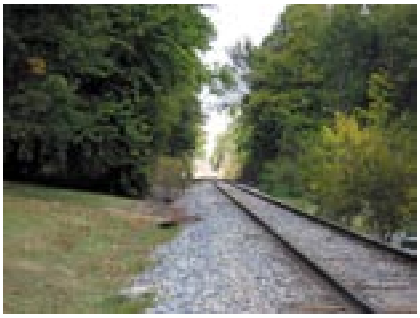

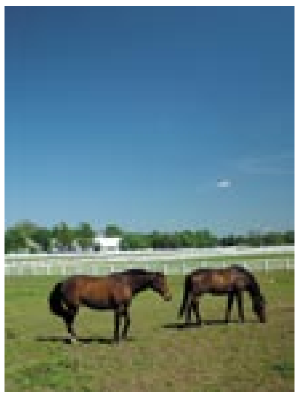

Accounting for Impact:
Economic Development Spending in Kentucky

Mountain Association for Community Economic Development

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Authorship credits:
Jason Bailey, Democracy Resource Center; Justin Maxson, Mountain Association for Community Economic Development

Primary research and writing conducted by:
Democracy Resource Center in cooperation with the Mountain Association for Community Economic Development

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Table of Contents

In recent years, progress in education has been a real bright spot in the indicators of Kentucky's well-being. The state has climbed to the national average in the share of high school graduates who enroll directly in college, up from 43rd among the states in 1994.[1] Kentucky's dropout rate, test scores and college graduation statistics have also shown improvement. But beyond advancement in education and a few other areas, the state continues to struggle economically. Some of Kentucky's challenges are rooted in its long history of low educational attainment, poverty and dependency on natural resource extraction. Other challenges are new and reflect an economy that is undergoing significant restructuring. Rapid changes are creating a mix of opportunity and upheaval for communities across the state.

Kentucky's rural areas continue to face declining income and employment from tobacco and coal and the loss of jobs from branch plant closings in the apparel and other industries.[2] Especially troubled are those rural communities located far from interstate highways. Kentucky's cities—though more prosperous overall than rural areas—face a growing income gap, the loss of good-paying manufacturing jobs and the challenge of urban sprawl. As a whole, the state remains near the bottom in too many economic indicators. For the past 34 years, Kentucky has been stuck at 42nd among the states in per capita personal income. And the average annual wage and salary per job in Kentucky has actually fallen relative to the national average, dropping from 92 percent in 1980 to 85 percent in 2003.[3]

In its *Development Report Card* for the States, the Corporation for Enterprise Development (CFED) assesses states' economic health using a set of 68 statistical indicators. The 2004 edition gave Kentucky a grade of D in "Economic Performance," C in "Business Vitality," and D in "Development Capacity."[4] CFED's analysis matches up with the perception of many Kentuckians. The Kentucky Long-Term Policy Research Center recently surveyed the state's residents on whether Kentucky was "making progress," "standing still," or "losing ground" on a variety of social and economic goals. The share of respondents who thought the state was "making progress" toward *diversified long-term development that stresses competitiveness and a rising standard of living for all citizens while maintaining a quality environment* fell from 36 percent in 1998 to only 22 percent in 2004. 51 percent thought the state was "standing still." Similarly, only 11 percent of respondents saw progress on the goal *Kentucky will end poverty and alleviate its adverse consequences and debilitating effects*. 44 percent thought the state was "losing ground" in that effort.[5]

In addressing Kentucky's economic challenges, there is wide agreement that state government has a vital role to play. The state certainly does not have complete control over Kentucky's economic status, which is determined by a complex mix of internal and external factors. But through its programs and policies—through its spending and through its rules--state government is an important contributor to Kentucky's economic condition. The question for business groups, political leaders, non-profit organizations and others is not "whether" the state should play a role in economic development, but "how."

A meaningful discussion of "how" first requires a solid understanding of what efforts are in place now. But the state doesn't look at or report on its *entire* economic development system in any systematic way. There is no document or analysis that catalogues the state's development expenditures, which are spread across many parts of state government and happen both through the budget and more quietly through state tax laws. This lack of unified information is a serious shortcoming. Its absence makes it nearly impossible to effectively coordinate development efforts, respond to rapid economic changes and achieve a maximum return on investment.

It is increasingly crucial that Kentucky's economic development system be as strategic and efficient as possible. This report is a first attempt to fill the gap in information and understanding through a comprehensive analysis of Kentucky's economic development expenditures. The report catalogues and categorizes six years of economic development spending. It also broadly analyzes the system of planning and decision-making that is the framework for that spending and collects the evaluation and reporting requirements that are tied to expenditures. Through the report's basic data, key findings and policy recommendations, we hope to spur a deeper discussion about the need for a more intentional, coordinated and accountable economic development system. Such a system is necessary for a brighter and more prosperous future in the Commonwealth.

On-budget and off-budget spending

This report catalogues and analyzes state government spending on economic development. The report takes a comprehensive view of that spending to include programs receiving state budget appropriations as well as spending that occurs "off-budget" through provisions in state tax law. On the budget side, the report incorporates the Cabinet for Economic Development but also includes programs operated by fifteen other cabinets or agencies that are economic development-related.[6] On the tax side, it includes "tax expenditures" that are justified on economic development grounds. Tax expenditures are "departures from the normal tax structure designed to favor a particular industry, activity or class of persons."[7] They are ways in which the tax system is altered to benefit certain groups, resulting in a loss of state funds for other purposes. Tax expenditures include, by the state's definition, "special exemptions, exclusions, deductions, credits, deferrals and preferential rates in tax law."[8]

Tax Expenditures: "departures from the normal tax structure designed to favor a particular industry, activity or class of persons."

There are two main types of economic development tax expenditures (Box 2 explains these in more detail). The first type is general business tax preferences such as Kentucky's sales tax exemption for the purchase of tractor trailers. The second type consists of company-specific tax incentive programs like the Kentucky Rural Economic Development Act (KREDA), which awards tax breaks and subsidies to manufacturing facilities that locate in rural counties. The reason for the term "tax expenditure" is that such advantages, just like programs and services for which funds are appropriated in the budget, are ways the state spends money to achieve certain ends. Tax expenditures, however, are less noticed and scrutinized than items in the budget (see Box 1 for more).[9]

By including both types of expenditures and by examining all parts of state government, this report is intended to foster a new level of understanding of Kentucky's current economic development spending patterns and the explicit or implicit strategies the state is pursuing.

Box 1: Bringing Scrutiny to Tax Expenditures

Government at all levels has slowly increased its reporting on tax expenditures over the last thirty years. To get a better grip on these preferences, Congress passed legislation in 1974 requiring the executive branch to produce a federal tax expenditure analysis as part of the President's annual budget proposal. That law also requires the congressional Joint Committee on Taxation—with membership from both the House and the Senate—to produce an independent tax expenditure report every year.[10] Thirty states now produce their own reports and Kentucky began publishing its analysis in 1988. The state budget bill requires the Office of the State Budget Director to publish the report by October 15 of every odd-numbered year.

One reason for the growth of reporting is recognition of the similarity between tax expenditures and normal on-budget spending. The Joint Committee on Taxation notes that such tax provisions "are referred to as tax expenditures because they may be considered analogous to direct outlay programs and the two can be considered as alternative means of accomplishing similar budget policy objectives."[11] Similarly, the National Conference of State Legislatures advocates reviewing tax expenditures in conjunction with the state budget in its publication *Fundamentals of Sound State Budgeting Practices*: "Tax expenditures are the fiscal equivalent of state expenditures for the same purpose, but only the beneficiaries of tax expenditures tend to remember their existence. They are not subject to the examination that formal budget items regularly encounter. Comprehensive budget review should include them and individual tax expenditures should be reviewed just as other state expenditures are."[12]

A second reason for the rising scrutiny is the proliferation of tax expenditures and concern about their impact on revenue. More and more, at a time when anti-government sentiment is high, decisions are made to operate programs through tax credits rather than on-budget spending. One of the largest federal anti-poverty programs, for example, is now a tax expenditure: the earned-income tax credit. Kentucky's *2004-2006 Tax Expenditure Analysis* contains 42 more tax expenditures than were included in the 1988 edition.[13] The tax plan that passed the 2005 General Assembly exemplifies the growth trend. While no new money was raised overall to pay for expanded services or new programs, the plan included new tax expenditures for "clean coal" power plants, brownfield redevelopment, business construction costs, research and development expenses, production of new environmental technologies (like hybrid cars), biodiesel production, historic preservation and more.

