MEMORANDUM

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To:	Members, Special Committee on Taxation
From:	Kristen Rottinghaus, Deputy Post Auditor, and Josh Luthi, Principal Auditor
Date:	November 13, 2023
Subject:	**Review of Recent Tax Incentive Evaluations and Suggestions for Improving Effectiveness Evaluations**

State law (K.S.A. 36-1137) requires us to evaluate economic development incentive programs as directed by the Legislative Post Audit Committee. As part of that work, we evaluated a number of tax credits that may be of interest to this committee. Below, we summarize the results of the relevant evaluations and our takeaways about what things would help improve future evaluations of incentive effectiveness.

Angel Investor Tax Credit Program (2020)

Description: Under the Angel Investor Tax Credit (AITC) program, investors receive a tax credit equal to 50% of their investments in start-up businesses participating in the program. The Department of Commerce allocates a limited amount of tax credits each year (e.g., $6.5 million in tax year 2023) to participating businesses. Those businesses exchange the tax credits for investments from investors. The investors then use the tax credits to offset their income or premium tax liabilities. If investors don't have enough tax liability to use their credit, they can carry the credit forward to future years until it's used up. Investors may also transfer their credit to another individual.

The Legislature created the AITC program in 2004. The program will sunset in 2026 unless the Legislature extends it.

Statutory Goals: According to K.S.A. 74-8131, the purpose of the AITC program is to encourage investment in start-up businesses in Kansas. But statute is broad and doesn't include expectations or benchmarks for measuring effectiveness beyond this general purpose. As part of our evaluation, we recommended the Legislature consider clarifying the program's goals and setting benchmarks for program success.

Frequency of Use: Between 2015 and 2018, investors received about $20.2 million in tax credits for investing about $51.5 million in Kansas businesses. Most investments came from Kansans, but about 27% came from investors from outside of Kansas.

Program investments went to 78 businesses in only 8 counties. Most investment was for businesses in Johnson County.

Effectiveness Evaluation: We evaluated how long businesses that received AITC funding operated and how many jobs they created. We asked the agency that administers the credit, the Department of Commerce, how they defined effectiveness since statute didn't include clear and measurable goals. They said they consider the AITC program to be successful if businesses last at least 5 years and, to a lesser extent, whether they create jobs. Our evaluation compared businesses that participated in the program between 2009 and 2019 to similar businesses that didn't.

Businesses that participated in the program stayed in business for 3 to 5 years about as often as businesses that didn't participate. 39% of the AITC-participating businesses operated for 3 years and 28% operated for 5 years. That compared to 53% of non-participating businesses that operated for 3 years and 38% for 5 years. These differences weren't statistically significant. However, businesses that participated in AITC created fewer jobs on average than similar businesses that didn't participate. Participating businesses created about 1 job every 2 years on average, compared to non-participating businesses that created about 1 job every year. These differences were statistically significant. It's unclear whether the AITC program caused these results. It could be the AITC program helps lower-quality businesses perform more like higher-quality peers. Or it could be the program has no effect.

Evaluating the Department of Commerce's Major Economic Development Incentive Programs (2023)

High Performance Incentive Program (HPIP)

Description: HPIP provides businesses 3 potential tax benefits. A business may receive a tax credit equal to 10% of its qualifying capital investments. This tax credit may be carried forward for up to 16 years. A business may receive a sales tax exemption on materials or services needed for capital investment projects. And a business may receive a tax credit that matches its expenditures for employee training and education. This credit is capped at $50,000 per year and cannot be carried forward.

The Department of Commerce certifies that a business is eligible to participate in the program. Commerce doesn't have discretion as to whether a given business can participate. Any business that meets program criteria can benefit from the program. The Department of Revenue administers the program benefits (e.g., by issuing sales tax exemption certificates to businesses).

The Legislature created the program in 1993. It has no sunset.

Statutory Goals: State law doesn't say what HPIP's goal is.

