KANSAS LEGISLATIVE
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POST AUDIT

LPA Guide to Economic Development Incentive Evaluations

It is important for policymakers to evaluate if incentives are a good use of taxpayer money.

- States give businesses money to do things policymakers think will help the local economy. This includes trying to get businesses to move to their state. Or trying to keep or expand businesses that are already there.

Incentives usually have opportunity costs.

States could use the money spent on incentives to pay for other things. Many of those also would promote economic development. For example, quality schools create a skilled workforce. Good highways lower transport costs. Broad-based tax cuts increase profitability. All these things make the state a more appealing place to do business.

- States usually do this through tax incentives, like credits, exemptions, or rebates. They also do it through cash subsidies. All these things cost the state, which has a finite amount of money. Using it for incentives means the state has less money to pay for other things.

- Policymakers can better use taxpayer money by evaluating which incentives are most effective.

Policymakers can evaluate incentives several ways.

- There are many ways to measure an incentive's success. For example, evaluations can measure the number of new jobs or the amount of new investment an incentive creates. Or the incentive's overall ratio of benefits to costs (i.e. its return on investment, or ROI).

- An evaluation can be very simple. It can look at who uses an incentive, how often, and whether an incentive benefits the intended people.

- Conversely, an evaluation can use complex economic modeling. Some models look backward to measure an incentive's actual effects. Other models look forward to forecast what an incentive's effects could be.

Evaluations try to estimate incentives' positive and negative effects.

- Incentives give businesses direct financial benefits for doing things like moving or expanding. This increases their profitability. It also affects the workers, other businesses, and local and state governments in the area. For example, it increases consumption, wages, housing demand, and property values.

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- This activity has positive and negative effects that at least partially offset one another. Economic models use data and assumptions based on research to estimate these effects. The estimates are reasonably accurate, but no one can know the effects with certainty. These effects include:
  - **Direct economic effects (+)**: This reflects the incentive amount the state provided to increase business profitability. These businesses pay less in taxes or receive cash for things like moving, expanding, or staff training.
  - **Secondary economic effects (+)**: Businesses receiving an incentive create jobs, raise wages, or make capital investments. This helps retailers and suppliers in the area because the incented businesses and their workers spend money at these other places. The retailers and suppliers grow in turn. The total income increase is larger than the original incentive amount.
  - **Increased tax revenue (+)**: The increased wages, consumption, and property values from incentives lead to higher tax revenue. Local and state governments receive more income, sales, and property taxes.
  - **The "but for" issue (-)**: States offer incentives to get businesses to make choices they otherwise would not have made. Businesses often make location or expansion decisions based on factors other than incentives. This means many businesses get incentives for things they were going to do anyway.
  - **Opportunity costs (-)**: Most of the time, the state could use the money it spends on incentives for other things, like education or infrastructure. Some of these other options may be better uses of taxpayer money. A few incentives may not always have opportunity costs.
  - **Displacement effect (-)**: Businesses receiving an incentive sometimes hire staff away from others in the area that did not get the incentive. People who used to shop elsewhere may begin buying more from the businesses receiving an incentive. Businesses receiving incentives sometimes benefit at other businesses' expense.
  - **Increased demand for public services (-)**: Bringing in workers from other areas reduces the displacement effect, but it means more people need public services. These services include education, roads, and public safety. This makes these services more expensive to provide or can lower their quality.

Other factors affect business decisions more than incentives.

Unless they are very large, incentives generally do not tip the balance in a state's favor. Businesses often make decisions based on things like whether the right workers are available and how much they cost. They also consider whether needed infrastructure is present, like highways and broadband internet. Good schools and a high overall quality of life are also major factors. Spending money on these things may be a better use of taxpayer money than incentives.

Policymakers should evaluate incentives from several angles.

- Evaluations provide many types of information useful for understanding and comparing incentives. Each element helps inform economic development discussions. A single ROI number is not enough to show whether an incentive is working or to compare incentives to one another.

- ROI figures could vary across evaluations depending on which benefits and costs they include. They also may not capture how incentives are benefiting or harming different groups of people, businesses, and areas of the state.

- Policymakers also should consider things like how incentives fit with their policy goals. For example, an evaluation may show an incentive has a small ROI. But it may also meet certain policy goals (e.g. environmental protection, attracting certain types of businesses to the state) better than other incentives with higher returns.