Tax expenditures are most similar to "entitlement" spending programs, in which an individual or business that meets the criteria for the program is automatically eligible. Medicare and Social Security, for example, are entitlements—they are automatically available to all who qualify without reference to an amount budgeted for the program. Almost all tax expenditures are also entitlements in which any taxpayer that qualifies for the advantages automatically receives them. As Citizens for Tax Justice has noted, these expenditures "run on auto-pilot" once enacted. If the oil industry receives a special tax break in federal law, it is entitled to receive that break every year no matter if there is enough money for housing programs or Head Start.

One reason for the growth of tax expenditures is their perceived political advantage. Usually, when elected officials seek a new program, they must pass a tax increase to pay for it. Tax expenditures offer the advantage of increasing spending for a particular purpose without seeming to raise taxes. However, the lost revenue that results from the tax expenditure must be made up somehow, and the result is an increase in somebody else's taxes or a cut in a service that benefits some or all taxpayers. Bringing more visibility to tax expenditures and examining them alongside budget appropriations allows a more accurate view of how governments spend money and helps halt such hidden decision-making.

Defining economic development

In choosing which programs and expenditures to include in the analysis, it is important to note, along with the National Conference of State Legislatures, that

> *a complete list of state activities that foster economic development would include almost everything states do. Public education, transportation, public safety and administration of the courts are essential parts of the physical and social infrastructure. Regulation of labor and working conditions, public health, banking and other financial activities and environmental conditions affect the climate for economic development.*[15]

Rather than the broadest view, this report focuses on those expenditures whose primary and overt purpose is economic development—that spending directly oriented toward fostering business activity. The report attempts to strike a balance, avoiding the extremes of a definition that would include "everything state government does" and a very narrow interpretation that includes only job recruitment and retention. Borrowing from the California Budget Project's study *Maximizing Returns*, this report includes expenditures that meet the simple definition of "*activities that foster job creation, technological development, a healthy business sector and a skilled workforce.*"[16] On-budget and off-budget expenditures included in this analysis totaled $808 million in 2004.[17]

Categorizing the spending

Individual expenditures were classified by broad strategy or type of expenditure. While many items could fit into more than one category, expenditures were placed in the category most closely corresponding to the program's primary development function or purpose. What follows is a brief description of those categories. The report also identifies those expenditures that are sector- or industry-specific and the results of that analysis are included in the Key Findings section of the report. In total, 60 percent of the economic development spending included in this report benefits a certain sector or industry.

Capital and Financial Subsidy

This category consists of expenditures that promote business activity through the provision of financial subsidies that lower the cost of business. Often, this takes the form of tax preferences and exemptions that decrease the tax liability of particular businesses or sectors. Also included here are programs that offer loans, grants or other forms of capital provision.

Economic Development Planning

The Economic Development Planning category contains programs that focus on creating economic development strategies and plans. Such planning might be regional, sector-specific, tailored to cities or statewide. Programs in this category, like the Main Street revitalization program operated by the Kentucky Heritage Council, gather information and set up processes that bring individuals and groups together to craft strategies for economic advancement.

Facilitating Regulatory Compliance

Expenditures in the category Facilitating Regulatory Compliance have the goal of assisting businesses in meeting state environmental, worker health and safety and other regulatory requirements. These expenditures are geared toward helping businesses reduce compliance costs and navigate the regulatory process through training and assistance. Not included here is state spending for regulatory enforcement.

Industrial Recruitment and Site Development
This category contains expenditures directly related to the recruitment of businesses to the state and the creation of industrial sites used to lure industry. Included here are international or regional offices or organizations whose focus is recruitment and programs that track and market industrial sites to prospective businesses. Not included are many of the financial tools and incentives used in recruitment, which are located in the Capital and Financial Subsidy category.

Marketing and Market Development
The Marketing and Market Development category consists of programs designed to promote the development of new markets, both within the state and abroad and to increase the marketing capacity of Kentucky businesses and business sectors. Examples include the tourism department's state marketing efforts, agricultural marketing assistance and the Kentucky Coal Marketing and Export Council's programs promoting Kentucky coal.

Management Support for Business
This category includes programs that foster business establishment and development through assistance that improves management and operations, including financial management, business planning and human resources. This category includes the Small and Minority Business Division of the Cabinet for Economic Development.

Technology, Innovation and Modernization
This category includes investments whose goal is to promote high-tech economic development and technological innovation in business products and processes. Programs include those promoting research and development, technology transfer and commercialization and entrepreneurship in high-tech sectors. Much of the expenditures are from programs created through the 2000 Kentucky Innovation Act.

Training and Workforce Development
The training and workforce development category consists of expenditures that increase the skills and knowledge of Kentucky workers in order to promote business activity. This category does not include programs whose primary purpose is to assist individuals' ability to participate in the workforce, such as vocational rehabilitation. Nor does it include general programs that build basic, pre-workforce knowledge and skills, such as K-12 and postsecondary education. Rather, this report focuses on those workforce development programs that are geared toward job creation and on building worker skills to match business needs.

Evaluation and planning procedures

In addition to the identification and categorization of expenditures, this report examines their reporting and evaluation requirements. Included here are only the formal requirements contained in statutes or in the state budget bill. Expenditures with mandates are classified by (1) those requiring "output only" reporting or (2) those requiring an evaluation of "outcomes." "Output only" refers to reporting that measures the activities of a program. For example, a training program might be asked to report on the number of workers served by the program over the course of a year or the number of trainings held in a given region. Outputs are quantitative measures of a program's activities, such as the number of units of service provided. While outputs describe what work went on, they do little to measure a program's effectiveness.

Outputs are measures of the activities of a program, such as how many units of service are provided. *Example:* For a small business program, one output would be the number of technical assistance calls fielded by program staff.

Outcomes are the results of a program or expenditure. They refer to the program's impact or the positive or negative changes that result from a program's activities. *Example:* For a small business program, one outcome indicator might be the percentage of small businesses served by the program that survive the first five years of operation.

Evaluation of "outcomes" looks at the results of a program's activities. Rather than simply listing what a program did, outcomes-based evaluation looks at whether the program worked. Instead of reporting on the number of workers enrolled, the above-mentioned training program might examine whether program graduates obtained jobs that paid higher wages than previous employment or gained skills that made them more work ready. Measurement of "outcomes" is a better way to assess programs, but is more complicated than a simple accounting of activities through "output only" reporting. "Outcomes" evaluation requires clear goals a program is seeking to achieve along with appropriate ways to measure success relative to those goals.

In addition to evaluation procedures, this report contains a broad review and assessment of the state's processes for economic development planning and budgeting. We looked primarily at how the variety of procedures that are in place now fit together, assessing whether they allowed an adequate level of accountability and facilitated coordination of the state's economic development spending.

Following the collection and analysis of data, this report identifies "Key Findings" that represent broad patterns and areas of concern. From those findings, we make a series of recommendations about policy directions. The report also contains a series of three appendices that catalogue the expenditures. Appendix A consists of descriptions of the programs and expenditures that were included in the analysis. Appendix B breaks out the spending detail for the years 1999-2004. And Appendix C collects the reporting and evaluation requirements.

