

Embracing Dynamism: The Next Phase in Kansas Economic Development Policy

Arthur P. Hall, Ph.D.
Executive Director
Center for Applied Economics
University of Kansas School of Business
arthall@ku.edu

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Created by the Legislature in 1986, Kansas, Inc. is an independent, objective, and non-partisan organization designed to conduct economic development research and analysis with the goal of developing policies and recommendations to ensure the state's ongoing competitiveness for economic growth. To attain our mission, Kansas, Inc. undertakes these primary activities: 1) Identifying, building, and promoting a Strategic Plan for economic development efforts in the State of Kansas; 2) To complement the Strategic Plan, Kansas, Inc. develops and implements a proactive and aggressive research agenda, which is used to identify and promote sound economic development strategies and policies; 3) Through collaboration and outreach with economic development entities and other potential partners, Kansas, Inc. conducts evaluation reviews and provides oversight of economic development programs to benchmark development efforts in the State of Kansas.

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Executive Summary

Embracing dynamism provides the theme for this report in describing the next phase of economic development policy in Kansas.

- **Embracing dynamism suggests an economic development model that works with the mega trends that continue to shape the Kansas economy.**
- **Embracing dynamism suggests that economic development efforts discard the traditional industry-centric focus and replace it with a region-centric focus.**

A state-level economic development model that embraces dynamism should create a set of policies that work well across the whole array of regions, regardless of their development stage. In brief, state-level policies should:

- 1) **Treat all business and investment opportunities equally,**
- 2) **Facilitate business development in the unique context of the regional economy, and**
- 3) **Embrace rather than impede the continuing patterns of structural change.**

Almost every state offers economic development incentives. Yet, in general, benchmarking literature suggests that these incentives do not have a significant impact on economic growth. Benchmarking literature also suggests that states must continue to offer such incentives to remain competitive.

This report challenges key elements of that conclusion: Kansas can break out of the benchmarking race by developing a strategy built on embracing dynamism. Such a strategy can distinguish itself by building unique capabilities that create a different mix of value to all business seeking to thrive in Kansas—a mix of value that can enhance the probability of long-term economic success through enhanced opportunity. **Embracing dynamism can change how Kansas plays the economic development game.**

The goal of embracing dynamism is simply stated: **Create the conditions necessary to induce as much commercial experimentation as possible on Kansas soil.** Proper execution of the embracing dynamism strategy will create an environment where all manner of people—inside and outside the state—feel motivated to commit their time and treasure to Kansas soil. The policy challenge centers on promoting dynamism by establishing a business environment that induces business birth and expansion without bias related to the size or type of business. **Every business matters.**

Embracing dynamism starts with a change in vision—the state government of Kansas should abandon its prevailing policy of the State as an active investor in targeted businesses or industries and instead adopt the policy vision of the State as a caretaker of a competitive platform that seeks to induce as much commercial experimentation as possible. This vision implies the state government need not commit scarce resources to the enormously difficult task of predicting the outcome of competition if it focuses on the much more manageable task of creating the **platform** on which the competition takes place.

Measures of Success

This report suggests the following measures of performance for a change in vision. Conspicuously absent from the list is job count. The economic development process is job destroying as well as job creating, with patterns that shift over time. If Kansas performs well in the measures provided, it will also perform well in terms of job count.

- **Income Growth** – State or regional income growth occurs in some combination of 1) an increase in the number of people earning income, or 2) an increase in the income earned per person.
- **Population Density and Population Migration** – Measuring the change in population (or employment) density and the prevailing trend of population migration can augment the income measure, which can sometimes produce ambiguous interpretations—especially at the sub-state level. Growing population density and net population in-migration offer clear measures of growing regional economies.
- **Productivity** – Productivity growth is the ultimate goal of economic development. Productivity growth tends to happen in geographic areas characterized by population density. Tracking the patterns of productivity growth across the geography of Kansas will offer an approximate measure of successful economic development.
- **Capital Investment** – The act of investment by Kansas businesses must precede sustainable increases in productivity. A measurable increase in the rate of capital investment in Kansas offers a clear signal that Kansas has established a sound strategy related to economic development.
- **Gross Business Starts and Expansions** – A strategy of embracing dynamism must look beyond the inevitable failures of particular businesses. A higher gross volume of business starts and expansion will mean more people have selected Kansas as the platform of choice to take business risks, a clear signal that Kansas has established a sound strategy related to economic development.
- **Customer Service and Throughput Measures of State Economic Development Agencies** – A strategy of embracing dynamism recommends that state resources be shifted away from the management of incentive programs and towards a package of hands-on business assistance services that induce business formation by lowering the cost of business birth and expansion. Maintaining current levels of customer satisfaction at double the throughput rate would signal strong progress toward a model of embracing dynamism.

Recommendations to Animate the Strategy

The following set of recommendations seek to capture the spirit of an economic development model consistent with 1) a strategy of embracing dynamism, and 2) the prevailing spirit of Kansas law. The set of recommendations illustrate a prototype model that allows Kansas to remain a strong competitor against other states in the competition for economic development while shifting the policy emphasis from “targeting” to “embracing dynamism” in a manner that offers logical consistency, simplicity, transparency and equality.

Recommendation #1: Replace the list of state-level economic development incentive programs and investment-related tax credits on page 3 with the following three policies (which assume the continuation of the property tax exemption for machinery and equipment, the elimination of the business franchise tax, and the elimination of the estate tax).

- 1) Implement a system of 100 percent accelerated depreciation for all capital investments—equipment and structures—made in Kansas.
- 2) Allow all new business firms (and new business establishments from expanding firms) started in Kansas to retain 100 percent of their payroll withholding tax for the first 12 months of operation upon hiring the business’s first non-owner employee(s).
- 3) Exempt from capital gains taxation the proceeds from the sale of Kansas-based business assets and Kansas-based business enterprises (and the equity investors in said business enterprises that must pay Kansas income taxes).

Prototype Plan Would Eliminate These Programs and Tax Credits (but grandfather current participants)

Programs

- Kansas Industrial Training (KIT)
- Kansas Industrial Retraining (KIR)
- Investments in Major Projects and Comprehensive Training (IMPACT)
- Kansas Economic Opportunity Initiative Fund (KEOIF)
- Kansas Enterprise Zone
- Sales Tax and Revenue Bonds (STAR)

Tax Credits

- High Performance Incentive Program Credits (HPIP)
- Business and Job Development Credit
- Biomass-to-Energy Credit
- Electric Cogeneration Facility Credit
- Environmental Compliance Credit
- Alternative-Fuel Tax Credit
- Integrated Coal Gasification Power Plant Credit
- Nitrogen Fertilizer Plant Credit
- Petroleum Refinery Credit
- Qualifying Pipeline Credit
- Storage and Blending Equipment Credit
- Swine Facility Improvement Credit
- Research and Development Credit
- Angel Investor Credit

This recommendation illustrates a **prototype** set of specific changes to current law that capture the vision related to embracing dynamism. Naturally, other combinations of specific changes could work too. Consistent with the vision, the key ingredients of any combination should: **a) provide a set of transparent and predictable policies that induce business experimentation via investment and risk-taking, and b) allow access by all current or future Kansas businesses equally and automatically with minimal compliance costs for both businesses and the state.**

Recommendation #2: With the resources made available by eliminating the menu of current state-level economic development programs and tax credits from Recommendation #1, the Department of Commerce should focus its resources on developing the most cost-effective economic development ombudsman program in the nation.

This recommendation relates primarily to established businesses in expansion mode. (Recommendation #4 deals with assistance activities related to new businesses). Department of Commerce personnel already engage in much of the activity suggested by this recommendation.

Recommendation #3: Statutorily name the Secretary of Commerce to serve as the chair of the Board of Directors of the Kansas Enterprise Technology Corporation, Kansas Bioscience Authority, Network Kansas; and the chair of the Advisory Board of the Small Business Development Center. Make the Secretary of Commerce a non-voting member of the Kansas, Inc. Board of Directors.

Over the past two decades, Kansas has chosen to build an economic development model that primarily relies on free-standing agencies governed by independent Boards of Directors. This model offers a sound operational foundation: it provides for strong stakeholder input and offers continuity in the context of the transient executive leadership inherent to the state government of Kansas. This model presumes that the agencies will undertake effective voluntary coordination. Evaluations by Kansas, Inc. indicate that some cooperation takes place; however, the evaluations also indicate that the agencies operate too much as independent silos.

Recommendation #4: Develop a task force to better align and manage the resources, activities, and geographical accessibility of the regional components of the Kansas economic development model. The end goal, as suggested by a strategy of embracing dynamism, should be to create a nationally-recognized system of business consulting, training, networking, and incubation services to induce as much business formation and expansion as possible – in the context of the many unique regional economies in Kansas.

The strategy of embracing dynamism will ultimately place stress on many hands-on business services related to inducing business start-ups and expansions, such as providing world-class business consulting, training services, partnerships, collaboration, individualized counseling, expertise, technical and financial assistance.

Embracing Dynamism: The Next Phase in Kansas Economic Development Policy

“It is inherent in any dynamic capitalist economy that some firms thrive and grow while others decline and sometimes fail. . . . Sorting successful business endeavors from unsuccessful ones is, in fact, a central and necessary part of our market economy, and it is essential that the public and policy makers understand this process.”

— Kauffman Foundation report¹

Determining [the] future is a matter of perpetual small scale experiment, mostly unsuccessful, and we will all be surprised to discover which developments turn out to be future opportunities. It is almost self evident that committees of wise people from . . . industry, and consultations dominated by vested interests and their followers, will not include those who are likely to be the important players.

— John Kay²

“The most fundamental problem is that many public officials appear to believe that they can influence the course of their state and local economies through incentives and subsidies to a degree far beyond anything supported by even the most optimistic evidence. We need to begin by lowering expectations about their ability to micro-manage economic growth and making the case for a more sensible view of the role of government—providing foundations for growth through sound fiscal practices, quality public infrastructure, and good education systems—and then letting the economy take care of itself.”

— Alan Peters and Peter Fisher³

¹ Steven J. Davis, John Haltiwanger, and Ron Jarmin, “Turmoil and Growth: Young Businesses, Economic Churning, and Productivity Gains,” Kauffman Foundation, June 2008, p. 2.

² John Kay, 2009 Wincott Lecture, “The Future of Markets,” October 20, 2009. Reprinted here: <http://www.johnkay.com/2009/10/20/the-future-of-markets/>

³ Alan Peters and Peter Fisher, “The Failure of Economic Development Incentives,” *Journal of the American Planning Association*, Vol. 70, No. 1, 2004, p. 35-36.