Frequency of Use: Between tax years 2018-2020, businesses were awarded more than $3 billion in HPIP tax credits. Most businesses were located in relatively few counties (e.g., Johnson, McPherson, Sedgwick, and Wyandotte).

Effectiveness Evaluation: We evaluated the return-on-investment HPIP was estimated to create over 20 years. We measured returns in terms of their estimated direct and indirect economic activity (e.g., job creation, increased wages, population growth, and business profits) and their tax revenues (e.g., state and local tax revenues created by the program's economic impacts). We chose to focus on return-on-investment because the program appeared to be focused on economic development.

We used a research-based model to estimate the returns for 28 projects. 8 of those projects included HPIP benefits, among others. The model helped us do 2 things: (1) estimate the extent to which incentives like HPIP caused businesses to do things they otherwise wouldn't have, and (2) estimate the economic activity and tax revenues the projects will generate over the next 20 years.

We estimate HPIP will generate about $2.91 in economic activity for every $1 in foregone tax revenues. We also estimate HPIP will generate about $0.35 in tax revenues for every $1 in foregone tax revenues. These results suggest HPIP may successfully generate economic activity, but it may not generate enough tax revenues to cover the cost of the incentive.

We also noted a couple of issues that created problems for our evaluation, and would continue to create challenges for future effectiveness evaluations:

- No one knows the true amount of foregone sales tax revenues due to HPIP. That's because businesses aren't required to report how much in sales tax they were actually exempted from. Therefore, we weren't able to evaluate the HPIP sales tax exemption.

- The 16-year carryforward makes it difficult to know how many HPIP incentives businesses will use and when. Businesses appear to claim many more HPIP credits than they're able to use each year. State law allows businesses to carry forward any unused credits for up to 16 years. This makes it hard to estimate whether and when businesses will claim credits they're carrying forward. For example, according to the Department of Revenue, businesses claimed about $913 million in HPIP credits in 2019. But businesses used (i.e., were allowed) only about $88 million in credits. And some of those credits were likely carried forward from prior years.

Promoting Employment Across Kansas (PEAK) Program

Description: The PEAK program allows businesses to keep (or receive a refund on) 95% of state withholding taxes for new jobs they create. Commerce decides which businesses participate in the program. Any business that participates in the program must enter into an agreement with Commerce. The agreement lays out things like the minimum number of jobs a business must create, how many years it can participate in the program, and the maximum benefit it can earn each year.

The Legislature created the program in 2009. It has no sunset.

Statutory Goals: According to K.S.A. 74-50,210, the PEAK program's goal is to promote economic development. It does this by creating new jobs and incenting businesses to locate in Kansas.

Frequency of Use: Between fiscal years 2017-2021, Commerce awarded about $400 million in PEAK incentives to 210 businesses. About 55% of those businesses (and 60% of the total amount awarded) were in Johnson County.

Effectiveness Evaluation: We evaluated the return-on-investment PEAK was estimated to create over 20 years using the same research-based model and approach we used to evaluate HPIP. That's because of PEAK's focus on economic development, and that incentives through programs like PEAK, HPIP, and the other Department of Commerce programs are packaged together. We reviewed 18 projects that included PEAK benefits, among others.

We estimate PEAK will generate about $4.54 in economic activity for every $1 in foregone tax revenues. We also estimate PEAK will generate about $0.45 in tax revenues for every $1 in foregone tax revenues. These results suggest PEAK may successfully generate economic activity, but it may not generate enough tax revenues to cover the cost of the incentive.

There's a separate Owner's PEAK tax credit (K.S.A. 79-32,266), which we didn't evaluate. Individuals who own businesses that relocated to Kansas, participated in PEAK, and work for the businesses they own can claim an individual tax credit equal to 95% of their business's income tax liability. The Legislature created it in 2011. At the time of our evaluation the Department of Revenue said no one had ever claimed the credit.

Evaluating the Rural Opportunity Zones Program (2023)

Description: The ROZ program includes 2 components: a student loan repayment assistance component and a tax credit component. Our evaluation of the effectiveness of the ROZ program looked at both components together. So, it's important to understand how each component works.