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

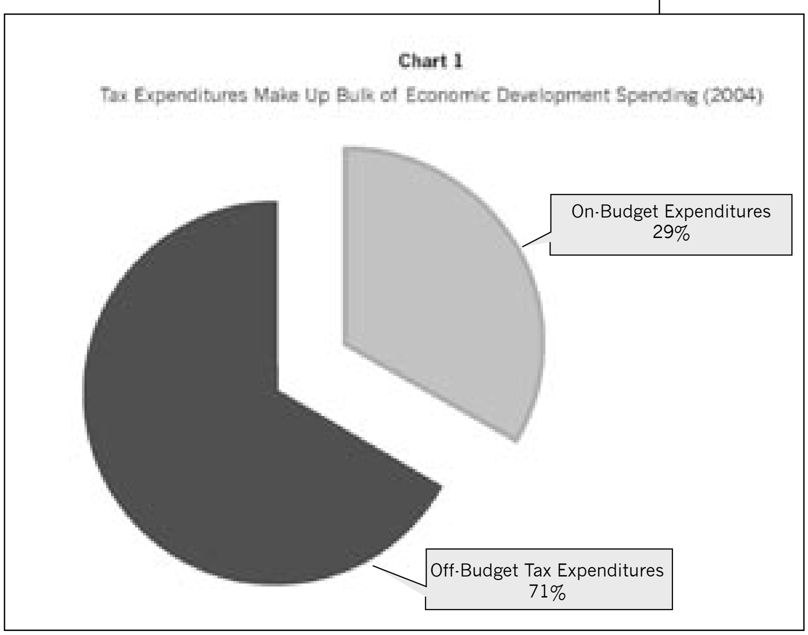
In 2004, Kentucky spent approximately $808 million in the area of economic development. But the vast majority of that spending was not out in the open, subject to the public scrutiny of the state budget process. Instead, it happened under the radar through business tax breaks and subsidies buried in 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 (2004). By contrast, the on-budget programs cost $237 million that same year.

The steady expansion of Kentucky's economic development tax incentive programs

1982: Enterprise Zone Program
1988: Kentucky Rural Economic Development Act
1992: Kentucky Jobs Development Act
1992: Kentucky Industrial Revitalization Act
1992: Kentucky Industrial Development Act
1996: Kentucky Tourism Development Act
2000: Kentucky Economic Opportunity Zone Act
2000: Tax Increment Financing
2003: Kentucky Reinvestment Act

As mentioned in the overview, these tax expenditures take two different forms. The first group consists of tax preferences or advantages embedded in the tax code, which totaled $448 million in lost revenue in 2004. These preferences are the least visible type of economic development tax expenditure. The legislature passed each of them at some point in the past, often with little notice and they remain in the law permanently. Though the revenue impact of each tax break may have seemed insignificant at the time of its enactment, if such holes in the tax code are created as a regular practice their toll on state revenue can climb to considerable levels. That is exactly what has happened in Kentucky in recent years. Some of these preferences are targeted to particular sectors or industries, such as the tax credit for businesses that convert to coal as their energy source or the lower property tax rate for manufacturing machinery. Others are available more broadly and are designed to generally keep business taxes low. Two such examples are the reduced property tax rate on business inventories and the (pre-2005) ability to avoid the corporate license tax by organizing as a limited liability entity.

The second group consists of the more commonly-recognized economic development tax incentive programs, which in 2004 resulted in $123 million in uncollected revenue. In these programs, tax breaks are awarded on a business-by-business basis with the intent of luring companies to Kentucky. Specific credits vary by program and can include corporate income tax exemptions, sales tax breaks and "job assessment fees," which in essence allow businesses to keep a portion of the individual income taxes their employees would normally pay to the state. Especially following the enactment of the Kentucky Rural Economic Development Act in 1988, the state has rapidly introduced new tax incentive programs while also steadily expanding eligibility for the programs that already exist (see above for a timeline of recently-enacted programs). Since 1990, state records show, Kentucky has given out $4.3 billion in such economic development tax credits.[18] These credits are tax reduction promises that businesses could potentially cash in, creating a huge liability for the state that is only beginning to be realized in the above revenue loss.



Box 2: Types of Economic Development Expenditures

On-Budget Programs

Services carried out by a cabinet or agency of state government and funded through budget appropriations. Examples include the agricultural marketing programs of the Department of Agriculture; the Kentucky Tech system of 53 area technology training centers; and the Site Evaluation Division of the Cabinet for Economic Development, which compiles and makes available information about industrial parks and sites.

Off-Budget Tax Expenditures

Tax exemptions or preferences: Tax advantages in state law targeted to particular industries or available broadly to many businesses. They are automatically available to any business meeting the qualifications. Examples include:

- Purchases of horses less than two years of age are exempt from the sales tax provided the sale is made to a non-resident of Kentucky.
- The property tax rate for business inventories is set significantly lower than the normal tangible property tax rate.
- Owners of coal land can deduct up to 50 percent of their income from royalties received from such land from corporate income tax liability (depending on other deductions taken).

Tax incentive programs: Company-specific economic development subsidy programs. Examples include:

- Kentucky Jobs Development Act (KJDA): Eligible service and technology companies receive an exemption from the corporate income tax and a 5 percent "job assessment fee" for up to ten years. Job assessment fees essentially allow companies to keep a portion of the individual income tax with held from employees rather than turning it over to the state. Eligible businesses must create at least 15 jobs, meet a designated wage floor for 90 percent of their employees and provide at least 75 percent of services to out-of-state customers.
- Enterprise Zone program: Eligible businesses located in one of six remaining zones across the state can receive a variety of state and local tax incentives, including a sales tax exemption for the purchase of building materials, machinery and equipment; an exemption from the motor vehicle usage taxes; and a corporate income tax exemption.
- Tax Increment Financing (TIF): Allows a portion of the additional tax revenue created by a development project (personal income taxes, sales taxes, property taxes, etc.) to go toward paying costs related to the project for up to twenty years. Projects must meet eligibility requirements, including a minimum of 25 new jobs and a $10 million investment.

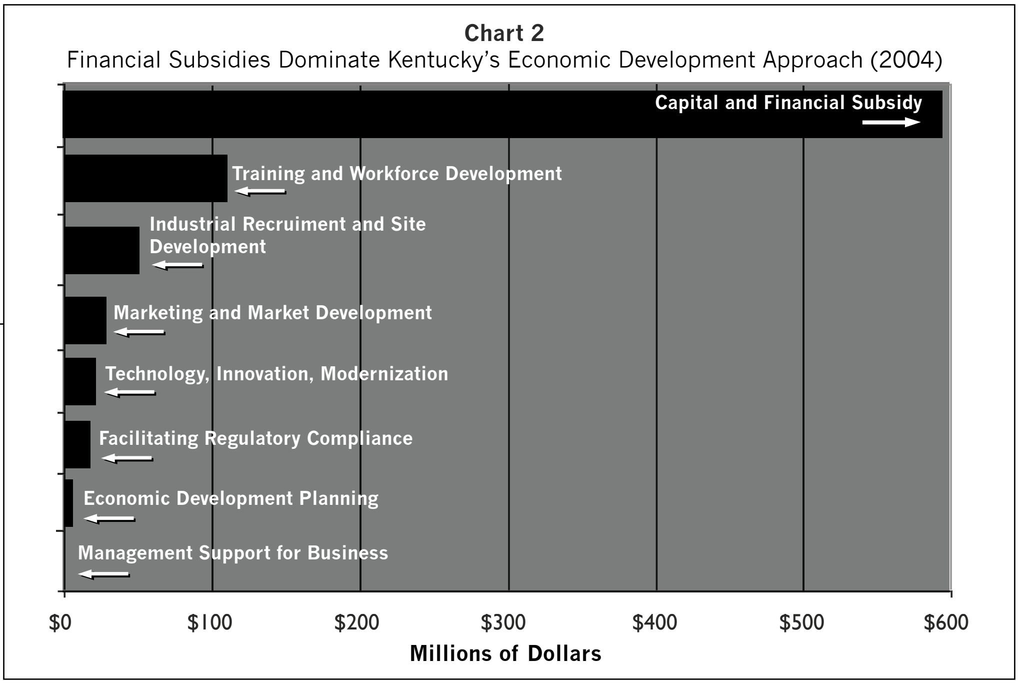
Finding #2: Kentucky relies narrowly on a single strategy of attracting businesses with financial subsidies.

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. Instead of a more balanced menu of technical assistance in business planning, marketing, job training, product development and other areas, Kentucky primarily supports businesses by lowering or eliminating their tax liability or providing other financial support.