Introduction and Historical Context

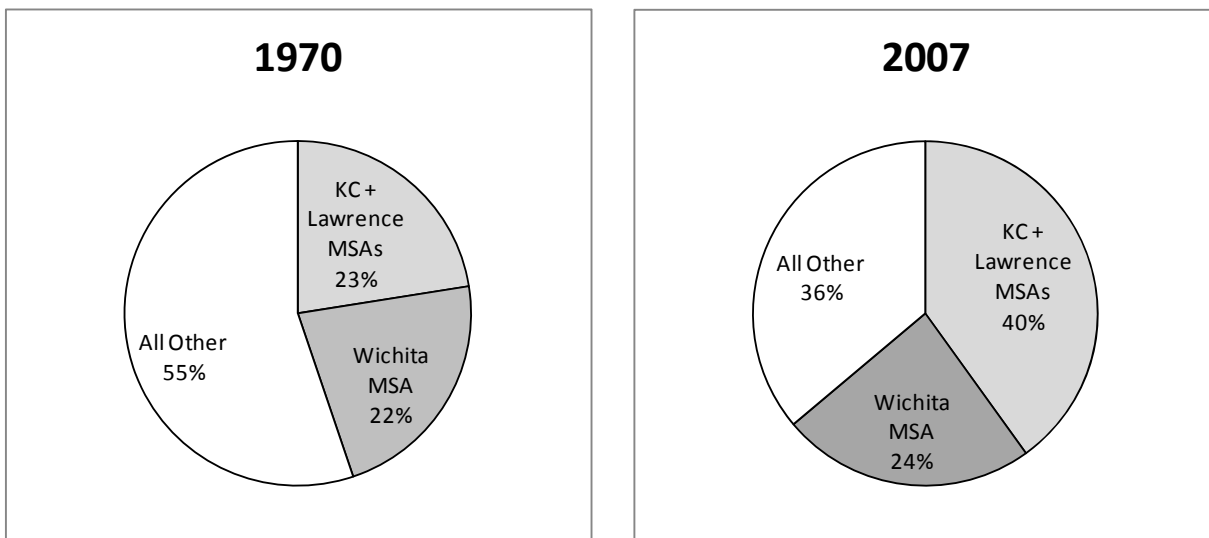
The Kansas economic development model dates back decades. The state created the Kansas Industrial Development Commission in 1939. In 1963, the legislature of Kansas adopted the following statutory language (in connection to what is now known as the Department of Commerce):

“The legislature declares it necessary and to be the public policy of this state to promote, stimulate and encourage development of the general economic welfare and prosperity of the state through the promotion and development of industry, commerce, agriculture, labor and natural resources in this state. Such promotion and development requires that cognizance be taken of the continuing migration of people to the urban areas in search of job opportunities, and the fact that Kansas is making a needed transition to a diversified economy which creates new challenges for its people. Greater diversification and attraction of additional industry, accelerated development of natural resources, expansion of existing industry, creation of new uses for agricultural products, greater emphasis on scientific research, development of new markets for the products of the state and the attainment of a proper balance in the overall economic base are all necessary in order to create additional employment opportunities, increase personal income and promote the general welfare of the people of this state. To attain these goals, and to coordinate the activities of groups, public and private, which are engaged in these efforts, the organization, consolidation, coordination and arrangements herein provided have been established.” (K.S.A 74-5002)

In 1986, when the so-called Redwood-Krider report⁴ offered recommendations for augmenting the state’s economic development model, the essence of the 1963 statement had not changed. In 2010, more than two decades after implementation of the Redwood-Krider recommendations, and several subsequent augmentations, the essence of the 1963 statement still has not changed, and the contours of the stated goals in 1963 largely capture the economic development goals of 2010.

The 1970s and 1980s were economically tough years for Kansas (and the Plains states in general). In that context, the Redwood-Krider report stated a concern of the times: “Unabated, a continuation of existing trends will result in an on-going and relative erosion of the state’s economic base.” But the existing trends and the natural economic dynamism of the transforming state economy was evolving in ways that may not have been fully appreciated at the time. Northeastern Kansas, especially around the Kansas City metro area, was becoming one of the fastest growing and most prosperous regions in the nation, a trend that essentially began after the 1973 recession and accelerated after the 1982 recession.

Figure 1: Shift in Kansas Regional Earnings, 1970 vs. 2007

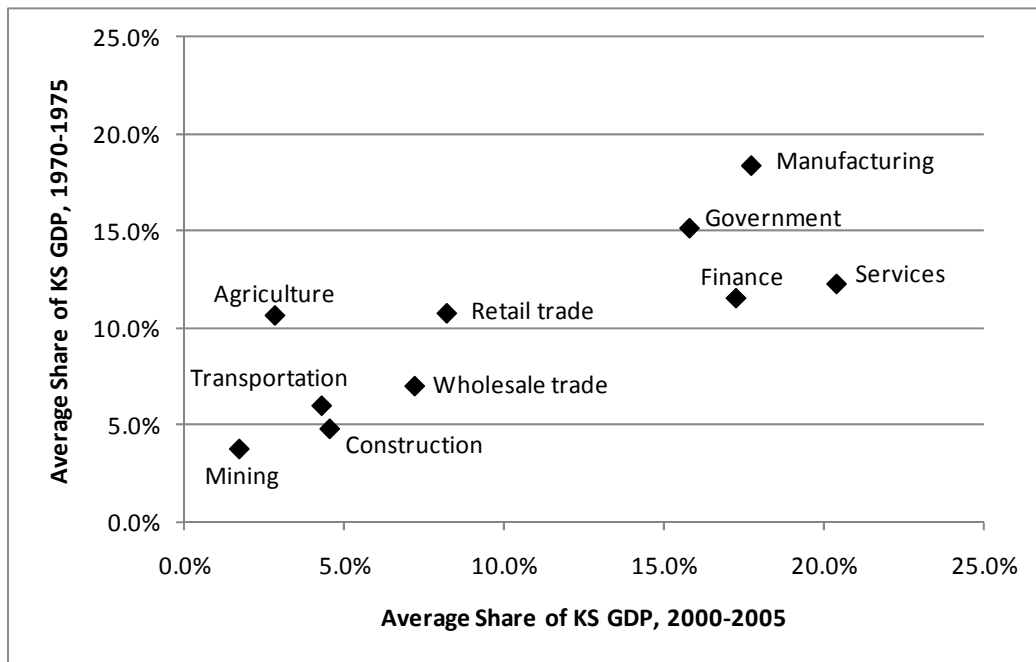


Source: U.S. Bureau of Economic Analysis; Center for Applied Economics, KU School of Business

⁴ Anthony Redwood and Charles Krider, “Kansas Economic Development Study: Findings, Strategy, and Recommendations,” Institute for Public Policy and Research, University of Kansas, Report No. 108, June 1986. A summary is available here: <http://www.ipsr.ku.edu/resrep/pdf/m108.pdf>

The state's economic base did not erode. It grew—while shifting in terms of composition and geography. Generally speaking, the shifting occurred for the reasons identified by the legislature in its 1963 statement. Kansas, like the Plains states generally, has been urbanizing since at least the 1930s—a trend still underway, with a long way to go. Figure 1 on page 5, illustrates that most of the geographic shift in Kansas has been eastward toward Kansas City.⁵ Figure 2 shows that the urbanization trend also helps explain the compositional shifts. Over the past three decades, the GDP from agriculture has become much less important and the GDP from services and finance has become much more important. The “economic base” in most other broad industry categories has remained relatively stable—in value terms, not necessarily geographic terms or compositional terms. The operational details and productivity levels associated with the industry categories have modernized and increased substantially. Enhanced productivity and diversity in the basic industries has helped fuel the growth and diversity in service-related industries.

Figure 2: Industry Shares of Kansas GDP, 1970-75 vs. 2000-05



Source: U.S. Bureau of Economic Analysis

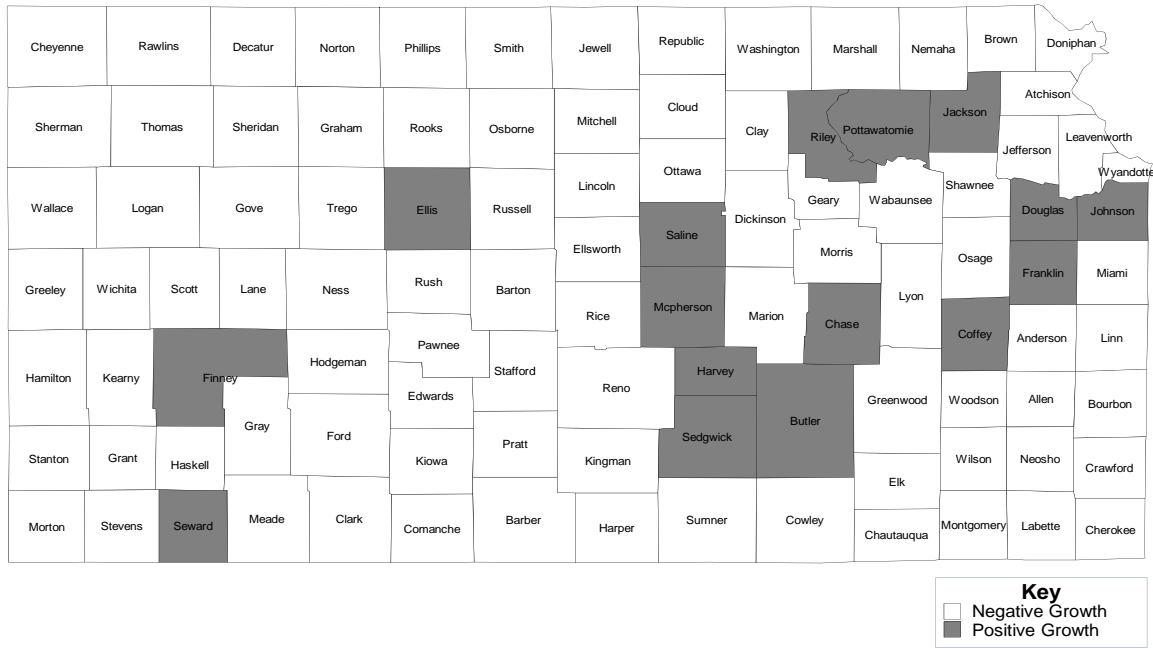
Maps 1 and 2, in combination with Figures 1 and 2, help set the stage for *embracing dynamism*—the theme in this report for the next phase of economic development policy in Kansas. Embracing dynamism suggests an economic development model that works with the mega-trends that continue to shape the economic platform in Kansas.

Map 1 helps to further illustrate the urbanization theme. Population density facilitates productivity-driven economic growth, the true economic definition of economic development and the cause of higher family incomes. Map 1 shows that employment shares (a measure of relative density) have grown the most in the eastern half of Kansas, but the western half also has pockets of increasing density. The growing relative density has primarily happened around established urban centers.