Individuals who relocate to a Kansas county designated as a rural opportunity zone can apply through the Department of Commerce for student loan repayment assistance. If they're accepted (i.e., they meet program criteria and a county, city, or employer is available to help repay their student loans), they can get up to $3,000 a year for 5 years to help with student loan repayment. Individuals can relocate to a ROZ county from within Kansas and still qualify for this benefit.

Individuals who relocate to a Kansas county designated as a rural opportunity zone from out-of-state may claim the ROZ tax credit. Currently, 95 of the state's 105 counties are designated as ROZ counties. The tax credit is equal to 100% of an eligible individual's state income tax. The credit can be claimed for up to 5 consecutive years.

The Legislature created the ROZ program in 2011. It will sunset in 2026 unless the Legislature extends it.

Statutory Goals: State law doesn't say what the ROZ program's goal is. As part of our evaluation, we recommended the Legislature consider clarifying the program's goals and setting benchmarks for program success.

Frequency of Use: Between 2012 and 2022 about 1,500 individuals used almost $14 million in tax credits to offset their income tax liabilities.

Effectiveness Evaluation: We evaluated how many people ROZ likely brought to rural Kansas and compared those estimates to population trends in rural Kansas during the same time. That's because legislative testimony suggests the Legislature created the ROZ program to counteract rural depopulation.

We estimated the ROZ program caused about 1,430 people to move to ROZ counties between 2012 and 2022 (this includes people who participated in both parts of the ROZ program, plus their family members). This offset about 5% of rural population losses, which totaled about 29,400 during that time. However, ROZ may have benefitted 19 individual counties (mostly in the northwestern part of the state) more than it benefitted other participating counties.

Our evaluation also showed the ROZ tax credit may not keep most participants in rural Kansas long-term. We reviewed tax records for 26 credit claimants. As of 2022, 18 (69%) had moved to another state (17) or a non-ROZ Kansas county (1). Only 8 of the 26 remained in a ROZ county.

Evaluating New Economic Development Incentive Programs Created in 2021 (2022)

Eisenhower Foundation Tax Credit

Description: Individuals who donate to the Eisenhower Foundation can claim a state income tax credit equal to 50% of their donation. The foundation maintains a museum for and preserves the legacy of President Eisenhower. The credit is capped at $25,000 per individual or $50,000 per corporation. The credit is also limited to $350,000 total per year. The credit cannot be carried forward or transferred.

The tax credit is available only in tax years 2021 through 2025, unless the Legislature extends it.

Statutory Goals: State law doesn't say what this tax credit's goal is.

Frequency of Use: This credit was brand new when we evaluated it, so limited data was available. In tax year 2021, taxpayers earned about $121,000 in credits for donating about $242,000 to the Eisenhower Foundation. However, at the time of our work, the Department of Revenue told us taxpayers had used only about $1,000 of the credits they earned.

Effectiveness Evaluation: We did not evaluate effectiveness because the credit was too new.

Friends of Cedar Crest Association Tax Credit

Description: Individuals who donate to the Friends of Cedar Crest Association can claim a state income tax credit equal to 50% of their donation. The association helps preserve and promote public knowledge of Cedar Crest, the Kansas Governor's residence in Topeka. The credit is capped at $25,000 per individual or $50,000 per corporation. The credit is also limited to $350,000 total per year. The credit cannot be carried forward or transferred.

The tax credit is available only in tax years 2021 through 2025, unless the Legislature extends it.

Statutory Goals: State law doesn't say what this tax credit's goal is.

Frequency of Use: This credit was brand new when we evaluated it, so limited data was available. In tax year 2021, taxpayers earned about $35,000 in credits for donating about $70,000 to the Friends of Cedar Crest Association. However, at the time of our work, the Department of Revenue told us taxpayers had used only about $350 of the credits they earned.

Effectiveness Evaluation: We did not evaluate effectiveness because the credit was too new.

