

TESTIMONY

Donna K. Ginther

Dean's Professor, Department of Economics
Director, Center for Science, Technology & Economic Policy
At the Institute for Policy & Social Research
University of Kansas
and
Research Associate
National Bureau of Economic Research

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Introduction

Chair Lynn, Vice Chair Pilcher-Cook, Ranking Member Holland and distinguished members of the Committee, thank you for the opportunity to testify before the Senate Commerce Committee on House Bill 2006. My testimony will address the goals of this legislation through the lens of my personal experience as an evidence-based policy researcher.

I have the following observations for the committee: First, evidence-based policy is critically important for the efficient allocation of government resources. The procedures outlined in HB2006 will allow the state to become more effective stewards of taxpayer dollars.

Second, key provisions of HB2006 are essential for understanding the costs and benefits of economic development and tax incentives. My testimony will highlight the goals of HB2006: first, to provide an inventory of economic development and tax incentives provided by the state of Kansas and second, to provide independent evaluations of these programs every three years using primary data.

Third, I will discuss the challenges in obtaining accurate estimates of the return on investment or economic impact of economic development and tax incentives. Economic impact analyses that calculate returns on investment require accurate, primary-source data as well as justifiable assumptions. Without both of these key inputs, the output of economic impact studies are seriously flawed and inaccurate.

Finally, based on my experiences as an economic policy researcher, I endorse this bill as an effective approach to allocating the state of Kansas' scarce taxpayer resources to promote economic development. I also recommend that the Committee consider expanding the scope of HB2006 to require independent economic evaluations based on primary data of proposed tax and economic development incentives prior to the introduction of these incentives to the state legislature. Thus, when making a decision the state legislature has the best information available on the potential costs and benefits of their policy decisions.

In the testimony that follows, I will provide a brief overview of my work related to evidence-based policy, evaluate key provisions of the legislation, discuss the sensitivity of economic impact studies to data and assumptions, and I will conclude that the Kansas Legislature should pass House Bill 2006. Before I proceed, I would like to acknowledge my colleague, Patricia Oslund, who assisted me in preparing this testimony.

Background in Evidence-based Policy

I am the Dean's Professor of Economics at the University of Kansas, and I direct the Center for Science, Technology & Economic Policy at the Institute for Policy & Social Research at KU. Prior to joining the University of Kansas, I served as a research

economist and associate policy adviser in the regional group of the Research Department of the Federal Reserve Bank of Atlanta. My research fields include scientific labor markets, gender differences in employment outcomes, wage inequality, scientific entrepreneurship, and children's educational attainments.

The Center for Science Technology & Economic Policy that I direct engages in three major activities: contract research and evaluations for state agencies, foundations, and community groups; scholarship based on sponsored research projects; and organizing the annual Kansas Economic Policy Conference (KEPC). CSTEP has received contracts from the Kansas Board of Regents (KBOR) to match KBOR enrollment and graduation records for all public community colleges, technical colleges and four-year universities in the state to employment records from the Kansas Department of Labor in order to analyze the efficacy of KBOR programs.

I have received several federal and foundation grants for work in the interdisciplinary field of the Science of Science and Innovation Policy (SciSIP). At the core of Science Policy research are two related economic questions: 1) How should the federal government allocate scarce research and development resources to maximize economic growth and development? 2) What is the return on the federal government's research and development investments? My research contributes to the study of science policy by examining the allocation of grant funding, gender and race/ethnicity differences in academic careers, and scientific entrepreneurship and innovation. I was also the principal investigator on the National Science Foundation grant to fund the Kansas City Research Data Center,¹ one of the twenty-four Federal Statistical Research Data Centers.

¹ "Kansas City Research Data Center." National Science Foundation SES-1359527.

In addition, I organize the Institute for Policy & Social Research's annual Kansas Economic Policy Conference (KEPC). Each year the topic of the conference changes to address a specific economic policy issue confronting the state. Last year's KEPC, "Pragmatic Policy: Reforming Kansas Taxes" focused on the implications of state tax policy for counties, municipalities and school districts in the state.²

Finally, I have testified before the federal *Commission on Evidence-Based Policy Making* in January 2017. At that hearing, I argued that evidence-based policy is critically important for the efficient allocation of government resources. In my testimony, I cautioned the commission that from the perspective of state and local policy-makers, "qualified researchers and institutions" need to be known, trusted, and local. Given my research interests and background, I am qualified to comment on House Bill 2006.