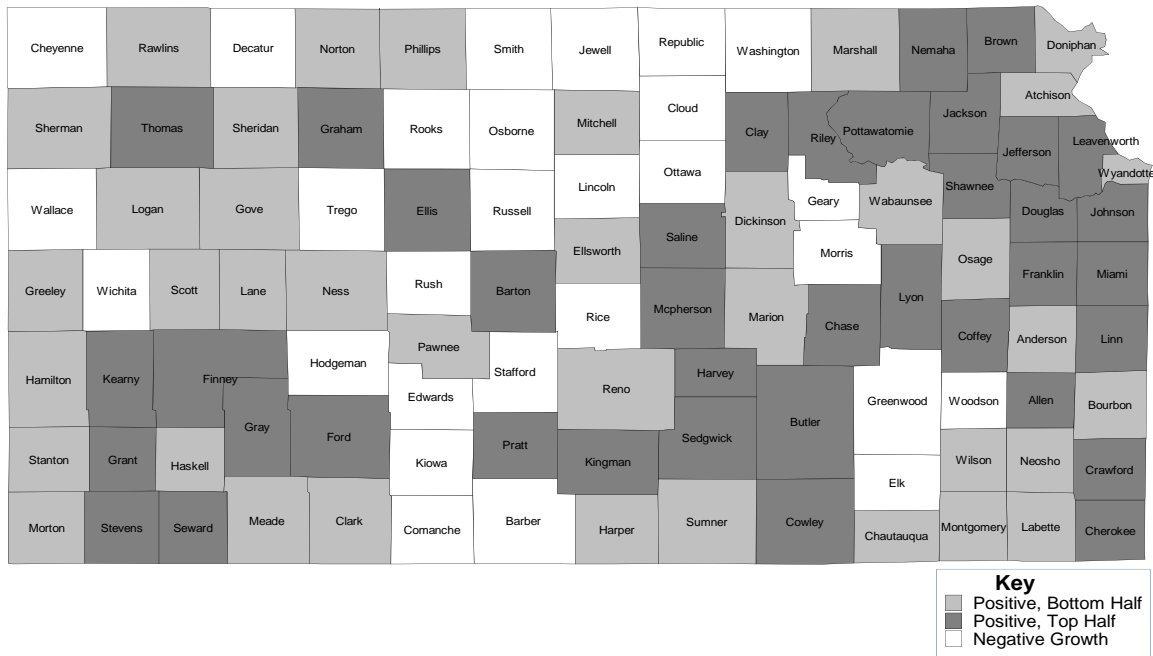
Map 2 helps to tell the Kansas story as one of relative concentration (density) not general decline. An evaluation of actual employment growth, as opposed to the growth of shares in Map 1, shows that three-quarters of Kansas counties have experienced employment growth over the past four decades—and that, among the counties with positive growth, those in the top half have a broad statewide distribution.

⁵ For detailed analysis on the population migration trends, see Arthur P. Hall, Scott Moody, and Wendy Warcholik, “The County-to-County Migration of Taxpayers and Their Incomes, 1995-2006,” Technical Report 09-0306, Center for Applied Economics, University of Kansas School of Business, March 2009.

Map 1: Growth in Shares of Kansas Employment, 1970-2007



Map 2: County-Level Employment Growth, 1970-2007



Embracing dynamism suggests that economic development efforts discard the traditional industry-centric focus and replace it with a region-centric focus. Based on inter-county commuting patterns, Kansas hosts at least 25 regional economies. Each one of these regional economies has its own unique economic history that establishes the economic foundation for how it might further develop. Each region may be experiencing different stages of transition in the Great Plains mega-trend toward urbanization. The different stages matter because—to use two common but misleading terms—some parts of Kansas are growing into or through an “old economy” stage and some parts have entered the “new economy” stage.

A state-level economic development model that embraces dynamism should create a set of policies that work well across the whole array of regions, regardless of their development stage. In brief, state-level policies should: **1) treat all business and investment opportunities equally, 2) facilitate business development in the unique context of the regional economy, and 3) embrace rather than impede the continuing patterns of structural change.**

Embracing Dynamism: Moving from Benchmarking to Strategy

The evolution of the Kansas economic development model has not occurred in a vacuum. State economic development models have evolved since the late 1930s. Along the way, “economic development” has become its own (mostly taxpayer funded) industry, complete with hard-working professionals and professional associations. As in all competitive endeavors, economic development professionals (all incented by similar metrics) have aggressively “benchmarked” against one another. Consequently, scholars can document “waves” in the evolution of economic development policy and practice.⁶

Table 1 on page 10, provides a checklist for site locators developed by Conway Data, the publisher of *Site Selection Magazine*, the official publication of the Industrial Asset Management Council. Generally speaking, most states have most economic development “tools” as a result of decades of benchmarking. The details of how states deploy them may differ, but competition has made the overall packages competitive from state to state.

The general uniformity from a business perspective, in part, helps explain why economic research has had difficulty determining the success of economic development incentives. The overall lack of variation creates few “natural experiments” to aid in evaluation. It also helps explain why the benchmarking process has, in important respects, evolved essentially into bidding wars for large employers. In many ways, the process has taken on the characteristics of a zero-sum game leveraged by industry for financial advantage (and understandably so, from a business perspective). Yet true economic development is a positive-sum game, a win-win for all parties.

In the mid-1990s, Michael Porter, the renowned scholar of business strategy, argued that business managers had become so focused on benchmarking against competitors in terms of operational effectiveness that they had lost sight of competitive strategy, to the detriment of their companies. In Porter’s words: “The more benchmarking companies do, the more they look alike. . . . Competitive strategy is about being different. It means deliberately choosing a different set of activities to deliver a unique mix of value.”⁷

In many ways, the economic development industry has arguably fallen victim to the same over-emphasis on benchmarking at the expense of strategy. That helps explain why the 2008 Kansas Legislative Post Audit report on economic development programs argued that:⁸

Almost every state offers economic development incentives. And although the literature we reviewed suggests that, in general, these incentives don’t have a significant impact on economic growth; it also suggests that states have to continue offering such incentives to remain competitive.

Officials from Kansas economic development agencies have repeatedly stated that economic development assistance must be offered. In essence, they said, “you can’t afford to not play the game” or the State loses out on economic development opportunities.

The evidence presented in this report challenges key elements of that conclusion. Kansas can break out of the benchmarking race by developing a strategy built on embracing dynamism. Such a strategy, far from losing opportunity, can distinguish itself by building unique capabilities that create a different mix of value that can enhance the probability of long-term economic success through enhanced opportunity. Embracing dynamism can change *how* Kansas plays the game.

⁶ Andrew M. Isserman, “State Economic Development Policy and Practice in the United States: A Survey Article,” *International Regional Science Review*, Vol. 6, p.63. Also see, Keon S. Chi and Daniel J. Hofmann, “State Business Incentives: Trends and Options for the Future, 2nd Edition,” Council of State Governments, 2000.

⁷ Michael E. Porter, “What is Strategy?” *Harvard Business Review*, November–December 1996, p. 64.

⁸ Kansas Legislative Post Audit, “Economic Development: Determining the Amounts the State Has Spent on Economic Development Programs and the Economic Impacts on Kansas Counties,” August 2008, p. 31.

Table 1: State Economic Development “Tools”

	Number of States	Used in Kansas
Financial Assistance for Industry		
State-Sponsored Industrial Development Authority	42	N
Privately Sponsored Development Credit Corporation	39	N
State Authority or Agency Revenue Bond Financing	45	Y
State Authority or Agency General Obligation Bond Financing	24	Y
City and/or County Revenue Bond Financing	47	Y
City and/or County General Obligation Bond Financing	38	Y
State Loans for Building Construction	41	N
State Loans for Equipment, Machinery	42	N
City and/or County Loans for Building Construction	45	Y
City and/or County Loans for Equipment, Machinery	45	Y
State Loan Guarantees for Building Construction	30	N
State Loan Guarantees for Equipment, Machinery	34	Y
City and/or County Loan Guarantees for Building Construction	18	N
City and/or County Loan Guarantees for Equipment, Machinery	18	N
State Financing Aid for Existing Plant Expansion	44	Y
State Matching Funds for City and/or County Industrial Financing Programs	27	Y
State Incentive for Establishing Industrial Plants in Areas of High Unemployment	43	Y
City and/or County Incentive for Establishing Industrial Plants in Areas of High Unemployment	38	Y
Tax Incentives for Industry		
Corporate Income Tax Exemption	41	Y
Personal Income Tax Exemption	37	Y
Excise Tax Exemption	28	N
Tax Exemption or Moratorium on Land, Capital Improvements	40	Y
Tax Exemption or Moratorium on Equipment, Machinery	44	Y
Inventory Tax Exemption on Goods in Transit (Freeport)	49	Y
Tax Exemption on Manufacturers' Inventories	47	Y
Sales/Use Tax Exemption on New Equipment	49	Y
Tax Exemption on Raw Materials Used in Manufacturing	50	Y
Tax Incentive for Creation of Jobs	45	Y
Tax Incentives for Industrial Investment	45	Y
Tax Credits for Use of Specified State Products	8	N
Tax Stabilization Agreements for Specified Industries	12	N
Tax Exemption to Encourage Research and Development	42	Y
Accelerated Depreciation of Industrial Equipment	41	Y
<i>Source: Site Selection Magazine, Nov. 2009</i>		

Embracing Dynamism: Economic Evidence in Support of a New Strategy

A substantial amount of economic research has taken place during the evolution of the economic development industry. Data and research techniques have steadily improved. It has allowed scholars to have a much greater appreciation of the huge volume of change and diversity that works to continuously shape the United States economy—and, by extension, the many regional economies of Kansas.

The data in Table 2 shows that without the birth of brand new business establishments, Kansas would have experienced negative net job growth in 22 of the 28 years represented in the data. The Kansas job market is in continual flux from four sources: business births, business deaths, business expansions, and business contractions.⁹ Figure 3 on page 13 provides a visual aid for understanding the overall statewide dynamics of job change. On average, Kansas businesses create about 149,000 jobs each year and eliminate about 139,500. (A picture of business establishments instead of jobs would show a similar pattern. On average, each year in Kansas, about 7,000 businesses start; 6,750 close; 18,750 expand; and 17,950 contract. Those numbers represent businesses with employees. Kansas had about an additional 183,000 businesses currently without employees undergoing dynamic change. Many of them will become employers as the businesses mature.)

Table 3 on page 14 reinforces the story told by Table 2 and reveals that the size of the firm (in terms of the number of people it employs) is much less important to job creation than the start of a new business establishment. Over the five-year period from 2000 to 2005, age-zero firms created almost all of the net new jobs. Smaller firms had a higher propensity to add net new jobs than larger firms, but the age of the firm dominates that pattern.