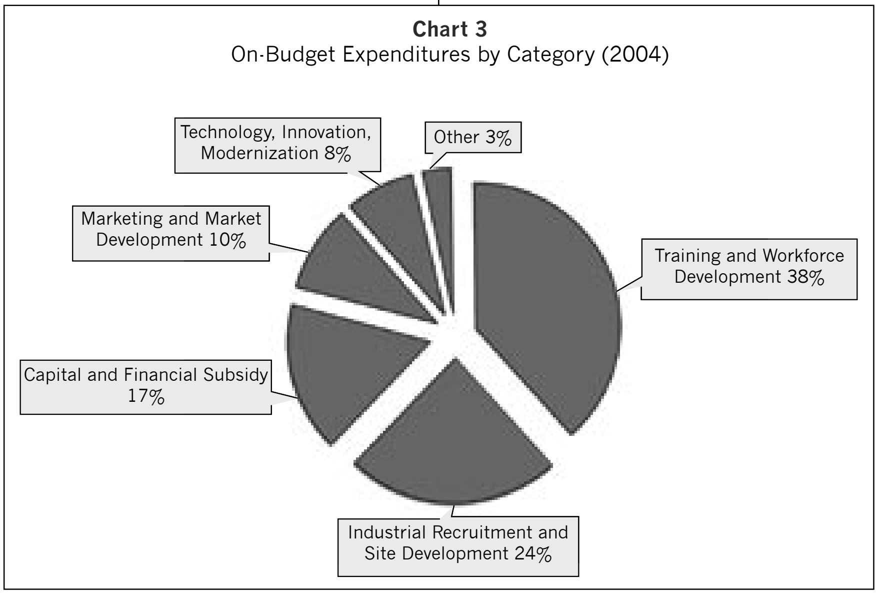
The categories primarily concerned with business subsidies and industrial recruitment make up 79 percent of economic development spending.

The array of financial subsidies the state offers is closely related to its spending on industrial parks and sites and direct spending 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. Indeed, even when on-budget programs are examined in isolation, Industrial Recruitment and Site Development receives the second-largest amount of funds and Capital and Financial Subsidy the third (see Chart 3).

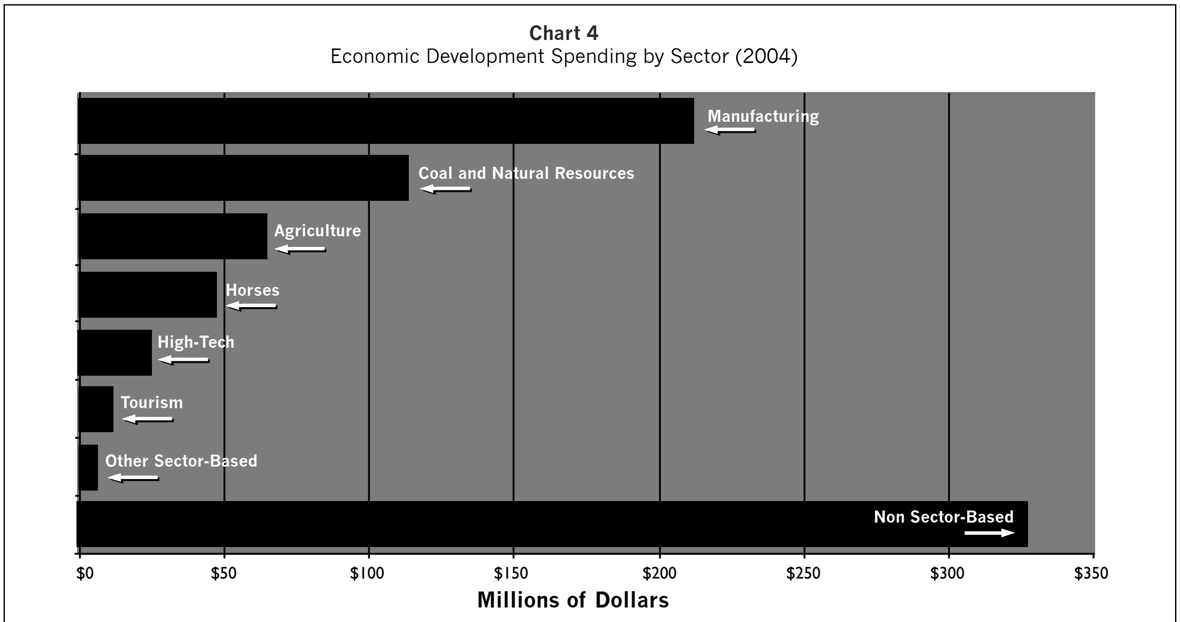
The state's overwhelming focus is clearly attracting industries to the state with the help of financial subsidies. Accordingly, it is difficult to discern other strategies that are funded at a comparatively noticeable scale. Small business development services (like business planning or human resources support), for example—which are addressed primarily in the Man-



agement Support for Business category—are barely funded.[19] Most other strategies could be considered immature in comparison rather than active and identifiable approaches the state is pursuing.



The clear emphasis in terms of sector-specific investment, as can be seen in Chart 4, is more traditional industries like manufacturing and coal. Kentucky should be concerned both about which sectors are receiving state funding as well as the nature of that funding. For example, much of the spending on manufacturing and for the coal industry is "general support" in nature and takes the form of tax subsidies. This approach is in sharp contrast to the smaller amount spent on high-tech economic development, which is funded according to a clearly defined strategy and spent on a set of inter-related programs in such areas as research and development, technical support for start-ups and commercialization. Agriculture spending falls in both of these camps. The state's economic development spending across sectors needs closer analysis that is beyond the scope of this report. However, this chart and the nature of the investments suggest a concern regarding how strategic and appropriate Kentucky's sector-based investments are.



Box 3: Problems with a Narrow Tax Subsidy Approach

A growing number of policy experts are questioning the heavy, unbalanced emphasis on tax incentives and recruitment that characterizes Kentucky's and most states' approach to economic development.[20] In the new report *Rethinking Growth Strategies*, economist Robert Lynch analyzes hundreds of survey, econometric and representative firm studies that looked at the impact of tax incentives and state and local tax cuts on economic development and job creation. Lynch finds "little grounds to support tax cuts and incentives—especially when they occur at the expense of public investment—as the best means to expand employment and spur growth."

Because they result in lost revenue that inevitably means cuts in public services, such measures can end up destroying more jobs than they create—along with lowering state living standards and eroding internal capacity. By contrast, Lynch reports, expansion of investments in key public services "can be one of the most effective strategies to advance the quality of life of citizens."[21]

The use of tax incentives in the growing interstate competition for jobs has become increasingly costly for states and localities. Economist Kenneth Thomas has estimated that in 1996 states and cities spent a total of nearly $50 billion a year on tax incentives.[22] Because incentives are intended to influence corporate location decisions in favor of one state over another, they result in no new investment or job creation overall. They are an inefficient use of public resources because they often subsidize businesses to do what they would have done anyway. While expensive in the aggregate, Lynch points out that the taxes being abated are only a minor cost to individual firms. In 2000, state and local taxes paid by businesses amounted to just 1.2% of the cost of doing business and 0.8% once federal deductibility is taken into account.[23] The relative insignificance of taxes to business decision-making is confirmed by a number of studies of the factors businesses consider when making location decisions. In a recent survey of 1,000 business executives by Louisiana State University's Public Policy Research Lab, corporate taxes ranked 10th in importance on the list of factors, while state and local incentives were 16th and tax exemptions 18th. Tax preferences ranked far below other factors that require adequate public investment. Labor productivity and the availability of skilled labor topped the list, while access to highways, quality of health facilities and public schools all ranked above taxes and incentives.[24]

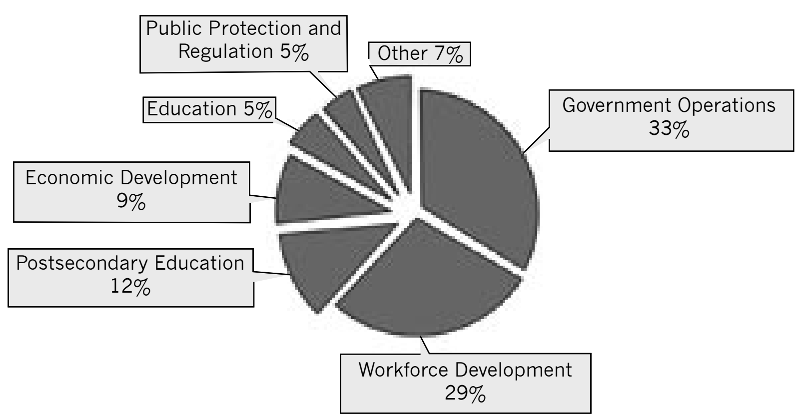
Finding #3: Economic development planning and budgeting are fragmented.