Comments on Key Provisions in House Bill 2006

It is important to highlight key provisions of the legislation. First, HB 2006 authorizes the Kansas Legislative Post Audit to oversee and conduct evaluations of economic development incentive programs. In my opinion, Legislative Post Audit is the appropriate organization within the state government to oversee and conduct these evaluations. The Pew Charitable Trusts 2017 report, *How States Are Improving Tax Incentives for Jobs and Growth*, examined each state's approach to evaluating these programs. The Pew Report notes for Kansas, "Given the LPA's experience evaluating incentives, the office would be well-suited to studying the programs regularly should lawmakers create a process to do so. The LPA has a record of carefully studying whether

² The agenda of the 2018 Kansas Economic Policy Conference is available at: <http://ipsr.ku.edu/conferen/kepc18/program.shtml>.

government programs are operating efficiently and identifying potential improvements.”³

Second, HB 2006 authorizes the creation of a public database and evaluation of economic development and incentive programs. This approach is long overdue. According to Department of Commerce website, the state of Kansas has 18 major economic incentive programs that “include retention of withholding taxes, investment tax credits, sales tax project exemptions and revolving loan funds for local infrastructure projects, as well as loans and/or grants.”⁴ How many of these programs exist? What are the costs associated with these programs and what are the benefits? Most importantly, do the costs exceed the benefits? HB 2006 will start the process of answering these critically important questions by developing a public database of these programs and evaluating the impact of these incentives every three years.

Third, HB 2006 is very specific about the content and quality of these evaluations. Essentially, these evaluations are cost-benefit analyses of tax exemptions and economic development incentives. To be clear, “Both tax exemptions and tax-deductibility are a form of subsidy that is administered through the tax system. A tax exemption has much the same effect as a cash grant to the organization of the amount of tax it would have to pay on its income.” *Regan v. Taxation With Representation of Washington*, 461 U.S. 540 Opinion by Former Justice Rehnquist for a Unanimous Court (1983). Every tax exemption or incentive provided by the state has an associated opportunity cost. The goal of these evaluations is to gain a better understanding of this opportunity cost. In

³ Page 58. The report is available at: https://www.pewtrusts.org/-/media/assets/2017/05/edti_how_states_are_improving_tax_incentives_for_jobs_and_growth.pdf?la=en&hash=30874D04D965B7C2AEBEA57ECE303ABBDB2D8A71

⁴ These programs are listed on the website at: <https://www.kansascommerce.com/93/Business-Community-Finance-Incentives>.

other words, how could that money have been spent on the best alternative course of action?

Fourth, the provisions of HB 2006 offer detailed specifications for the evaluations of economic development incentive programs with the goal of uncovering the full costs and benefits of the policy. The legislation requires a return on investment calculation for each program. The evaluations are required to examine how the incentive changes business behavior and the positive and negative effects of the incentive on the Kansas economy. In order to complete the evaluations, the legislation stipulates that Legislative Post Audit is provided access to primary data to perform its own analysis. To quote the legislation: “In conducting such evaluations, the post auditor and the division of post audit shall have access to all books, accounts, records, files, documents and correspondence, confidential or otherwise, to the same extent permitted.” Access to primary data is a key input into this process. Without accurate data, models will be biased and inaccurate, and essentially become “garbage in – garbage out.”

Fifth, the provisions of HB 2006 recommend an “return on investment calculation for the economic development incentive program. For purposes of this paragraph, "return on investment calculation" means analyzing the cost to the state or political subdivision for providing the economic development incentive program and analyzing the benefits realized by the state or political subdivision from providing the economic development incentive program.” Essentially, this provision requires Legislative Post Audit to carefully examine both the direct and indirect economic impact of the policy. These indirect (or multiplier) effects are subject to the assumptions used to model the economic impact. As a result, they can be manipulated to obtain a “result” that shows positive

economic impacts. In the remainder of my testimony I will provide my opinion on the legislation and expand on the importance of careful consideration of multiplier effects.

The Kansas Senate Should Pass House Bill 2006

What does the state get in return for these myriad economic development incentives and tax exemptions? Taxpayers deserve to know, and House Bill 2006 will go a long ways towards providing that information. As I mentioned in my introduction, I have spent my 24-year career as an economist researching the economic impact of policy on a wide variety of socioeconomic outcomes. I am a strong supporter of using evidence to inform policy, and I applaud the intent of this legislation. Having Legislative Post Audit conduct and oversee these evaluations will provide unbiased estimates of the overall impact of these programs. However, I caution the Legislature that access to primary data is a key input into this process. Without accurate data, models will be biased an inaccurate.