⁹ Table 2 works by starting with all firms in existence in 1977, with an emphasis on those born in that year. The table then tracks net job creation by age of firm. “Left Census” tracks net job creation from business establishments that already existed before 1977.

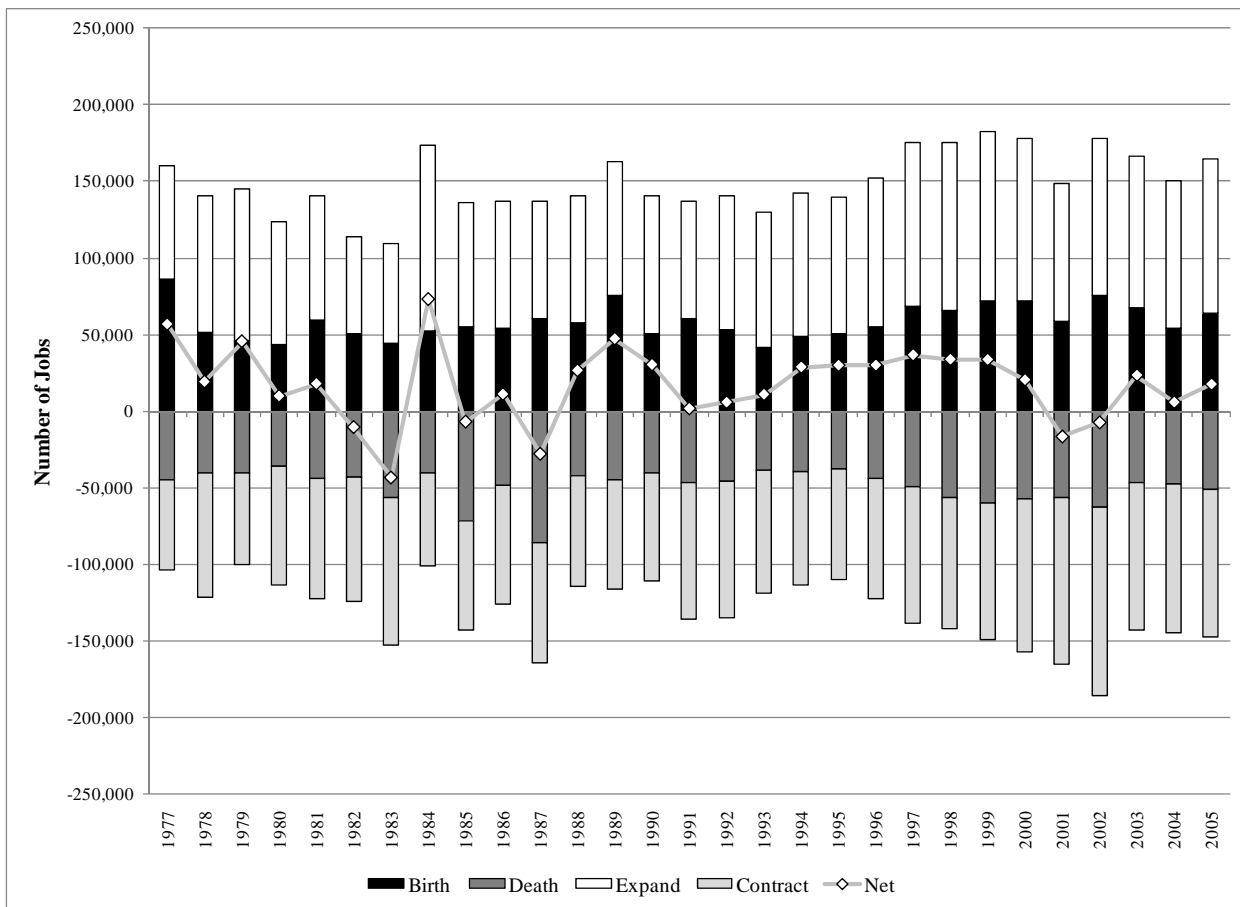
Table 2: Kansas Net Job Creation by Business Establishment by Age of Firm that Owns the Establishment

(Bolded figures show positive net job growth)

Year	Age of Firm in Years													Total Net Job Creation	Net Job Creation without Age Zero
	0	1	2	3	4	5	6-10	11-15	16-20	21-25	26+	Left Censored			
1977	62,303	0	0	0	0	0	0	0	0	0	0	0	-5,709	56,594	-5,709
1978	32,173	-21,808	0	0	0	0	0	0	0	0	0	0	8,704	19,069	-13,104
1979	29,584	-3,999	-1,378	0	0	0	0	0	0	0	0	0	21,161	45,368	15,784
1980	27,468	-3,382	-4,057	-2,263	0	0	0	0	0	0	0	0	-8,002	9,764	-17,704
1981	34,166	-1,765	-1,637	-2,380	-1,588	0	0	0	0	0	0	0	-8,955	17,841	-16,325
1982	27,794	-2,778	-2,837	-2,875	-2,776	-1,445	0	0	0	0	0	0	-25,605	-10,522	-38,316
1983	25,415	-3,313	-4,400	-2,891	-1,402	-1,234	-1,067	0	0	0	0	0	-54,496	-43,388	-68,803
1984	31,454	43	-1,286	2,366	-168	-100	-2,272	0	0	0	0	0	42,755	72,792	41,338
1985	29,734	388	-3,758	-1,075	-3,346	-1,397	-1,109	0	0	0	0	0	-26,398	-6,961	-36,695
1986	30,385	-3,951	-3,021	-2,659	-1,677	-355	-1,573	0	0	0	0	0	-6,097	11,052	-19,333
1987	32,653	-2,038	-2,842	-2,593	-842	-2,434	-5,746	0	0	0	0	0	-44,050	-27,892	-60,545
1988	27,183	-1,503	-300	-1,568	-1,255	-812	-1,248	1,521	0	0	0	0	4,453	26,471	-712
1989	25,257	-1,628	-2,893	-1,890	-1,757	381	-3,213	176	0	0	0	0	32,695	47,128	21,871
1990	27,141	1,791	-1,173	-2,244	-1,001	-1,629	-2,624	938	0	0	0	0	9,019	30,218	3,077
1991	24,336	835	-2,891	-1,805	-2,538	-1,399	-2,751	-2,906	0	0	0	0	-9,255	1,626	-22,710
1992	26,142	-1,275	-4,193	-920	-451	29	-5,835	428	0	0	0	0	-8,160	5,765	-20,377
1993	25,239	-1,175	-2,537	-1,203	-221	-2,309	-1,843	-616	696	0	0	0	-5,217	10,814	-14,425
1994	27,704	-689	-1,388	-444	1	-1,609	-517	425	1,271	0	0	0	3,887	28,641	937
1995	28,559	-208	-1,210	-959	-1,003	-135	-1,697	-296	604	0	0	0	6,117	29,772	1,213
1996	26,645	993	-1,487	-1,249	-488	401	-2,381	174	-1,404	0	0	0	8,654	29,858	3,213
1997	31,155	-1,270	-2,158	-1,147	-836	-1,632	-790	484	196	0	0	0	12,521	36,523	5,368
1998	34,435	943	-1,670	-2,464	-1,095	-617	-3,223	-3,629	-1,708	1,201	0	0	11,444	33,617	-818
1999	30,550	2,442	-637	-700	-1,309	533	-4,135	373	-224	-767	0	0	7,415	33,541	2,991
2000	30,559	-389	-169	-783	-646	-1,153	-1,264	-2,125	-278	-2	0	0	-3,394	20,356	-10,203
2001	25,964	-1,404	-4,140	-703	-3,588	-1,089	-5,170	-4,931	-4,842	-2,397	0	0	-14,417	-16,717	-42,681
2002	30,126	-1,287	-229	-1,433	-2,814	-750	-5,369	-2,426	-2,039	-4,037	0	0	-17,239	-7,497	-37,623
2003	27,891	-3,189	-2,232	-321	-432	265	-1,121	-1,094	-1,511	1,932	-88	0	3,226	23,326	-4,565
2004	26,274	-1,505	-3,420	-1,599	-811	-645	-461	-1,101	-1,913	-1,040	793	0	-8,884	5,688	-20,586
2005	28,377	-371	-1,109	-1,041	-1,306	-390	-3,030	-2,761	1,454	-1,407	2,177	0	-3,141	17,452	-10,925

Source: U.S. Census Bureau, Center for Applied Economics, KU School of Business

Figure 3: Kansas Job Dynamics, 1977-2005



Source: U.S. Census Bureau, Center for Applied Economics, KU School of Business

One important caveat to the data reported in Tables 2 and 3 requires comment. Nothing in the data suggests that large, mature business have no importance for economic growth. Large, mature businesses tend to offer higher wages, better employee benefits, and general stability of employment opportunities.¹⁰ They also tend to spawn entrepreneurs with important industry knowledge and established professional networks.

The important economic development issue concerns business birth and expansion to redirect the employment of talented Kansans released because of inevitable business death and contraction. Generally speaking, dynamism represents persistent, annual change in about one-third of Kansas jobs. Job creation may be a key goal of economic development policy but job creation is a residual economic outcome of business dynamism. **The policy challenge centers on promoting dynamism by establishing a business environment that induces business birth and expansion without bias related to the size or type of business.**

¹⁰ See, for example, Kelly Edmiston, "The Role of Small and Large Businesses in Economic Development," Federal Reserve Bank of Kansas City, *Economic Review*, 2007, 2nd Quarter, pp. 73-97.

The job reallocation rate sums together the rates of job change associated with business birth, death, expansion, and contraction.

The important lesson from Figure 4 is that growth and change go together. The causality runs in both directions.¹¹ “When a door shuts a window opens.” That proverb holds for economic development as well as personal development. An economic development strategy built around embracing dynamism acknowledges that business birth and expansion are the goals but that business death and contraction are vital to the dynamic process that promotes growth. Policies of business and job “retention” may inadvertently work in a manner contrary to the goals of economic development if the policies shelter businesses from dynamism rather than motivating (or assisting) them to cope with dynamism.

