County Credit, and the Renewable Energy Incentive:

- The Residential Improvement Program provides property tax abatements to encourage improvements to single-family and multiple-unit dwellings, under State Law, Code 14, Section 201.1. Abatements are obtained through application by the property owner, including proof that the improvements have been made, and equal 100 percent of the additional property tax resulting from the increase in assessed value as a result of the improvements. The amount of the abatement is deducted from the recipient's tax bill.
- Under the County Economic Development Act of 20X3, two divisions of the County government administer tax abatements:
  - The Office of Film and Television Production Incentives provide abatements of the County's sales and corporate income tax to attract television, movie, and commercial productions. Production companies apply to the Office for admittance into the program in advance of commencing production. Production companies can apply for a refund of sales taxes on qualifying spending in the county within three years of the date of admittance. Production companies' county corporate income tax liabilities also are reduced by the amount of qualifying spending, up to 100 percent of the taxes owed.
  - The Department of Economic Assistance administers three tax abatement programs: the Economic Assistance Initiative (EAI), the High-Tech Investment Program (HTIP), and the Competitive County Credit (3C). The agreements entered into by the Department include clawback provisions should the recipient of the tax abatement fail to fully meet its commitments, such as employment levels and timelines for relocation.
  - EAI offers individual incentive packages to attract new business to the county. Abatements may be granted to any company agreeing to relocate to the County or to establish a new business in the County. The Department abates up to 75 percent of the property tax bills through a reduction in the assessed value of the facilities that the new or relocating businesses construct or purchase. The Department also arranges for the county to construct certain infrastructure features that are ancillary to newly constructed facilities. One agreement involving the construction of a new office building for the central headquarters of a major corporation included a substantial commitment from the County to construct a new exit on County Highway 84 and connecting roadways and ancillary features between the highway and the building.
  - HTIP offers reductions in business income taxes to attract businesses in technology industries to move to the County High-Tech Industry Park (CHIP). Abatements may be granted to any technology company agreeing to move into CHIP. The abatement is administered as a credit on a company's County income tax return and equals 25 percent of the company's corporate income tax liability. The abatement begins in the year when the company begins its relocation to CHIP.
  - 3C offers reductions in business income taxes to attract and retain jobs. Abatements may be granted

to any business agreeing to remain in the County or to relocate to the County. The abatement is a credit on a company's County income tax return and is effective beginning in the year of the agreement (for job retention) or the year when the business begins its relocation to the County (for job attraction). The amount of the abatement is based on the number of jobs retained or attracted.

- The Environmental Conservation Department administers the Renewable Energy Incentive to encourage businesses to invest in solar, wind, and other sources of clean, efficient energy. The program also covers investments in energy-efficient vehicles such as hybrid, electric, and alternative-fuel cars and ancillary facilities, such as charging stations. These abatements are provided under the authority of the State of Example's Environmental Protection Division. After their application and acceptance into the program, companies can file for two types of tax abatements: a refund of sales taxes on spending related to renewable energy; and a credit against their County corporate income tax liability for eligible spending, up to a maximum of $100,000.

State of Sample Tax Abatements

County property tax revenues were reduced by $28,346,000 under agreements entered into by the State of Sample. Under the State's biennial budget for fiscal years 20X1–20X2, the state reimburses the County for one-third of the reduction in tax revenues. The County received $9,449,000 in County fiscal year 20X1.

Regional Economic Development Corporation (REDC) Tax Abatements

Under agreements entered into by REDC, County sales tax revenues were reduced by $7,657,000.

Tax Abatement Programs	Amount of taxes abated ($thousands)
Residential Improvement Program	$32,912
Film & Television Production Incentives	
Sales tax	$13,435
Corporate income tax	$12,479
Economic Assistance Initiative	$18,566
High-Tech Investment Program	$9,578
Competitive County Credit	$11,158
Renewable Energy Incentive	
Sales tax	$8,157
Corporate income tax	$4,619

ENDNOTES

1 Amy Liu, "Remaking Economic Development." The Brookings Institution Metropolitan Policy Program, 2016.

2 C2ER, "State of State Business Incentives," 2015.

3 ICMA Survey Research, "Economic Development 2014 Survey Results."

4 Council of Development Finance Agencies, "Tax Increment Finance State-By-State Report," 2015.

5 http://www.goodjobsfirst.org/megadeals, accessed May 2016.

6 IEDC Economic Development Research Partners, "Incentives for the Twenty-First Century," 2015.

7 Tax Abatement Disclosures, http://gasb.org/jsp/GASB/Page/GASBBridgePage&cid=1176164472248, accessed June 2016.

8 Financial Accounting Foundation, GAAP and State and Local Governments, http://www.accountingfoundation.org/jsp/Foundation/Page/FAFBridgePage&cid=1176164539408, accessed June 2016.

9 Statement No. 77 of the Governmental Accounting Standards Board, Tax Abatement Disclosures, August 2015, p. 2.

10 Ibid, p. 12.

11 Ibid, p 11.

12 Ibid, p. 27.

13 Government Finance Officers Association, "GFOA Best Practice. Enhancing Tax Abatement Transparency," January 2016.