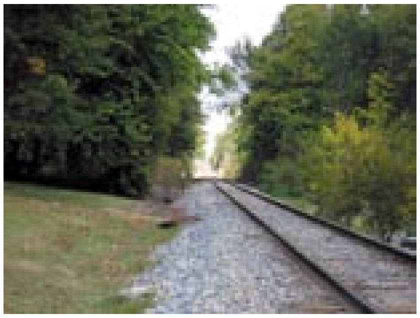

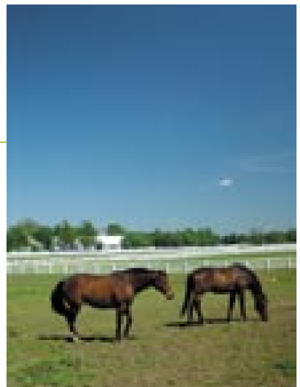

Accounting for Impact:

Economic Development Spending in Kentucky

Executive Summary

State government has a critical role to play in furthering economic development in Kentucky. Over the years, the state has created dozens of programs and policies intended to spur job creation and economic growth. These efforts face growing economic challenges, including the decline of traditional industries like tobacco and coal; the rising interstate competition for jobs; the new realities of global economic restructuring; and the limits brought on by a state budget crisis. In light of these pressures, does the state have the right priorities? Do its economic development efforts fit together in strategic ways? How effective is the economic development system as a whole in increasing the state's prosperity?

Currently, no one really knows the answers to these questions. That's because the state doesn't look at its entire economic development system in any systematic way. There is no document or analysis that catalogues the state's development spending, which is spread across many parts of state government and happens both through the budget and more quietly through state tax laws. This lack of unified information is a serious shortcoming. Its absence makes it extremely difficult to coordinate development programs, respond to rapid economic changes and achieve a maximum return on investment.

This report is a first attempt to create a comprehensive analysis. It catalogues six years of economic development spending and identifies key findings and recommendations regarding the state's priorities and the system of economic development planning, budgeting and evaluation. The report confirms two critical issues: (1) the need for greater accountability in Kentucky's economic development system; and (2) the need to diversify economic development strategies to match the state's many challenges and opportunities. This report is intended to spur a serious statewide conversation about those issues.

MACED
Mountain Association for Community Economic Development

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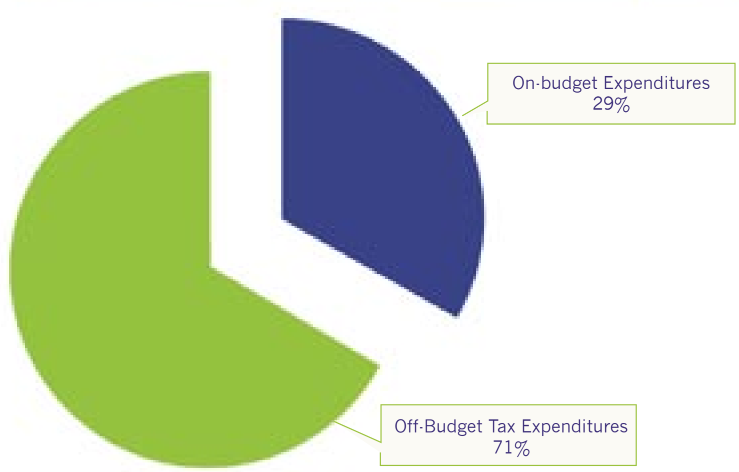
> Finding #1: Most economic development spending is hidden away in state tax laws.

In 2004, Kentucky spent approximately $808 million in the area of economic development. But the vast majority of that spending was not out in the open, subject to the public scrutiny of the state budget process. Instead, it happened under the radar through business tax breaks and subsidies buried in state tax law. While 71 percent of Kentucky's economic development spending is in this quieter form—known as tax expenditures—only 29 percent is from programs paid for through the budget (see Chart 1). The 52 tax expenditures included in the report cost the state an estimated $571 million in the most recent year of the analysis. By contrast, the on-budget programs cost $237 million that same year. These tax expenditures consist of both general business tax preferences ($448 million in 2004) and company-specific tax incentive programs ($123 million). The first set includes preferences that apply to particular industries along with those designed to keep business taxes generally low. The second set, made up of programs that have expanded greatly in type and scope in recent years, are awarded on a business-by-business basis. Since 1990, state records show, Kentucky has given out $4.3 billion in tax credits through incentive programs, creating an enormous potential liability that is only beginning to be realized in the above revenue loss.