The strategic plan of the main body responsible for state economic development planning—the Partnership Board of the Cabinet for Economic Development—is focused primarily on the activities and programs of the Cabinet itself, which is the only entity the Partnership Board has the authority to govern. But only 9 percent of on-budget economic development spending happens through the cabinet (see Chart 5) and only 21 percent of off-budget tax expenditures.[25] State law directs that there be cooperation and coordination between economic development-related cabinets and agencies.[26] However, as a practical matter, the Cabinet for Economic Development's somewhat separate organization from the rest of state government (see Box 4) and the scattering of economic development spending makes effective coordination a major challenge.

Other economic development-related plans, while laudable, exist independently of each other and the Partnership Board's plan rather than being integrated. In 1993, the Kentucky Long-Term Policy Research Center led a process developing a set of 26 goals for the state through its Visioning Kentucky's Future Project. Those goals concern the state's economy along with the areas of education, community, the environment and government. The Center regularly reports on progress toward those goals using statistical indicators and survey data. Also, the state's high-tech initiatives established with the Kentucky Innovation Act of 2000 are associated with a set of detailed plans and studies, as is the Agricultural Development Board's plans for spending Phase II tobacco settlement money for agricultural diversification.[27] The fragmentation of the state's planning—and the absence of plans in some other economic development areas—necessarily lessens the coherence of the state's efforts.

Most importantly, all of this planning is disconnected from the budgeting process, where the most important decisions about the allocation of resources are supposed to be made. Planning is not integrated into Kentucky's budget because the state uses a traditional line-item budgeting format. That system includes very little or no narrative about the goals and past performance of individual programs and legislators must ask for additional information that agencies submit to the executive branch. A line-item system focuses the attention of the legislature on details about program inputs—like how much to spend on personnel or operating expenses for a particular program—rather than the impact a program has made in the past and the objectives it is working to achieve.[28] Line-item systems differ greatly from performance-based systems like Texas has adopted. Such a system requires strategic planning according to uniform guidelines and planning information is integrated into the budget document. Performance-based systems allow easier comparison and coordination across programs and link statewide goals with the appropriation of funds. In Texas' system, it is possible to examine in a unified manner all state expenditures aimed towards economic development, one of the eight goals in the government-wide strategic plan.[29]

Chart 5
On-Budget Economic Development Spending by Cabinet (2004)



In addition to the fragmentation caused by the state budget format, there is a disconnection between on-budget programs and other economic development spending across the state. One distinct area is the

Key Findings

variety of development-related efforts carried out by individual universities and community colleges. This report was initially intended to include economic development programs carried out by those institutions. But that information was excluded—except for system-wide programs with line-items in the state budget—because of the difficulty in obtaining comparable data from the institutions. Kentucky's universities and community colleges are carrying out significant and important economic development activities—most of which are carved out of broad appropriations to the institutions—but the planning and coordination of these efforts is not linked in a formal way with other economic development initiatives across the state.

Also distinct are local economic development expenditures. The Kentucky Constitution and the state legislature allow cities to award five-year property tax abatements to new manufacturing facilities and a number of state tax incentive programs have local components in which city or county governments must agree to provide accompanying tax breaks. Recently, the General Assembly passed legislation allowing local governments to use tax increment financing (an incentive program) without state approval. In formal and informal ways, local government economic development spending is linked to state spending, but there is no planning mechanism to bring local and state resources into alignment in deliberate and strategic ways.
And as noted, the bulk of state economic development expenditures are not budgeted at all at any level because they are happening through tax law. Kentucky made an important step towards accountability in 1988 when it became one of the states to produce a tax expenditure report. However, the findings of that report are not part of the state budget in any formal sense; therefore, its implications for spending decisions are not necessarily clear when the budget is made.

Box 4: Background on Kentucky's Cabinet for Economic Development

In 1992, the General Assembly restructured the Cabinet for Economic Development into a partially independent entity overseen by a combination of private sector and government representatives. The legislation created a new Partnership Board to govern the cabinet. The Partnership Board was to be made up of eleven members, eight of whom were to represent business groups and the private sector. The Governor and the secretaries of the Natural Resources and Environmental Protection and Finance and Administration Cabinets were also placed on the board. This legislation made the Cabinet for Economic Development somewhat autonomous from the rest of state government. Among the board's duties was to hire and fire the Cabinet Secretary.

The Partnership Board was charged with creating a statewide economic development strategic plan and updating it every two years. The first plan was adopted in May 1994.

Also created in 1992 was the Kentucky Economic Development Finance Authority, which has the responsibility of approving tax incentives for individual companies. The Authority is made up of representatives of business and finance. That same year, the state expanded the variety of tax incentive programs and put in place new exemptions to the open records and open meetings law to increase the level of secrecy for economic development-related documents and negotiations.

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 be subject to some level of reporting or evaluation, the same standard does not hold for economic development tax expenditures. A full 79 percent of the spending on tax expenditures has no evaluation or reporting requirements at all, while only 10 percent of on-budget development spending lacks requirements. The few requirements that do exist for tax expenditures involve simple reporting instead of evaluation of impact, while 69 percent of on-budget spending is subject to an outcomes-based evaluation (see Chart 6 and Chart 7).

In total, $479 million in on-budget and off-budget economic development expenditures are unevaluated. Only 20 percent of the total spending is linked to an outcome-based evaluation, or an assessment of the effectiveness of a particular expenditure. In many cases, even for spending with evaluation or reporting requirements, few specific guidelines exist in law about how assessment should be carried out.

It should be noted that when the state budget is being compiled, all programs on the budget side are required to submit some level of information on their activities to the governor with their budget requests. Through that process, then, at least a modest level of reporting takes place. Also, program administrators may be asked to answer questions about their programs in front of legislative panels when the budget is being decided. Beyond the tax expenditure report—which provides estimates of lost revenue—no comparable scrutiny exists on the tax side. Also, because of changes to the open records law enacted along with the expansion of tax incentive programs in 1992, independent evaluations of many incentive programs are impossible because the public cannot access the records (and even if the files were open, reporting in some cases does not exist). In 2000, the Legislative Research Commission began a study analyzing economic development tax incentive programs, but abandoned the study in part because of challenges involved in getting necessary data. And none of the economic development tax expenditures have "sunsetting" provisions—with the exception of the Enterprise Zone program—by which the expenditures would automatically expire unless reauthorized by the state legislature.

Chart 7
Evaluation/Reporting Requirements for
Off-Budget Tax Expenditures (2004)

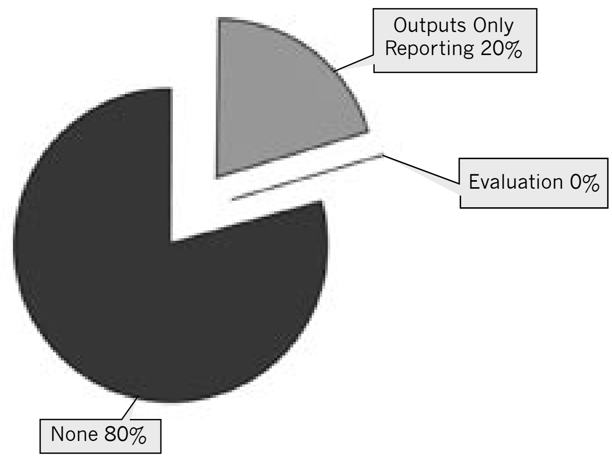
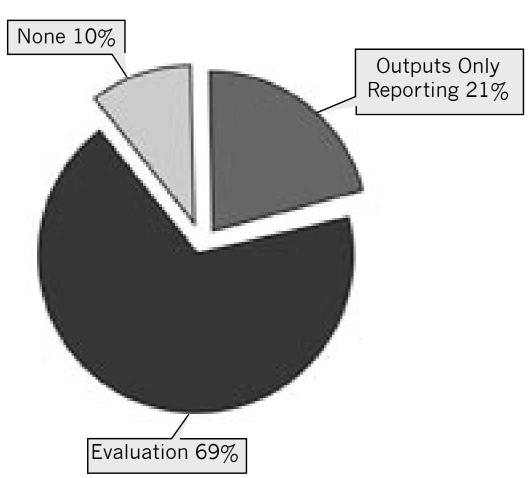


Chart 6
Evaluation/Reporting Requirements for
On-Budget Programs (2004)



This report describes an economic development system in great need of improvement. Too much current spending lacks accountability, unity and strategic purpose. Most of the money is spent in the way least subjected to the light of assessment and debate. Changes are needed to the overall framework of economic development planning, coordination and evaluation as well as the spending priorities themselves. While none of the solutions to the problems with Kentucky's economic development system are easy to formulate or carry out, the state must begin an intentional process of reform in order to move Kentucky's economy forward. The following recommendations are broad in scope and represent general directions that state economic development policy should take.