Why should the state enact this legislation? Economics is essentially the study of the allocation of scarce resources, and the intent of this bill is to assure that economic impacts are accurately evaluated. It is the legislature's job to allocate economic development incentives and tax exemptions--the state's scarce resources--effectively. HB 2006 will allow the state to allocate resources to policies that provide the greatest benefits the state and reduce funding for ineffective policies such as the so-called Border War with Missouri.

That said, I must caution the Legislature about the role of assumptions and multiplier effects in return on investment or economic impact analyses. Current

approaches to evaluating economic impact are often flawed and require additional scrutiny. All economic models can be easily manipulated based on the assumptions incorporated in the models. The models give users the ability to change some assumptions. But without understanding the role of various assumptions, users can unintentionally distort results.⁵ Researchers have shown that results for the same project can differ widely (often by a factor of two) depending on what model is used for estimation.⁶ Every economics student learns that economic activities have opportunity costs. For example, if a state did not build a new highway, it would have done something else with its tax resources. The “something else” is the opportunity cost of building the highway. In principle, direct effects should be measured net of opportunity costs. However opportunity costs are rarely discussed in impact analysis. Implicitly they are set to zero. Hence the benefits of projects or policies are likely to be overstated.

When impact models are run by project proponents, there may be incentives to choose assumptions that give large results and to understate opportunity costs (or leave them out completely). John Crompton (2006) provides examples from tourism impact studies and concludes: “Most economic impact studies are commissioned to legitimize a political position rather than to search for economic truth. Often, this results in the use of

⁵ Rickman, Dan S. and R. Keith Schwer. A Comparison of the multipliers of IMPLAN, REMI, and RIMSII: Benchmarking ready-made models for comparison. *Annals of Regional Science*. 1995, Vol. 29 363-374. <https://doi.org/10.1007/BF01581882>.

⁶ See for example: Lynch, Tim. Analyzing the Economic Impact of Transportation Projects. Center for Economic Forecasting and Analysis. Institute for Science and Public Affairs. Florida State University. October, 2000. Rickman, Dan S. and R. Keith Schwer. A Comparison of the multipliers of IMPLAN, REMI, and RIMSII: Benchmarking ready-made models for comparison. *Annals of Regional Science*. 1995, Vol. 29 363-374. <https://doi.org/10.1007/BF01581882>.

mischievous procedures that produce large numbers that study sponsors seek to support a predetermined position.”⁷

Finally, economic impact model projections are rarely or never compared against what actually happens when a project or policy change takes place. House Bill 2006 will remedy this situation because it mandates impact analyses every three years.

With these caveats in mind, Legislative Post Audit is well-positioned to provide unbiased estimates of the effects of these programs. Legislative Post Audit’s incentives are aligned with those of the taxpayers: to determine whether state resources are being allocated effectively. As a result, the return on investment or economic impact evaluations provided or overseen by Legislative Post Audit will be unbiased as long as they are based on primary source data. Thus, I also recommend that the Legislature consider expanding the scope of this legislation to provide the necessary data to Legislative Post Audit to conduct independent economic impact evaluations of new economic development and tax exemption incentives prior to enactment. In this way, the state of Kansas will have the best information to use when making these important economic development decisions.

Furthermore, the Legislature should consider expanding the time period of the evaluation to be within five years of the incentive program. Three years may be too soon to realize the full gains of these programs. It will take at least a year to get the program underway, leaving only two potential years of outcome data.

⁷ Crompton, John L. Economic Impact Studies: Instruments for Political Shenanigans? Journal of Travel Research, 2006 Vol. 45 67-82. DOI: 10.1177/0047287506288870

In summary, I will provide my own cost-benefit analysis of House Bill 2006. The costs are extra time and resources spent by Legislative Post Audit to obtain unbiased estimates of the economic impact of extant economic development incentives and tax exemptions. A fiscal note on HB 2006 indicates that the Department of Commerce will need 1.0 additional FTE at a cost of \$59,813 in FY 2019 and an additional .60 FTE at a cost of \$44,550 for subsequent years. These costs are relatively low. The opportunity cost is the time and resources that the Kansas Legislative Post Audit subcommittee spends on creating the database of programs and providing the economic impact evaluations of these programs that could have been spent on other Legislative Post Audit activities. That said, the benefits may prove to be significantly larger than the direct and opportunity costs of the evaluations. To the extent that these evaluations can identify the most successful programs and lead to the sunset of unsuccessful ones, the savings to taxpayers and the economic impact on the state promises to be substantial.