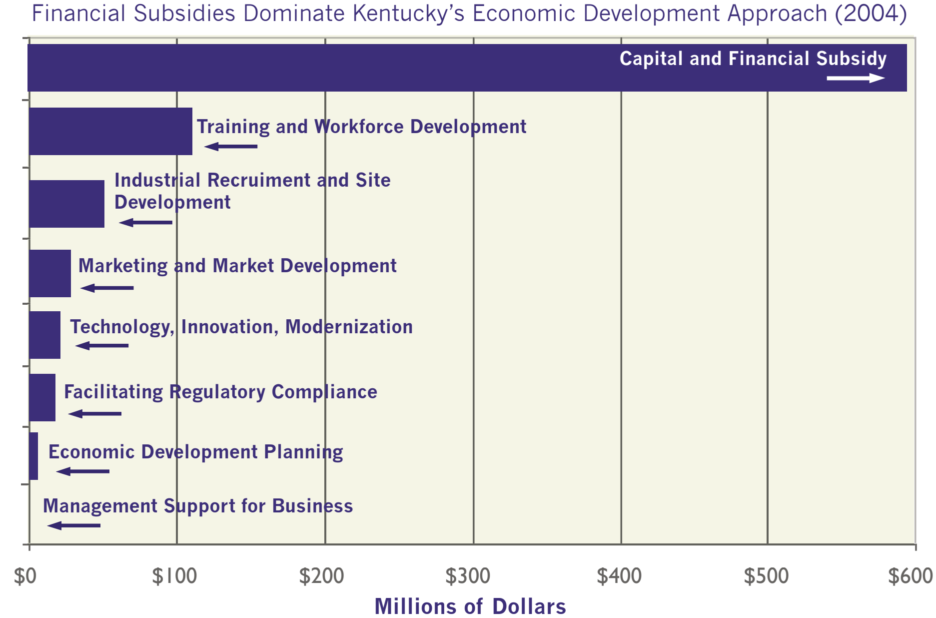
Chart 1
Tax Expenditures Make Up Bulk of Economic Development Spending (2004)



> Finding #2: Kentucky relies narrowly on a single strategy of attracting businesses with financial subsidies.

When it comes to economic development strategy, Kentucky puts almost all its eggs in one basket. As Chart 2 reveals, Kentucky spends six times more on the category Capital and Financial Subsidy than it spends in any other area. Many of these subsidies are linked with the spending Kentucky does on industrial parks and sites and on courting and recruiting individual companies. That category, Industrial Recruitment and Site Development, is the third largest in this analysis. Combined, the Capital/Financial Subsidy and Industrial Recruitment/Site Development categories make up 79 percent of economic development spending. The state's narrow emphasis means that other important strategies are comparatively neglected.

Chart 2
Financial Subsidies Dominate Kentucky's Economic Development Approach (2004)



> Finding #3: Economic development planning and budgeting are fragmented.

The strategic plan of the Cabinet for Economic Development's Partnership Board—the main body responsible for state economic development planning—primarily concerns only the cabinet's own activities. But that spending makes up only 9 percent of on-budget economic development expenditures and approximately 21 percent of off-budget spending. Other economic development-related plans—including the visioning process of the Long-Term Policy Research Center and plans related to the Kentucky Innovation Act and the Agricultural Development Board—exist independently of each other and the Partnership's plan rather than integrated.

Most importantly, this planning is disconnected from the legislative budgeting process, where the most important decisions about the allocation of resources are supposed to be made. Kentucky's reliance on a traditional line-item budgeting system focuses the attention of the legislature on questions about personnel and operating expenses rather than program objectives and performance. Because there are no overarching goals that the budget is designed around, its format makes difficult the unified examination of all programs with an economic development purpose. Also separate in both planning and budgeting are the development programs carried out by individual universities and community colleges, local economic development spending and, as has been mentioned, the enormous amounts of money spent through tax law. This fragmentation lowers the level of accountability in the system and prevents coordination that would make the state's efforts more effective.

> Finding #4: Kentucky fails to evaluate economic development tax subsidies.

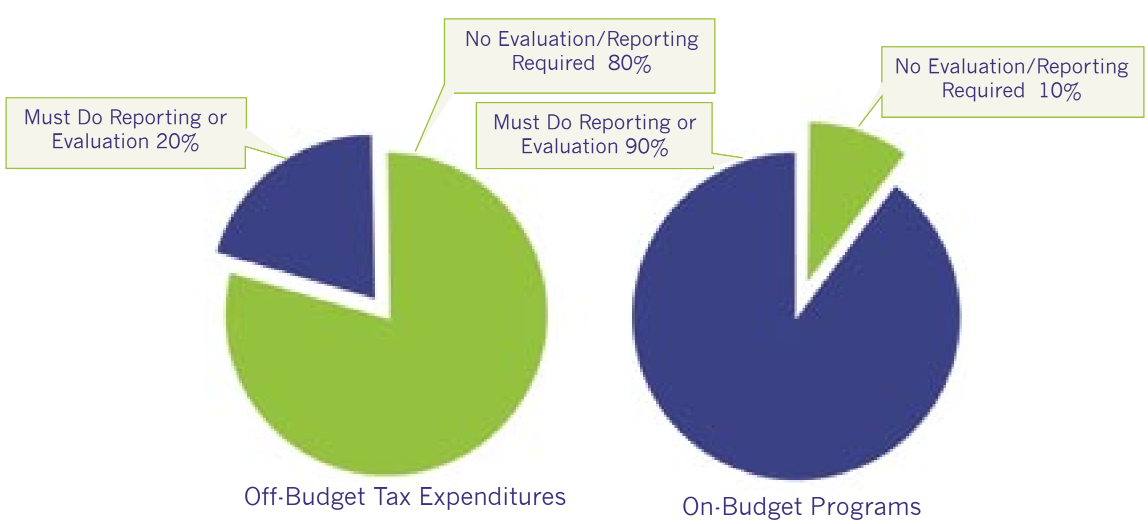
The state focuses its resources on economic development tax expenditures, but doesn't collect the data to back up the assumption that these investments work. While the state requires most of its on-budget economic development programs to submit to at least a modest level of reporting or evaluation, the same standard does not hold for tax expenditures. While 80 percent of the spending on tax expenditures has no evaluation or reporting requirements at all, only 10 percent of on-budget development spending lacks such mandates.