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 the state use its resources more strategically and increase the efficiency of its efforts. Some aspects of good planning do exist already, but are variously under-funded, insufficient or disconnected from the entire system. For a unified plan to work, it must have a number of characteristics, including:

1. *Plan should be directed towards a vision and set of broad quality-of-life goals and not just job creation.*
   Too often, economic development success is measured solely by the number of jobs created. Such a narrow approach can too often lead to the wrong conclusions about good policy. The goals developed by the Kentucky Long-Term Policy Research Center's "Visioning Kentucky" process are a good example of a set of broader goals. An economic development strategy would link those kinds of goals to actual programs.

2. *Planning should encompass all spending that is economic development related.*
   The state should work to address the fragmentation of current planning efforts and create a unified plan that addresses all aspects of state government that are economic development-related. Unified planning will not be easy and will require new levels of cooperation among institutions and agencies along with adequate resources for planning efforts.

3. *Plan should be developed through processes that involve a wide variety of institutions, organizations, and individuals.*
   The state should draw upon the knowledge, insights and perspectives of a wide variety of Kentuckians in developing a state economic development strategy. Business groups are important, but should not be the only perspective outside government involved.

4. *Plan should be based on solid research and analysis of the state's economy.*
   Planning must be grounded in data and in relation to trends in the state's work force, industry sectors, regions and the broader economic context.

The state should develop regular processes for revising the strategy as times and conditions change. To carry out better planning, Kentucky may need to examine the need for a new coordinating body that can develop and manage the strategy, facilitate communication between economic development efforts across the state, carry out the data research and analysis and conduct evaluation. The state should also promote and support additional planning processes that are linked to, but more specific than, the statewide plan. Such plans may be carried out by economic development agencies and departments as well as by industry sectors, regions, counties or cities.[30]

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 better linked to decisions about the allocation of resources. Currently, planning is disconnected from budgeting and

both are disconnected from tax expenditure reporting and the implicit spending decisions buried in tax law. Kentucky should create a Unified Development Budget that is linked to a new state-wide strategy. Like 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 would exist in addition to the regular state budget but be used in the appropriations process. The state of Illinois recently passed legislation requiring an annual unified development budget starting this year.

Recommendation #2: Evaluate all economic development spending based on results.

Most of the money spent on economic development in Kentucky lacks evaluation requirements. And the evaluation mandates that do exist often lack specificity or require only basic reporting of the activities of a program. Tax expenditures, in particular, are inadequately examined. Kentucky should create an evaluation system that assesses all development expenditures based on their outcomes.

To do that well, the state must assist programs in tying goals and objectives to carefully chosen indicators and help programs create data collection systems. For evaluations to be accurate, there must be uniformity and sensibility in the selection of indicators. In order for business tax preferences to be properly evaluated, each preference—unlike now—must have a clear statement of goals included in statute. Kentucky should require in statute a justification and statement of purpose for all new tax expenditures. And for some tax incentive programs, good evaluation will require new levels of reporting and disclosure by companies that receive subsidies. In several programs, individual businesses are awarded incentives over ten-to-fifteen year periods while only being required to report basic information about jobs, wages and activities in the first two years of the program.

Proper evaluation is a difficult task that must be adequately funded. Assistance with evaluation of economic development programs could be the role of an economic development coordinating body. The state should regularly compile and report on the evaluations of all economic development-related expenditures.

Recommendation #3: Put in place "sunsetting" provisions for economic development tax expenditures.

As noted in the state's own analysis, tax expenditures have an unfair advantage compared with conventional on-budget spending:

> *Unlike direct appropriations, which must be continuously reviewed and approved by the General Assembly to remain in effect, tax expenditures are usually not included in this review process. As a result, programs funded through tax expenditures receive priority funding over all other programs. In all probability, many "tax expenditure" programs would not receive the same priority if they had to compete with "direct funding" programs.*[31]

To bring balance and improve the quality of the state's spending decisions, Kentucky should put in place "sunsetting" provisions for tax expenditures. Such provisions attach regular "expiration dates" on which tax expenditures are automatically eliminated if not reauthorized by the legislature. Sunsetting would help put economic development tax expenditures on an equal plane with on-budget programs, funding for which in effect "sunsets" every two years.[32]

The Kentucky Enterprise Zone program began to expire in 2003 because the original legislation, established in the early 1980s, stated that individual zones would cease to exist twenty years after their creation. The zones' imminent expiration forced a debate about the program and several assessments were conducted.[33] To date, the legislature has chosen to let the program expire, although one tax measure that was part of the program was included in the tax plan that passed the 2005 legislature.[34] Sunsetting at least forces the state into a discussion about whether a tax expenditure is a proper use of state resources and makes the legislature weigh the expenditure in light of other investments.

Those tax expenditures that are not economic development related—though not the focus of this report—should also receive closer scrutiny through sunsetting and evaluation. According to the state's analysis, in 2004 Kentucky had approximately $6.5 billion in aggregate tax expenditures, an amount comparable to the $7.4 billion in General Fund appropriations that same year.[35] Each year, the state spends an enormous amount of money through the tax statutes largely out of the view of the public. These expenditures can lessen revenue stability and increase the administrative cost of tax compliance. Large amounts of tax expenditures inevitably drive up the tax rates of everyone else. Tax expenditures can violate widely-accepted principles of a good tax system, including that it be broad-based and have both "horizontal equity" (similar taxpayers should pay similar amounts in taxes) and "vertical equity" (taxpayers of lesser means should not pay an unfair share relative to those who are better off).

Recommendation #4: Expand investment in the building blocks of economic development and in a range of promising strategies.

The state's narrow reliance on the single strategy of tax subsidies and business recruitment is not enough to effectively advance Kentucky's economy. Beyond improvements to the economic development framework, changes must be made to the programs being carried out.[36] These programs should be diversified, better targeted and more adequately funded. And to work, they must be built upon adequate investment in education, infrastructure and other aspects of a solid economic development foundation.

Kentucky Must Invest in the Building Blocks of Economic Development
- High-quality, life-long education system
- Reliable, efficient and safe transportation network
- High-tech communications grid
- Regulatory system that upholds basic community standards
- Tax system that is fair and provides adequate revenue for investments

Values-based principles and a strong foundation

It is essential that the state define what economic development policies are trying to achieve. The following principles point to the kind of values that should underlie the state's policies and programs. Economic development should:
- Raise individuals' capacity by building a range of new skills and abilities.
- Build wealth, especially for those who have little access to it now.
- Stress innovation and high value-added goods and services.
- Be sustainable in the long-term, utilizing natural resources in a way that can be maintained.
- Advance racial, geographic and other forms of equity.
- Build upon the state's assets and competitive advantage and seize strategic opportunities.
- Be measured by their ability to increase the state's quality of life.

Besides being values-based, Kentucky's approach must be built upon a solid foundation of investment in the building blocks of economic development. Without that investment, individual strategies are bound to fail. In particular, the state must have a high-quality, life-long education system.[37] That system must be adequately funded at all levels—from early childhood education to advanced degree programs and adult worker training. Higher education institutions should also have the capacity to carry out research and development that can help create economic opportunities. The state needs a reliable and safe transportation network and an updated high-tech communications grid.[38] It needs a basic safety net and support services for those struggling or in need. And the state must have a tax and regulatory system that upholds basic standards, prohibits and does not subsidize business behavior that harms the state and provides an adequate amount of revenue for the investments Kentucky needs.