The following list summarizes the consistent findings of academic research relevant for a strategy of embracing dynamism:

- Large-employer businesses have no measurable net economic effect on local economies when properly measured. To quote from the most comprehensive study: “The primary finding is that the location of a large firm has no measurable net economic effect on local economies when the entire dynamic of location effects is taken into account. Thus, the siting of large firms that are the target of aggressive recruitment efforts fails to create positive private sector gains and likely does not generate significant public revenue gains either.”¹²
- Expansion of existing business establishments have a strong multiplier effect on employment (in the range of two for one) while the multiplier effect of newly-sited large employers is weak or negative (much less than one for one).¹³
- Industry mix does not influence economic development as much as commonly believed. Targeting specific business or “hot” industries is an inferior strategy to volume-driven diversity caused by dynamism.¹⁴ However, concentrations of existing industries tend to reinforce themselves.
- Dynamism drives productivity growth as the process of trial and error replaces inferior business models with superior ones.¹⁵ Policies of “retention” work against this positive attribute of dynamism.
- New information provided by several recent Kauffman Foundation surveys designed to better understand entrepreneurs and the ventures they start suggest that a strategy which embraces dynamism may yield greater success. Table 4 provides a select list of survey responses from 549 successful company founders—about 60 percent of them started multiple companies.¹⁶ Table 5 provides a list of the sources of funds for the first year of operation of 4,163 start-up companies.¹⁷ In both cases, the survey results indicate that government programs play a minor role in overall business formation. However, the results also indicate that well-crafted business coaching and incubation services (as well as enhanced opportunities for professional networking) might improve the odds of inducing people to start a business or improve the odds of success for those people that choose to start a business. Access to capital is important, but there is no reason to expect that good business plans cannot obtain the financing they require in the absence of taxpayer-funded capital programs.

¹¹ See, for example, Edward L. Glaeser and William R. Kerr, “Local Industrial Conditions and Entrepreneurship: How Much of the Spatial Distribution Can We Explain?” *Journal of Economics and Management Strategy*, Vol. 18, No. 3, 2009, pp. 623-663.

¹² William F. Fox and Matthew N. Murray, “Do Economic Effects Justify the Use of Fiscal Incentives?” *Southern Economic Journal*, Vol. 71, No. 1, 2004, p. 79. Also see, Todd M. Gabe and David S. Kraybill, “The Effect of State Economic Development Incentives on Employment Growth of Establishments,” *Journal of Regional Science*, Vol. 42, No. 4, 2002, pp. 703-730; and Dafna Schwartz, Joseph Plezman, and Michael Keren, “The Ineffectiveness of Location Incentive Programs: Evidence from Puerto Rico and Israel,” *Economic Development Quarterly*, Vol. 22, No. 2, 2008, pp. 167-179.

¹³ Kelly D. Edmiston, “The Net Effects of Large Plant Locations and Expansions on County Employment,” *Journal of Regional Science*, Vol. 44, No. 2, 2004, pp. 289-319.

¹⁴ Stephen Malpezzi, Kiat-Ying Seah, and James D. Shilling, “Is it What We Do or How We Do It? New Evidence on Agglomeration Economies and Metropolitan Growth,” *Real Estate Economics*, Vol. 32, No. 2, 2004, pp. 265-295. Also see: Maryann P. Feldman and David B. Audretsch, “Innovation in Cities: Science-Based Diversity, Specialization, and Localized Competition,” *European Economic Review*, Vol. 43, 1999, pp. 409-429; and Mark D. Partridge and Dan S. Rickman, “A Note on the Benefits to Current Residents of State Employment Growth: Is There an Industry Mix Effect on Migration?” *Journal of Regional Science*, Vol. 39, No. 1 (1999), pp. 167-181.

¹⁵ Steven J. Davis, et al., “Turmoil and Growth: Young Businesses, Economic Churning, and Productivity Gains,” Kauffman Foundation, June 2008.

¹⁶ Vivek Wadhwa, et al., “The Anatomy of an Entrepreneur: Family Background and Motivation,” Kauffman Foundation, July 2009; and “The Anatomy of an Entrepreneur: Making of a Successful Entrepreneur,” Kauffman Foundation, November 2009.

¹⁷ Alicia M. Robb and David T. Robinson, “The Capital Structure Decisions of New Firms,” Kauffman Foundation, November 2008.

Table 4: Select Survey Responses from 549 Successful Entrepreneurs

86% said assistance by the state or region was not at all or only slightly important.
78% said lessons from failure were important; 40% said "extremely important."
52% said lack of financial capital was a challenge; 11% "extremely big" challenge.
52% said lack of experience was a challenge; 4% "extremely big" challenge.
70% said personal savings was the main source of capital.
75% said they had worked as employees at other companies for more than six years before starting their companies; about 25% had worked for more than 15 years.
73% said professional networks were important to the success of their current business.
40 years of age was the average and median age of the company founders at the times of their first start-up.
95% had a bachelor's degree and 47% had more advanced degrees.
67% ranked their academic performance in the top 30% of their undergraduate class; 37% ranked it in the top 10%.
70% of respondents were married and 60% had at least one child when they started their companies.
<i>Source: Kauffman Foundation, "The Anatomy of an Entrepreneur," 2009</i>

Table 5: Capital Structure Choice in Initial Year of Operation: 4,163 Start-Ups

	Average: All Firms	Average: Firms > 0	Number of Firms
Owner Equity	\$27,365	\$34,509	3,292
Insider Equity	\$1,695	\$34,984	186
Spouse	\$479	\$28,697	67
Parents	\$1,217	\$34,509	3,292
Outsider Equity	\$6,979	\$150,733	223
Other informal investors	\$2,736	\$101,718	121
Businesses	\$1,807	\$162,097	61
Government	\$401	\$81,821	26
Venture Capitalists	\$1,655	\$335,868	28
Others	\$380	\$183,295	10
Owner Debt	\$3,506	\$11,695	1,221
Personal CC balances, respondent	\$3,179	\$10,899	1,185
Personal CC balances, other owners	\$304	\$10,008	133
Personal owner loan	\$23	\$15,853	5
Insider Debt	\$7,605	\$51,221	564
Personal family loan, respondent	\$2,798	\$28,656	350
Personal family loan, other owners	\$276	\$34,689	28
Business loan from family	\$1,258	\$42,610	116
Business loan from owner	\$1,732	\$118,065	64
Business loan from employees	\$66	\$19,349	9
Other personal loan, respondent	\$592	\$30,046	78
Other personal debt, respondent	\$883	\$69,567	51
Outsider Debt	\$31,255	\$85,681	1,487
Personal bank loan, respondent	\$11,066	\$65,154	669
Business CC balance, respondent	\$1,358	\$9,710	556
Personal bank loan, other owners	\$1,430	\$62,251	97
Business CC balance, other owners	\$190	\$11,929	62
Business CC balances, business	\$856	\$7,417	463
Business bank loan	\$9,357	\$150,704	242
Credit line	\$3,237	\$62,156	216
Non-bank business loan	\$2,033	\$123,622	75
Government business loan	\$721	\$80,333	37
Other business loan	\$163	\$61,586	20
Other individual loan	\$246	\$52,529	21
Other business debt	\$597	\$122,512	21
Total	\$78,406		
Number	4,163	see column	
<i>Source: Kauffman Foundation, "The Capital Structure Decisions of New Firms," 2009</i>			

- Rural areas have lower levels of dynamism than urban areas. Business births take place at a slower rate but so do business deaths. If a business fails in the relatively “thin” markets of a rural area, it may be harder for the business owner to cut his or her losses by selling the assets of the business. According to economists at Iowa State University: “The implied lower salvage value of rural firms suggests that firms sorting into rural markets must have a higher probability of success in order to leave their expected profits equal to what they could earn in an urban market.”¹⁸
- State and local tax burdens seem to have a strong inverse relationship to a state’s income growth. The channels through which taxes seem to effect income growth are: investment, employment, and population. Tax policy seems to have a more immediate (e.g., a five-year time frame) on investment and employment and a more delayed effect on population growth.¹⁹ Since tax policy takes time to work its effects on economic growth, stability and consistency of tax policy improves the ability of businesses to make plans.

Figures 5 and 6 show that the normal business and jobs dynamics in Kansas typically dwarf the amount of activity reported by the state’s formal economic development programs. (As with Table 2 and Figure 3, only businesses with employees are included.) The hands-on, active-management approach that characterizes a significant portion of the economic development policy (and delivery model) in Kansas cannot hope to adequately deal with the normal volume of economic activity. The current model cannot fulfill a strategy of embracing dynamism. Despite the worthiness of the anecdotal success stories, the results reported by Kansas economic development agencies do not rise to a level above the “statistical noise” of the high-volume economic dynamics that takes place across the state on a regular basis.

The business and jobs data reported in Figures 5 and 6 for the Kansas economic development agencies come from the 2008 Kansas Legislative Post Audit, arguably the most thorough accounting of results available.²⁰ The report states that: “Taken together, agencies’ reported results would suggest that Kansas’ economic development programs have had a major impact on the State’s economy over the past five years.”²¹ Placed in a dynamic context, that conclusion seems less plausible than it seems in the isolated context of the report—especially since the report adds these qualifications to the conclusion:

- The data likely contains substantial duplications. (The report cites the Business and Jobs Development Credit—BJDC in Figure 6—as one probable source of duplication.)
- “The number of new jobs reported isn’t always the ‘net’ amount.”
- “Companies report some of their results on surveys or tax returns without any supporting documentation, and agencies generally don’t or can’t verify that information.”
- “Some agencies take credit for all accomplishments their clients report, even if the agencies provided only minimal or partial assistance.”

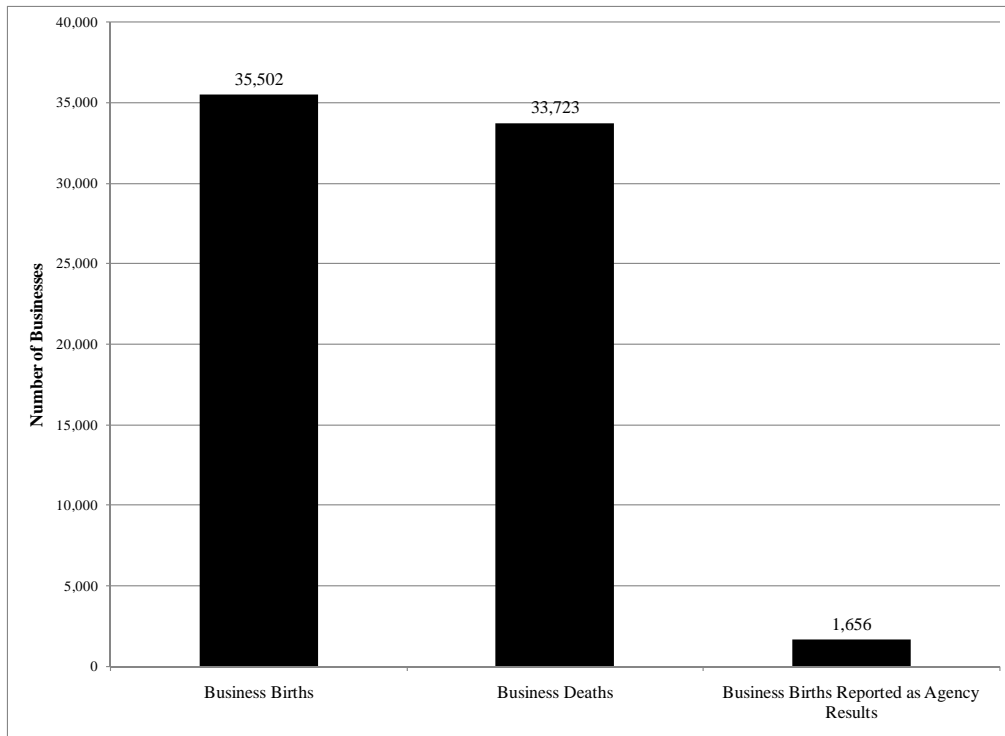
¹⁸ Li Yu, Peter F. Orazem, and Robert Jolly, “Why Do Rural Firms Live Longer?” Working Paper No. 09013, Iowa State University Department of Economics, July 2009.