Qualified Charitable Distribution Tax Credit

Description: Technology-enabled fiduciary financial institutions (TEFFIs) can claim a tax credit equal to the value of their qualified charitable donations. Under the state's 2021 TEFFI Act, TEFFIs are required to make charitable donations equal to 2.5% of the value of their transactions each tax year. A TEFFI may carry a credit forward for up to 5 years but it cannot transfer the credit.

Statutory Goals: State law doesn't say what this tax credit's goal is.

Frequency of Use: At the time of our work, the Department of Revenue told us no one had claimed this tax credit.

Effectiveness Evaluation: We did not evaluate effectiveness because the credit was too new. However, we noted potential data issues that could create problems for future effectiveness evaluations. For example, no agency could tell us how much the state's sole TEFFI, Beneficient, had made in charitable donations at the time of our review.

Developing Tax Incentives to Facilitate Evaluation

The committee requested that LPA staff share its thoughts on how the Legislature can help to develop tax incentives in a way that makes them feasible to evaluate for effectiveness.

This is a big question with a lot of potential suggestions. In preparing our thoughts for this meeting, we drew on our firsthand experience evaluating tax incentives and some suggestions from the State of Washington. Washington has been regularly reviewing its tax incentives for longer than many other states and serves as an example of one way to approach this topic.

The three concepts we think would be most helpful to facilitating effectiveness evaluations are:

1. Identifying a purpose (or purposes) for each tax incentive.

2. Identifying specific measures or benchmarks that evaluations must include to determine whether each incentive is effective.

3. Identifying what data is needed to determine if those measures are met and requiring agencies to collect that data.

This would require the Legislature to discuss these concepts *before* it passes new tax incentive legislation. Those discussions would make the Legislature's decisions about effectiveness clear and transparent. It would be helpful to include as many of these elements as possible in statutes. For example, Washington requires that each bill enacting a new tax incentive must include what's called a tax performance statement. The statement must include the three elements highlighted here along with some additional information. It also would be useful for the Legislature to discuss and define these concepts for existing programs. However, it would need to consider the effect such definitions could have on existing agency processes or existing incentive contracts and agreements.

Additionally, the Legislature would want to consider the following issues when developing the purposes, measures, and data needed to evaluate effectiveness:

1. A single measure of effectiveness such as return-on-investment will not work for all incentives. Tax incentives vary widely and would therefore benefit from more personalized measures. For example, HPIP clearly has an economic development component, whereas a tax credit for donations to Friends of Cedar Crest Association doesn't. Further, measures would benefit from being

as specific as possible. For example, specifying how much something should increase or decrease or whether return-on-investment should be measured as economic returns, tax revenue returns, or both.

2. A tax incentive's effectiveness can be measured on an individual basis (e.g., every business should grow by 10%) or across an entire industry or group of businesses (e.g., the industry should grow by 10%).

3. The Legislature may need to create certain data reporting and collection requirements if a data source doesn't exist.

4. Certain factors that are critical to determining effectiveness are also very hard to measure. For example, causality, displacement or substitution effects, and long-term direct and indirect economic effects require estimation and assumptions. The Legislature would want to consider these factors when deciding how to word effectiveness measures. It also will shape how conclusive determinations about effectiveness can be. For example, it is impossible to know if a tax incentive caused an individual or business's behavior. Accounting for causality therefore makes the answer less clear, but not accounting for causality leaves out a potentially meaningful factor.

5. It takes time for the effects of tax incentives to be realized. And the timeframe for assessing effectiveness varies by incentive. The complexity of the incentive, its target recipient, the funding mechanism, and delays associated with filing and processing tax credits all influence when measurable data can be expected. For example, HPIP includes multiple incentive types and includes a 16-year carryforward. Therefore, the timeframe for evaluating effectiveness is much different than something like the tax credit for donating to the Friends of Cedar Crest Association.

Washington's legislative audit office created a guidance document, which provides additional details about these concepts. It's available on their website here.