A range of strategies that work

On that basis, Kentucky could experiment with a set of economic development strategies that have potential to move the state forward.[39] The state must be flexible and able to carry out a diversity of strategies critical to rapidly changing conditions. Such differentiation and nimbleness could set Kentucky apart and make the state more competitive. What follows is an example of a set of promising strategies the state could pursue. Kentucky does some version of many of these strategies now, but to increase success such strategies need to be sharpened and better funded.

1. *Expand promotion of entrepreneurism across the state.*

- Increase support for entrepreneurial education in the K-12 curriculum and increase integration of entrepreneurial education in two- and four-year colleges across the state;
- Develop and support model efforts that promote entrepreneurship in rural areas of the state (Like the University of Kentucky's Entrepreneurial Coaches Institute);
- Expand resources for the Kentucky Innovation Act including stronger public-private partnerships, additional angel and mezzanine investor funds and additional support for existing entrepreneurs whose ideas have growth potential;
- Expand university-based product and service research, development and commercialization in industries that create a unique niche in the state;
- Promote knowledge about Kentucky's competitive advantages, explore innovative approaches to those sectors and encourage exploration and risk taking;
- Develop a state coordinating entity that promotes and manages entrepreneurial development.

2. *Aggressively support the development, retention and expansion of existing locally owned small businesses.*

- Develop a high quality, real time research service that provides market data, competitive analysis and other information to Kentucky businesses;
- Target use of procurement and state pension funds to support and invest in local business development and expansion;
- Support networks of business owners to share ideas and explore contracting opportunities;
- Develop high risk and forgivable loan funds aimed at microenterprises and small businesses tied to existing technical assistance resources;
- Enhance small business support services;
- Support the infrastructure of nonprofit business development entities through grants and technical assistance;
- Invest additional resources in marketing of Kentucky products;
- Expand tax credits and incentives for locally owned companies to expand and weather difficult transitions.

3. *Promote mature and emerging sectors of business activity with a comprehensive range of services.*

In addition to evaluating promising manufacturing, high technology and service sectors or clusters (auto industry, pharmaceuticals, etc.),[40] Kentucky should put in place innovative support services for typically unrecognized but important candidates including:

- Sustainable forestry—focused on niche, high-value products with significant expansion of resources for improved forest management practices that raise timber values while conserving the resource;
- Tourism based on cultural and ecological assets—building on the state's beauty, arts and crafts, music, and cultural traditions;
- Appropriate alternative energy solutions—investments in energy efficiency and renewable energy source development that can lower business costs, reduce dependence on coal and have positive environmental effects and create jobs in a growing sector;
- Health and child care sectors—including training programs with the dual purpose of creating higher-quality jobs in an area of growing need and increasing the state's health and well-being;
- Value-added agriculture—continue and expand coordinated efforts to support cooperative development and value-added agricultural production in Kentucky's rural communities.

4. *Enhance adaptive and strategic workforce development efforts.*

- Orient workforce development efforts toward innovation-based skills and align initiatives with strategic sectors and industries in the state;
- Provide support for industries and businesses willing to rebuild career ladders and increase reliance on worker skills;
- Enhance investment in basic literacy and work readiness skills to expand the number of Kentuckians who can participate successfully in the workforce;
- Create targeted sector-based partnerships between existing employers, higher education institutions and workers to increase productivity and higher-skill, higher-wage jobs through upgraded management systems and production processes and new training programs;
- Continue efforts to promote seamlessness between the workforce development system and early childhood through postsecondary education.

5. *Engage in compatible recruitment strategies tied to Kentucky's assets and competitive advantages.*

- Develop compatible recruitment criteria that fit into an existing strategy and for which subsidies are tied to community-benefits agreements that assure high-quality jobs, accountability and a positive community impact;
- Target recruitment to key industries that reflect competitive sectors for Kentucky and reinforce existing clusters of Kentucky businesses.

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 approach to development that 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 deep and substantive conversation about the way economic development decision-making is structured and the way economic development money is spent. Reforms that increase accountability and make for good government are critical to good economic development. Improved accountability will mean better stewardship of the state's resources and an increased return on public investment. And a broadening of Kentucky's economic development approach to include a stronger foundation and a range of promising strategies will help move Kentucky's economy forward.

Economic development in Kentucky should take a page from the state's education reforms. There, a comprehensive overhaul plan was developed and enacted in 1990, accountability measures were put in place, innovative strategies were pursued and—for a time—more money was invested. As noted in the introduction to this report, education is one area where the state has made real progress. Similarly, Kentucky should put in place a better framework for the economic development system, experiment with new programs and investments and regularly measure our 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.

This report examines state economic development spending from fiscal year 1999 to fiscal year 2004. For on-budget expenditures, the report relies primarily on enacted state budget appropriations for each of the three biennia. The level of detail in the budget varies greatly across cabinets, so wherever possible expenditures were isolated at the programmatic level through conversations with agency staff. In order to focus the analysis on state spending, the on-budget portion does not include federal funds. The report includes spending drawn from General Fund appropriations as well as state restricted or agency funds. The report also excludes capital projects (Note: in this period, the legislature approved funding for a number of projects with coal severance tax funds. Some of these projects were economic development related, but were not part of this analysis).

For off-budget tax expenditures, the report relies on the tax expenditure analysis produced every two years by the Office of the State Budget Director. In some cases, there are significant changes in the estimates for particular tax expenditures from year to year, usually because of the use or acquisition of a new data source that provides a better estimate than the source previously used. That means that the data on tax expenditures in this report do not constitute a time series (and therefore were not analyzed in that manner). Officials with the Office of the State Budget Director report that they do not update past tax expenditure estimates when new data sources are used, so at this time there is no comprehensive and consistent look at historical tax expenditures. Tax expenditures that are constitutional in nature were not included in this analysis.

The reporting and evaluation requirements contained in the report were drawn from the relevant statutes and the reporting/evaluation requirements contained in the state budget bills passed over this period. The report only takes into account these requirements mandated by the legislature and therefore excludes any reporting or evaluation that may go on in departments or agencies in a voluntary manner or within the Executive Branch. The report does not confirm whether the reporting/evaluation requirements are actually being met.

[1] The National Center for Higher Education Policymaking and Analysis. Cited in the Kentucky Long-Term Policy Research Center, *Visioning Kentucky's Future: Measures and Milestones* 2004, p. 31.

[2] Kentucky has had a recent upsurge in demand for employees in the coal industry. While such temporary mini-booms have happened before, the general trend has been a decline in coal employment. The U. S. Department of Energy reports that coal employment in Kentucky fell from 49,190 in 1979 to 17,042 in 2002.

[3] Bureau of Economic Analysis data cited in Kentucky Long-Term Policy Research Center, *Visioning*, p. 43, 47, 48.

[4] Lillian Woo et al., *2004 Development Report Card for the States*, Corporation for Enterprise Development, December 8, 2004.

[5] Kentucky Long-Term Policy Research Center, *Visioning*.

[6] The timeframe for this analysis is fiscal years 1999-2004. Therefore, this report does not take into account the reorganization of state cabinets put in place by the Fletcher administration through the 7/9/04 executive orders and confirmed by the 2005 General Assembly.

[7] Leonard E. Burman, "Is the Tax Expenditure Concept Still Relevant?" *National Tax Journal*, September 2003, Abstract.

[8] Tax Expenditure Analysis Fiscal Years 2004-2006, p. 5.

[9] As noted by the Office of the State Budget Director:

> *Direct expenditures are evaluated during each budget cycle, and are approved, adjusted or rejected during the budget process. Tax expenditures, however, are evaluated and approved only when statutory adjustment is made. There is no requirement to revisit or re-evaluate tax expenditures once they are passed and placed within statute. So direct expenditures receive regular review and re-approval, while tax expenditures rarely receive any additional review once placed within statute.*
> *—Tax Expenditure Analysis Fiscal Years 2004-2006, p. 1.*

[10] "Analytical Perspectives," *Budget of the United States Government, Fiscal Year 2006*; Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009* (JCS-1-05), January 12, 2005.

[11] *Estimates*, p. 2.

[12] National Conference of State Legislatures, *Fundamentals of Sound State Budgeting Practices*, June 1995.

[13] Kentucky's 1988-89 Tax Expenditure Analysis included 190 entries, while the 2004-2006 analysis includes 234 entries.