¹⁹ W. Robert Reed, “The Robust Relationship between Taxes and U.S. State Income Growth,” *National Tax Journal*, Vol. 61, No. 1, March 2008, pp. 57-80.

²⁰ Kansas Legislative Post Audit, “Economic Development: Determining the Amounts the State Has Spent on Economic Development Programs and the Economic Impacts on Kansas Counties,” August 2008, p. 41.

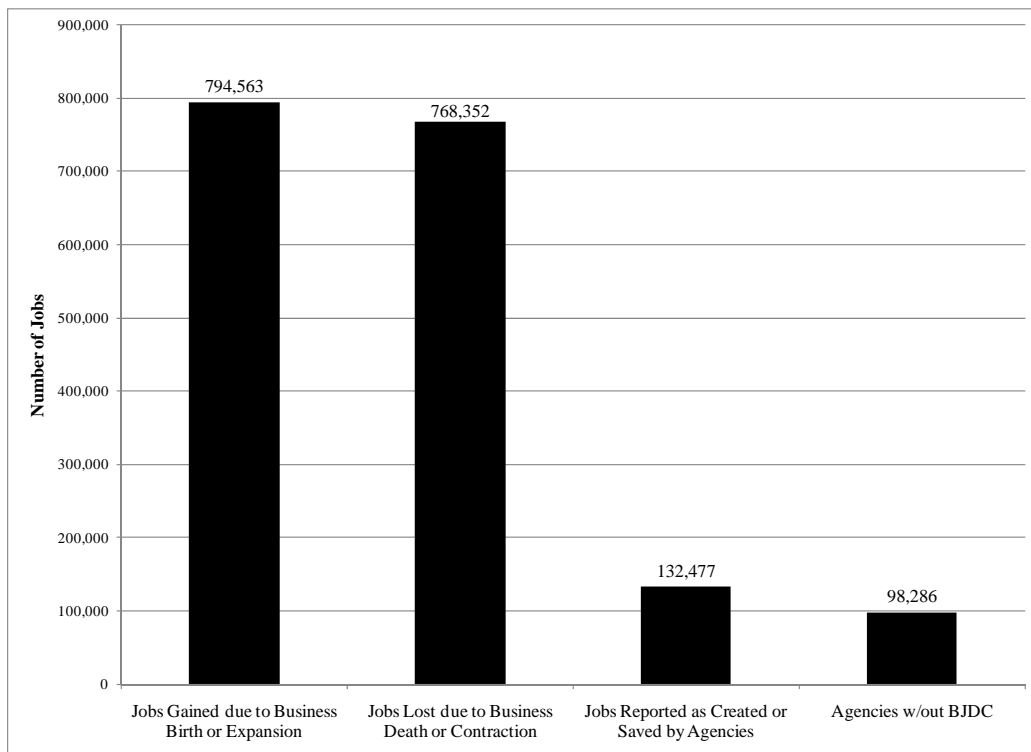
²¹ *Ibid.*

Figure 5: Business Births and Deaths in Kansas over Recent 5-Year Period



Source: U.S. Census Bureau; Kansas Legislative Post Audit

Figure 6: Kansas Job Dynamics and Agency Results over Recent 5-Year Period



Source: U.S. Census Bureau; Kansas Legislative Post Audit

Embracing Dynamism: A Strategy to Induce Maximum Commercial Experimentation

The goal of embracing dynamism is simply stated: Create the conditions necessary to *induce* as much commercial experimentation as possible. As a practical matter, that means creating an environment where all manner of people—inside and outside the state—feel motivated to commit their time and treasure to Kansas soil. The strategy seeks to strive for volume with regard to new business starts and business expansions. Every business matters.

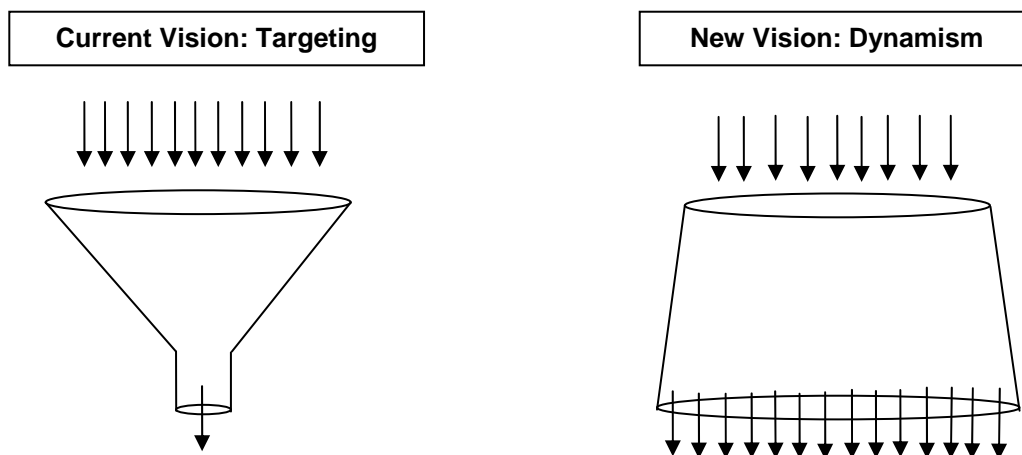
The mission statement of every state-level Kansas economic development agency is consistent with this fundamental goal. More often than not, however, the legislative directives that agencies must administer are not consistent with the fundamental goal. The operational model of economic development practice necessarily follows from the policy mandates imposed upon it.

Kansans would be hard pressed to find anyone in the state who does not share the sentiment that every business matters. Yet Kansas economic development policy tends to work as if only a small sub-set of businesses matter.

To a great extent, the conflict between the goals and operation of Kansas economic development policy results from a specific vision of economic development encoded into the statutes that dictate agency operations. That vision puts the state government in the role of being an active investor in specific businesses or industry sectors. The word “target” recurs (or is implied) frequently throughout the statutory guidance given to agencies. Targeting, a time- and labor-intensive activity, works against the goal of inducing as much commercial experimentation as possible.

Embracing dynamism starts with a change in vision. Simply stated, the state government of Kansas should abandon its prevailing policy vision of the State as an active investor in businesses or industries and instead adopt the policy vision of the State as a caretaker of a competitive “platform”—a platform that seeks to induce as much commercial experimentation as possible. By way of analogy, the platform-caretaker vision says: The State of Kansas runs tournaments; it does not field players. Creating a platform to host world-class tournaments will attract world-class players. The platform will endure but players will come and go. The platform-caretaker vision implies that the state government need not commit scarce resources to the enormously difficult task of predicting the outcome of competition if it focuses on the much more manageable task of creating the platform on which competition takes place.

Figure 7: A Profile of Two Visions for Kansas Economic Development Policy



Current Vision:	New Vision:
<ul style="list-style-type: none"> • Dedicate considerable human and financial resources to the difficult task of predicting the “right” technologies or businesses. • Determine winners based on criteria like job count or specified wage levels—criteria often at odds with the goal of inducing profitable new business starts and expansions. • Reward winners with special privileges or resources at the expense of non-winners. 	<ul style="list-style-type: none"> • Dedicate human and financial resources to promoting maximum experimentation through volume and diversity. • Establish stable policies that treat all investments and businesses equally, thereby liberating resources from the costly and economically dubious task of targeting. • Focus state resources on important activities that the state can do best: supply the “public goods” parts of the economic development process.

Replacing the prevailing direct approach represented by the active-investor vision with the indirect approach represented by the platform-caretaker vision will alter what it means for the state government of Kansas to “target” its limited resources:

- “Target” in the active-investor context requires state agencies to dedicate a considerable amount of human and financial resources to the difficult task of determining the “right” investments. The primary thrust of current Kansas economic development policy encourages or mandates state government agencies to act as a gatekeeper by essentially screening business deals the same way an active investor might. This vision of policy limits the state’s potential in three basic ways. First, it does not scale; that is, it cannot handle the volume of economic activity that takes place in Kansas. Second, the active-investor approach gives rise to the perennial (and usually irresolvable) questions related to the state government’s economic development “return on investment.” Third, official notions of “return on investment” usually have an explicit jobs-count component, which directly conflicts with the end goals of: a) productivity growth, and b) enabling profitable new business births or expansions.
- “Target” in the platform-caretaker approach requires the state government to establish policies that induce a maximum amount of commercial experimentation across the regions of Kansas. This experimentation takes place among tens of thousands of geographically dispersed organizations, all with unique goals and operating perspectives. No active-investor approach to policy can hope to intelligently handle the volume. However, few organizations other than the state government have an incentive to competently commit human and financial resources to certain parts of the economic development process. These parts represent the “public goods” components the process. In addition to infrastructure provision and law and order activities, the public good parts include: 1) site location and permitting assistance services for mature businesses, 2) incubation and coaching services for aspiring entrepreneurs that help lower the cost of business creation (services that cannot survive unaided in the “thin” markets that characterize much of Kansas), and 3) expanded networking and educational opportunities that create knowledge sharing and a greater awareness of business opportunity throughout the state. The competent provision of each of these three items, combined with appropriate investment policies open to all businesses, defines the platform-caretaker vision, which can substantially increase the productivity of the state government’s resources by inducing greater volume and diversity with regard to commercial experimentation. Greater volume and diversity can increase the probability of successful economic development.

Measures

This report suggests the following measures of performance. Conspicuously absent from the list is: job count. As the data herein illustrates, the economic development process is job destroying as well as job creating, with patterns that shift over time. Job creation is a residual measure that derives from profitable business births and expansions. If Kansas performs well in the measures below, Kansas will also perform well in terms of job count.

Income Growth

State or regional income growth occurs in some combination of: 1) an increase in the number of people earning income or 2) an increase in the income earned per person. Technically, “economic growth” means a sustained increase in per-person inflation-adjusted income. However, “economic development” can encompass both measures. For example, in many rural parts of Kansas, an absolute growth in income would measure successful economic development even if income measured on a per person basis remained constant. Such an outcome would indicate an increasing density of economic activity, which works as a precursor to the economic conditions that drive higher per-person incomes.

The U.S. Bureau of Economic Analysis regularly reports two measures of income: “gross domestic product by state” and “earnings by place of work.” Gross domestic product is a state-level measure (although the BEA has begun to make GDP calculations for metropolitan areas). The earnings-by-place-of-work measure offers a county-level measure useful for assessing the many regional economies of Kansas.