> Recommendation #1: Establish a unified state economic development strategy and budget.

Kentucky's economic development efforts must be better targeted, oriented toward long-term goals and coordinated. For that to happen, the state should create a new unified economic development strategy. A broad and detailed plan would help Kentucky use its resources more strategically and increase the efficiency of its efforts. Such a plan should be directed towards a set of broad quality-of-life goals and not just job creation. It should encompass all spending that is economic development related; be developed through a participatory process; and be based on solid analysis of the state's economy.

Perhaps most importantly, such a plan should be incorporated into the state budget and a better system of economic development budgeting in particular. It is crucial that planning efforts be

Chart 3
Economic Development Tax Expenditures Less Scrutinized than On-Budget Programs (2004)



better linked to decisions about the allocation of resources. Kentucky should create a Unified Development Budget, like Illinois recently established, that is linked to the state-wide strategy. Similar to the budget framework created for this report, it would compile all on-budget and off-budget economic development spending into a single document. Such a budget could be used in the appropriations process.

> Recommendation #2: Evaluate all economic development spending based on results.
Kentucky lacks adequate evaluation and assessment of its economic development spending, particularly its tax expenditures. The state should create a new evaluation system that assesses all development expenditures based on their outcomes. In order for business tax preferences to be properly evaluated, each preference must have a clear statement of goals included in statute, unlike now. And for many tax incentive programs, good evaluation will require more reporting by companies that receive subsidies than currently exists.

> Recommendation #3: Put in place "sunsetting" provisions for economic development tax subsidies.
To facilitate the scrutiny of tax expenditures, Kentucky should put in place "sunsetting" provisions under which tax expenditures automatically expire on a regular basis. Such "expiration dates" will force the legislature to take action to reauthorize individual tax subsidies if so desired. Sunsetting will help put economic development tax expenditures on an equal plane with on-budget programs, funding for which in effect "sunsets" every two years as a new state budget is developed. Kentucky's Enterprise Zone program is currently in the process of sunsetting, which has forced closer scrutiny of this program.

> Recommendation #4: Expand investment in the building blocks of economic development and in a range of promising strategies.
The state must move beyond its narrow reliance on tax subsidies and adequately fund a diverse set of smart economic development strategies. These strategies must be built upon a solid foundation of investment in the building blocks of economic development. In particular, the state must have a high-quality, life-long education system adequately funded at all levels. The state needs an efficient transportation network and an updated high-tech communications grid. And it must have a tax and regulatory system that upholds and promotes basic standards, prohibits and does not subsidize harmful business behavior and provides an adequate amount of revenue for needed investments.

On that basis, Kentucky could experiment with a diverse and flexible set of economic development strategies that have potential to move the state forward. Kentucky should introduce, sharpen and/or increase funding for strategies like the following:

- Expand promotion of entrepreneurism across the state;
- Aggressively support the development, retention and expansion of existing locally owned small businesses;
- Promote mature and emerging sectors of business activity with a comprehensive range of services;
- Enhance adaptive and strategic workforce development efforts;
- Engage in compatible recruitment strategies tied to Kentucky's assets and competitive advantages.

Conclusion

This report describes a current set of economic development expenditures that fail to add up to a coherent and accountable system and that overemphasize one economic development strategy at the expense of others. Much spending is hidden away in tax law and separate from the public scrutiny of the state budget process. The systems of planning and budgeting are fragmented and insufficient. And the expenditures themselves as a whole are narrow, focused on a single, tax-based approach to growth that neglects the building blocks of development and fails to engage the broad economic diversity and many needs, of the state.

The findings and recommendations of this report suggest the need for a serious and substantive conversation about the way economic development decision-making is structured and the way economic development money is spent. Kentucky must put in place a better framework for its economic development system, experiment with new programs and investments and regularly measure success in meeting goals. If we take seriously the state's potential role in furthering our economy, we have the opportunity to begin building a more prosperous future.