[14] Robert S. McIntyre, "Tax Expenditures: The Hidden Entitlements," Citizens for Tax Justice, May 1996.

[15] Ronald Snell, *A Review of State Economic Development Policy: A Report from the Task Force on Economic Incentives*, National Conference of State Legislatures, March 1998, p. 6. Cited in Erin Riches et al., *Maximizing Returns: A Proposal for Improving the Accountability of California's Investments in Economic Development*, California Budget Project, January 2002.

[16] Erin Riches et al., *Maximizing Returns*.

[17] This report uses fiscal year 2004 spending data for the charts and analysis that make up the Key Findings. 2004 data were used for several reasons: 1) because they are recent 2) because the same general findings held for each year of the analysis and the differences between individual years is not significant. Findings are not presented using cumulative data because of challenges with both budgeted and off-budget expenditures. On the budget side, reorganization in some instances made program-level data imprecise when compared over time. On the tax side, the tax expenditure analyses were prepared by the state in some years using different data sources and assumptions, meaning some revenue estimates for individual tax expenditures are not comparable over time. See Description of Methodology for more.

[18] Cabinet for Economic Development database acquired through open records request dated June 2, 2005.

[19] The Kentucky Small Business Development Center network is not included in this analysis because it does not receive a line-item appropriation in the state budget; instead, its funding is included in the bulk appropriation to the University of Kentucky. However, in 2004 the network received only $1.6 million in state funds (and $1.1 million in federal funds). Therefore, its inclusion in this analysis would not have altered the insignificance of small business support to state economic development spending. It still would have been the category with the least funding in Chart 2.

[20] Along with objecting to the rampant use of subsidies as effective economic development policy, there is increasing opposition to many of these subsidies on legal grounds. In November 2004, the U. S. Court of Appeals for the Sixth Circuit ruled that some of the incentives awarded by Ohio to *DaimlerChrysler* violate the Constitution's commerce clause. The Court suggests that the commerce clause is in place to prevent exactly the kind of destructive interstate competition that is on the rise through the use of subsidies. Kentucky is one of the four states that falls under the Sixth Circuit's jurisdiction. The case, *Cuno v. DaimlerChrysler*, is under appeal and the U. S. Supreme Court is expected to announce in Fall 2005 whether it will hear the case. Legislation co-sponsored by Rep. Ben Chandler has been introduced that would shield state programs from the outcome of the ruling.

[21] Robert G. Lynch, *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*. Economic Policy Institute. p. ix.

[22] Kenneth Thomas, *Competing for Capital: Europe and North American in a Global Era*. Georgetown University Press, 2000.

[23] Lynch, p. 4.

[24] The Public Policy Research Lab, Louisiana State University, "Louisiana Business Image Survey," January 24, 2005.

[25] "Government Operations" is not a cabinet but a budgeting category used for a variety of departments and agencies not organized under a particular cabinet.

[26] KRS 154.10-090 says "The secretary [of the Cabinet for Economic Development] and the directors of other state agencies and entities receiving state funds for programs and activities which may affect state economic development shall cooperate in the coordination of those programs and activities to achieve the successful implementation of the state's strategic plan."

[27] See "Kentucky Innovation: A Strategic Plan for the New Economy," http://www.one-ky.com/plan.html, "Kentucky's Near-Term Plan for Comprehensive Agricultural Development," http://agpolicy.ky.gov/planning/documents/nearterm_plan.pdf and "Cultivating Rural Prosperity: Kentucky's Long-Term Plan for Agricultural Development," http://agpolicy.ky.gov/planning/documents/plan/long_term_plan.pdf

[28] For a review of Kentucky's system of budgeting and an introduction to performance-based budgeting, see Greg Hager et al., *Performance-Based Budgeting: Concepts and Examples*. Legislative Research Commission Research Report No. 302. Also see Blaine Liner et al., *Making Results-Based State Government Work*. The Urban Institute, April 2001.

[29] In the 2000 state budget bill, the legislature appropriated $750,000 for a performance-based budgeting pilot project. All cabinets and agencies were charged with creating strategic plans and four varied programs were selected to develop performance-based budgets. Some information from those four programs was included in the 2002-2004 Executive Budget. In

its final report on the pilot project in 2002, the state auditor said that the program was showing success, noting that the state had modified its budgeting system to allow the input of performance-based information for the first time. Among the auditor's recommendations was that the General Assembly expand the pilot project, but no such expansion has occurred. Auditor of Public Accounts, "Third in a series update on the performance based budgeting pilot program HB 502 of the 2000 regular session—February 2002 Update."

[30] The Illinois law is Public Act 093-0552. For more on unified development budgets, see Matt Hull et al., "Budgeting and Economic Development Performance: A Guide to Unified Development Budgets," Corporation for Enterprise Development, December 2000. A unified development budget for Kentucky could be a first step towards a more comprehensive statewide system of strategic planning and performance-based budgeting to replace Kentucky's current budget format. Texas provides one important model of such a system.

[31] *Tax Expenditure Analysis Fiscal Years 2004-2006*, p. 6.

[32] In 2002 and 2004, the state operated for a time without a state budget, relying on an executive spending plan developed by the Governor. However, a May 2005 ruling of the Kentucky Supreme Court will severely restrict the spending that a governor can authorize on his own in the future.

[33] See Office of the State Budget Director, "The Costs of Kentucky's Enterprise Zones," Policy Paper Series 2 Issue 1, January 2002; Thomas Lambert and P. A. Coomes, "The Effectiveness of Louisville's Enterprise Zone," *Economic Development Quarterly*, May 2001, Vol. 15, no. 2, pp. 168-180; Perry Nutt et al., "The Costs, Benefits and Monitoring of Kentucky's Enterprise Zones," Legislative Research Commission (Not Adopted).

[34] The tax plan that passed the 2005 legislature included an "Enterprise Initiative" through which eligible companies can receive refunds of sales and use tax paid on the purchase of building materials and research and development expenses. The building materials portion is adapted from the Enterprise Zones and the new law gives "preference" for refunds to companies in existing zones. There is a statewide cap of $20 million for building expenses.

[35] Aggregating revenue lost from tax expenditures will not give a precise projection of potential revenue gained from the elimination of all or several tax expenditures. That is because the elimination of a particular tax expenditure can affect the revenue loss from other tax expenditures in positive or negative ways.

[36] A similar set of ideas to those listed in Recommendation #4 were generated at the Kentucky Long-Term Policy Research Center's November 2004 conference, *Getting Ahead of the Curve: A Working Conference to Generate Ideas, Innovations and an Agenda for Future Prosperity*. See Michael Childress, "Policy Options for Future Economic Development," *Policy Notes*, Kentucky Long-Term Policy Research Center, No. 18, May 2005.

[37] For the importance of investments in education to state economic development, see William Schweke, *Smart Money: Education and Economic Development*, Economic Policy Institute, July 2004; Robert G. Lynch, *Exceptional Returns: Economic, Fiscal and Social Benefits of Investment in Early Childhood Education*, Economic Policy Institute, October 2004.

[38] In 2003, only 12 percent of Kentucky households had a broadband internet connection compared to a national average of 20 percent. U. S. Department of Commerce, Current Population Survey cited in Childress, "Policy Options."

[39] For more on innovative state economic development strategies, see the National Governors Association Center for Best Practices; MDC, Inc., "The Building Blocks of Community Development," 2002; Brian Dabson with Kent Marcoux, *Entrepreneurial Arkansas: Connecting the Dots*, The Winthrop Rockefeller Foundation/Corporation for Enterprise Development, 2003; Stuart A. Rosenfeld, *Just Clusters: Economic Development Strategies that Reach More People and Places*, Regional Technology Strategies, September 2002; Daniel D. Luria and Joel Rogers, *Metro Futures: Economic Solutions for Cities and Their Suburbs*, Beacon Press, November 1999; *Governor Baldacci's Economic Development Strategy* (Maine), January 21, 2004; Michael Childress et al., *Entrepreneurship and Small Business—Kentucky's Neglected Natural Resource*, The Kentucky Long-Term Policy Research Center, 1998.

[40] For example, see Edward J. Feser and Jun Koo, *Kentucky Clusters: Industrial Interdependence and Economic Competitiveness*, Kentucky Science and Technology Corporation, June 2001.