Population Density and Population Migration

Measuring economic development strictly by income has important limitations—particularly when the measurement focuses on sub-state regions. Put in simplest terms, people often trade quality of life for income, so the growth in income or the levels of income per person may embody such trade-offs.

Measuring the change in population (or employment) density and the prevailing trend of population migration offer measures that avoid the ambiguities associated with sub-state income measures. Growing population density and net population in-migration offer clear measures of growing regional economies (and vice versa). The U.S. Internal Revenue Service compiles data annually on the county-to-county migration patterns in the United States.²²

Productivity

Productivity growth is the ultimate goal of economic development. Productivity growth—the volume and value of output per worker—drives the growth of wages and wealth. Productivity growth results from a risky trial and error process on the front lines of individual businesses, which is why Kansas economic development strategy should focus on embracing dynamism—a focus virtually indistinguishable from widespread business investment and risk-taking.

Productivity growth tends to happen in geographic areas characterized by density. This pattern shows up in Kansas. The dense population centers demonstrate superior productivity growth. Tracking the patterns of productivity growth across the geography of Kansas will offer an approximate measure of successful economic development across the regions of Kansas.

Capital Investment

The act of investment by Kansas businesses must precede sustainable increases in productivity. From a business perspective, expected rates of return drive investment decisions. Most of the economic development programs offered to businesses in Kansas work to help improve the expected rate of return on business

²² For a sample of population migration patterns in Kansas, see Arthur P. Hall, et al., “The County-to-County Migration Patterns of Kansas Taxpayers, 1985-2004,” Kansas, Inc. Research Report, October 2006. Also see, Arthur P. Hall, et al., “The County-to-County Migration of Taxpayers and Their Incomes, 1995-2006,” Technical Report 09-0306, Center for Applied Economics, University of Kansas School of Business, March 2009.

investment. But these programs tend to be selective rather than broad-based, and therefore work against the driving force of dynamism articulated in this report.

Every business matters. Establishing policies that increase the expected rate of return on investment for all businesses, without bias, works with the driving force of dynamism. A measurable increase in the rate of capital investment in Kansas offers a clear signal that Kansas has established a sound strategy related to economic development.

The U.S. Census Bureau regularly undertakes a state-level survey of manufacturing investment. Otherwise, investment data on state-level investment patterns is not readily available. The state government of Kansas could fill this void with its own, broader-based survey program—a program modeled after the Annual Capital Expenditures Survey conducted for the nation by the U.S. Census Bureau.

Gross Business Starts and Expansions

On average, each year in Kansas, about 7,000 businesses start; 6,750 close; 18,750 expand; and 17,950 contract. This tight symmetry of birth-death and expansion-contraction characterizes all parts of the U.S. economy. Failure, though unfortunate, represents a vital part of the evolutionary process related to sustainable economic development (and productivity growth).

A strategy of embracing dynamism must look beyond the failures (and, thereby, the net number of new business) and focus on the gross volume of business starts and expansions. A higher gross volume of business starts and expansion will mean more people have selected Kansas as the “platform” of choice to risk their time and treasure—a clear signal that Kansas has established a sound strategy related to economic development.

Customer Service and Throughput Measures of State Economic Development Agencies

As discussed in the Recommendations section, the strategy of embracing dynamism suggested by this report recommends that state resources be shifted away from the management of incentive programs and towards a package of hands-on business-assistance services that induce business formation by lowering the cost of business birth and expansion. The state’s economic development agencies should evaluate themselves as service business from the perspective of their clients. A substantial amount of this type of measurement occurs now. A strategy of embracing dynamism seeks to dramatically expand the volume of the client throughput while increasing customer-service measures related to program quality. (For example, the Kansas Small Business Development Center, which currently operates a network of 19 offices around the state, coaches at least 2,000 small business clients annually. Client evaluations indicate a high level of satisfaction with the services offered by the Center. Maintaining current levels of customer satisfaction at double the throughput rate would signal strong progress toward a model of embracing dynamism.)

Recommendations

The following set of recommendations endeavor to capture the spirit of an “economic development model” consistent with: 1) a strategy of embracing dynamism and 2) the prevailing spirit of Kansas law. The set of recommendations illustrates a prototype model that allows Kansas to remain a strong competitor against other states in the competition for economic development while shifting the policy emphasis from “targeting” to “embracing dynamism” in a manner that offers logical consistency, simplicity, transparency, and equality.

The recommendations strive to make a clear distinction between “incentives” and “business assistance.” Incentives should become automatic and available to all businesses equally. Assistance should focus on getting new businesses up and running as quickly and cost-effectively as possible (consistent with community standards of health, safety, and environmental stewardship). Generally, business assistance breaks down into two categories: 1) Kansans seeking to start new business ventures and 2) existing businesses that have decided to expand their operations within or into Kansas.²³

Recommendation #1: Replace the following list of state-level economic development incentive programs and investment-related tax credits with the following three policies (which assume the continuation of the property tax exemption for machinery and equipment, the elimination of the business franchise tax, and the elimination of the estate tax).

This recommendation illustrates a prototype set of specific changes to current law that capture the vision related to embracing dynamism. Naturally, other combinations of specific changes could work too. Consistent with the vision, the key ingredients of any combination should:

- Provide a set of transparent and predictable policies that induce business experimentation via investment and risk-taking.
- Allow access by all current or future Kansas businesses equally and automatically with minimal compliance costs (for both businesses and state government agencies).

Implementation of this recommendation will allow every Kansas business to receive an economically sound package of “incentives” to help underwrite their success but it will eliminate the opportunity for select businesses to receive a huge incentive package. More specifically, as sound tax policy, implementation of this recommendation will have four benefits: First, it will honor the perspective that every business matters. Second, it will provide an attractive—yet transparent and logically consistent—set of incentives for Kansas to remain competitive with other states. The more stable and predictable the state government can make the policy environment the more the state government can help induce business formation and expansion: uncertainty works against risk-taking and investment. Third, it will eliminate the need for businesses and state government to pay for needless negotiation and recordkeeping (outside of the normal process of tax compliance). Fourth, it establishes a set of policies that induces business formation and expansion while minimizing the downside risk from a state government budget (taxpayer) perspective.

Prototype Plan Would Implement These Three Policies:

- A. Implement a system of 100 percent accelerated depreciation for all capital investments—equipment and structures—made in Kansas (a tax policy known as “expensing”).²⁴ This recommendation became one component of the 2007 Kansas Economic Development Strategic Plan (p. 53). HB 2751 (2008 Session) captures the practical implementation of this idea, which offers expensing as a mutually-exclusive option to the many investment-related tax credits available in current law.

²³ For a set of recommendations related to technology-based economic development that complement the recommendations herein, see: Arthur P. Hall and Lee Lewellen, “Technology-Based Economic Development in Kansas: Issues, Opportunities, and Strategies,” Kansas, Inc. Research Report, December 2009. (<http://www.kansasinc.org/pubs/working/tbedks10.27.09.pdf>)

²⁴ For a detail explanation of this policy, see: Arthur P. Hall, “Expensing: A Competitive Leap for Kansas Tax Policy,” Technical Brief 07-0903, Center for Applied Economics, University of Kansas School of Business, September 2007. (http://www.business.ku.edu/_FileLibrary/PageFile/277/CAE--Expensing.pdf).

The option approach articulated in HB 2751 remains a viable alternative, if Kansans prefer it. This report recommends the replacement approach as a means to streamline and simplify Kansas law in a manner commensurate with the vision of embracing dynamism.

Appendix A provides a more detailed discussion of expensing (as implemented by HB 2751). Expensing shifts the time value of money from the state government to businesses undertaking investment. That shift explains the economic development “incentive” built into the recommendation; it improves the expected rate of return on every investment. Every investment-related tax credit works as an “incentive” for the same reason—they work to improve the expected rate of return on the investments they target. This recommendation seeks to make the “incentive” logically consistent and universally available rather than *ad hoc*. Expensing provides equal treatment for all investments across businesses of all sizes while simultaneously placing a logical limit on the state government’s budgetary exposure. With expensing, the state government’s return on investment will equal the business’s return on investment, so the state no longer needs to spend resources evaluating the return on investment—at least not for the current programs, listed on pages 25-27.

As drafted, HB 2751 applies to tangible assets only. The structure of expensing can also capture investment in research and development and intangible assets, like intellectual property or the going-concern value (“goodwill”) of a business. Inclusion of such items can create some measure of complexity but they can have strong economic development benefits for the same reasons discussed above related to the time value of money. Intangible assets should receive consideration for inclusion in any well-crafted expensing policy.

- B. Allow all new business firms (and new business establishments from expanding firms) started in Kansas to retain 100 percent of their payroll withholding tax for the first 12 months of operation upon hiring the business’s first non-owner employee(s). This idea expands and generalizes the Promoting Employment Across Kansas program enacted by the Legislature in 2009 (SB 97). Other Kansas economic development programs also use the mechanism of allowing businesses to retain some portion of payroll withholding taxes. This procedure offers a relatively efficient administrative mechanism for allocating incentives related to employment, a mechanism consistent with making incentives automatic.

A strategy of embracing dynamism places stress on business experimentation by emphasizing business birth and expansion. This recommendation will help induce risk-taking on the formation of new business establishments. It complements the investment-related expensing recommendation by helping to underwrite job creation (and labor intensive establishments) in a manner that offers an automatic procedure to help all new businesses with one of their biggest challenges: cash flow. Implementation of this idea will require well-defined compliance and administrative procedures on the part of the Kansas Department of Revenue to prevent fraud or manipulation by those that may attempt to portray on-going business concerns as “new.”

- C. Exempt from capital gains taxation the proceeds from the sale of Kansas-based business assets and Kansas-based business enterprises (and the equity investors in said business enterprises that must pay Kansas income taxes). The law should not set a minimum holding period for taxpayers to qualify for the exemption. A strategy that promotes dynamism should not create any tax-induced barriers to the sale of business assets or businesses. The state of Kansas should not discourage serial entrepreneurs (and their investors) from starting businesses and selling them (or the equity shares) to others.

An income tax on capital gains is economically equivalent to a transactions tax on the allocation of venture capital and the exchange of capital investments. Accordingly, elimination of the income tax on capital gains assists a strategy of embracing dynamism: to promote entrepreneurship and innovation both within and among Kansas businesses by inducing the maximum amount of business experimentation at the least possible cost. The free-flow of capital trying to find its best possible deployment drives a vibrant, innovative economy. Successful entrepreneurs quit as quickly as possible the projects that they perceive as losers and pursue new projects that they perceive as winners. Often, because of different visions and skill-sets, one entrepreneur’s perceived loser is another entrepreneur’s perceived winner. A tax on capital gains, because of its economic attributes, unduly increases the cost of this vital discovery process.

An income tax on capital gains is also economically equivalent to a tax on the returns to entrepreneurial risk-taking. A strategy seeking to induce as much business experimentation as possible should allow entrepreneurs—and their investors—to (automatically) realize the maximum upside of implementing their

ideas. Harvard Business School professors Paul A. Gompers and Josh Lerner, leading scholars on the venture capital industry, discovered that:

Capital gains tax rates have a significant effect at the industry, state, and firm levels. Decreases in the capital gains tax rates are associated with greater venture capital commitments. *The effect, however, appears to occur through the demand for venture capital:* rate changes affect both taxable and tax-exempt investors. Similarly, R&D expenditures, especially expenditures by industrial firms, are positively related to venture investments in particular states.²⁵

Prototype Plan Would Eliminate These Programs and Tax Credits (*but grandfather current participants*):

Programs	Description and Average Assistance (2002-2006)*	Reason(s) for Recommended Elimination
Kansas Industrial Training (KIT)	<ul style="list-style-type: none"> For companies involved in “net new job” creation. Average firms helped per year: 43 Average dollar allocation per year: \$1.6 million 	<ul style="list-style-type: none"> As Figure 3 makes clear, there is no way to know what businesses will be responsible for “net new jobs” from a Kansas perspective. The per-business average of \$37,200 can be reallocated to underwrite policies that help thousands of businesses per year—automatically, with no management expense.
Kansas Industrial Retraining (KIR)	<ul style="list-style-type: none"> For companies involved in restructuring or retraining their workforce. Average firms helped per year: 56 Average dollar allocation per year: \$1.6 million 	<ul style="list-style-type: none"> The expensing provision will automatically apply to key restructuring-based requirements of this program. The per-business average of \$28,200 can be reallocated to underwrite the assistance inherent in Recommendations #2 and #4 of this report.
Investments in Major Projects and Comprehensive Training (IMPACT)	<ul style="list-style-type: none"> Financial assistance to new and expanding businesses that are creating or retraining a large number of jobs paying higher than the average wages. Operates by allowing firms to retain state withholding taxes, as per item B in this recommendation. Average firms helped per year: 9 Average dollar allocation per year: \$16.7 million 	<ul style="list-style-type: none"> The expensing provision will automatically apply to a substantial amount of the investment activity related to this program—automatically, with no management expense. New establishments will be eligible to retain 100% of first-year withholding taxes, per item B of this recommendation—automatically, with no management expense. As indicated by Figure 4 of this report, an abundance of small suppliers is a good predictor of future growth. Large firms are attracted to areas of economic dynamism. The per-business average of \$1,855,555 can be reallocated to underwrite policies that help thousands of businesses per year, including the assistance inherent in Recommendations #2 and #4 of this report.
Kansas Economic Opportunity Initiative Fund	<ul style="list-style-type: none"> Financial assistance to a business that may have substantial impact on the Kansas economy, as determined by the Department of Commerce. Average firms helped per year: 15 Average dollar allocation per year: \$1.6 million 	<ul style="list-style-type: none"> All reasons stated for the previous three programs. (\$106,700 per-business average)
Kansas Enterprise Zone	<ul style="list-style-type: none"> Designed to encourage businesses to create new jobs. No operating details available. 	<ul style="list-style-type: none"> The combined effect of this recommendation (items A, B, C) will make the entire state of Kansas an enterprise zone.

²⁵ Paul A. Gompers and Josh Lerner, “What Drives Venture Capital Fundraising?” *Brookings Papers on Economic Activity—Microeconomics*, 1998, p. 150. Emphasis added.

<p>Sales Tax Revenue (STAR) Bonds (State participation)</p>	<ul style="list-style-type: none"> • Sales Tax Revenue (STAR) Bonds provide Kansas municipalities the opportunity to issue bonds to finance the development of major commercial, entertainment and tourism areas and use the sales tax revenue generated by the development to pay off the bonds. 	<ul style="list-style-type: none"> • STAR bonds establish taxpayers as a non-recourse lender in a commercial venture. Evidence indicates that Kansas can attract financing to develop worthy commercial, entertainment, and tourism areas. They are businesses like other businesses. Items A, B, and C of this recommendation will help improve the financial viability of any project (and eliminating state participation in STAR bonds will allow the state to retain sales tax revenue to help underwrite Recommendations #1 through #4 of this report): • The expensing provision will automatically apply to all investments related to a development. Taxpayers share in the investment when the project is a success; they are not exposed if the project fails. • All business establishments that may populate a development—and thereby help make it economically viable—will be eligible for the expensing provision and the ability to retain first-year withholding taxes.
<p>* <i>Kansas, Inc.'s "Evaluation of the Kansas Department of Commerce," November 2007, p. 29</i></p>		

Tax Credits	Description and 2007 Number of Filers and Fiscal Note*	Reason(s) for Recommended Elimination
High Performance Incentive Program Credits	<ul style="list-style-type: none"> • An investment tax credit of 10% for investments above \$50,000 and credit for training up to \$50,000. • Filers: 133 • Fiscal note: \$37.4 million 	Expensing achieves the same goal as the investment tax credit (the driving force of HPIP). True, expensing is less valuable for those taxpayers that qualify for HPIP by approximately three percentage points, but it is available to all business—automatically without management expense.
Business and Job Development Credit	<ul style="list-style-type: none"> • A 1% investment tax credit and a specified dollar credit for certain job counts. • Filers: 567 • Fiscal note: \$11.3 million 	Expensing achieves the same goal as the investment tax credit (with greater expected taxpayer value) and the first-year retention of withholding taxes achieves the same goal as the jobs credit.
Biomass-to-Energy Credit	<ul style="list-style-type: none"> • 10% tax credit for building or expanding a facility. • Filers: 0 • Fiscal note: \$0 	Expensing automatically applies to this type of investment.
Electric Cogeneration Facility Credit	<ul style="list-style-type: none"> • 10% tax credit for first \$250 million of Investment; 5% for amounts above \$250 million; must take credit in 10 annual installments. • Filers: 0 • Fiscal note: \$0 	Expensing automatically applies to this type of investment.
Environmental Compliance Credit	<ul style="list-style-type: none"> • 100% tax credit for refineries to meet environmental regulations. • Filers: 0 • Fiscal note: \$0 	Expensing automatically applies to this type of investment.
Alternative-Fuel Tax Credit (businesses not individuals)	<ul style="list-style-type: none"> • Allows for a credit for the establishment of alternative-fuel fueling stations. • Filers: 68 • Fiscal note: \$163,703 	Expensing automatically applies to this type of investment.
Integrated Coal Gasification Power Plant Credit	<ul style="list-style-type: none"> • 10% tax credit for first \$250 million of Investment; 5% for amounts above \$250 million; must take credit in 10 annual installments. • Filers: 0 • Fiscal note: \$0 	Expensing automatically applies to this type of investment.

Nitrogen Fertilizer Plant Credit	<ul style="list-style-type: none"> • 10% tax credit for first \$250 million of Investment; 5% for amounts above \$250 million; must take credit in 10 annual installments. • Filers: 0 • Fiscal note: \$0 	Expensing automatically applies to this type of investment.
Petroleum Refinery Credit	<ul style="list-style-type: none"> • 10% tax credit for first \$250 million of Investment; 5% for amounts above \$250 million; must take credit in 10 annual installments. • Filers: less than 5 • Fiscal note: confidential 	Expensing automatically applies to this type of investment.
Qualifying Pipeline Credit	<ul style="list-style-type: none"> • 10% tax credit for first \$250 million of Investment; 5% for amounts above \$250 million; must take credit in 10 annual installments. • Filers: 0 • Fiscal note: \$0 	Expensing automatically applies to this type of investment.
Storage and Blending Equipment Credit	<ul style="list-style-type: none"> • 10% tax credit for first \$10 million of Investment; 5% for amounts above \$10 million; must take credit in 10 annual installments. • Filers: 0 • Fiscal note: \$0 	Expensing automatically applies to this type of investment.
Swine Facility Improvement Credit	<ul style="list-style-type: none"> • Tax credit for capital improvements. • Filers: 0 • Fiscal note: \$0 	Expensing automatically applies to this type of investment.
Research and Development Credit	<ul style="list-style-type: none"> • 6.5% tax credit for expenditures made for qualifying research and development activities. • Filers: 179 • Fiscal note: \$2.3 million 	<ul style="list-style-type: none"> • Expensing automatically applies to any capital expenditures related to R&D. • Labor costs are already available for expensing. • As mentioned above, certain intangible assets should be evaluated for inclusion in the expensing provision.
Angel Investor Credit	<ul style="list-style-type: none"> • Tax credit of 50% for equity investments in firms pre-qualified by the Kansas Technology Enterprise Corporation, with a maximum credit of \$250,000 per taxpayer. • Filers: 68 • Fiscal note: \$1.1 million 	<ul style="list-style-type: none"> • Evidence presented in Kansas, Inc. report "Technology-Based Economic Development in Kansas" indicates that good business ideas in Kansas can attract capital. • The Angel Credit is a good tool. But elimination of capital gains taxation is similar and better: All investments qualify without the requirement of pre-qualification. It moves the investment "incentive" from the front end to the back end of all venture investment (so Kansas taxpayers effectively participate in the successful ventures not the unsuccessful ones).
*Legislative Post Audit, "Kansas Tax Revenues, Part I: Reviewing Tax Credits," February 2010, pp. 17-20.		

Recommendation #2: With the resources made available by eliminating the menu of current state-level economic development programs and tax credits from Recommendation #1, the Department of Commerce should focus its resources on developing the most cost-effective economic development ombudsman program in the nation.

This recommendation relates primarily to established businesses in expansion mode. (Recommendation #4 deals with assistance activities related to new businesses.) Department of Commerce personnel already engage in much of the activity suggested by this recommendation.

A strategy of embracing dynamism does not imply that Kansas should stop promoting itself to the world as a first-class platform from which to operate a business. Nor does it suggest that the focus of economic development policy should shift from a concentration on large-employer businesses (which is the current focus, intended or not) to small businesses. Instead, the recommended shift in strategy aims to establish a better value proposition from the perspective of all businesses. This particular recommendation emphasizes a greater focus on creating valuable business service for large-employer businesses instead of a focus on negotiation and compliance related to business incentives. An ombudsman will act as a dedicated service representative to expanding businesses.

The ombudsman program should excel at:

- Site location consulting and positive relations with the community of professional site locators.
- Permit acquisition and compliance, which implies a liaison role with all permitting agencies.
- Physical infrastructure planning.
- Minimizing the time and cost of starting (or opening) a new business or operation.

Recommendation #3: Statutorily name the Secretary of Commerce to serve as the chair of the Board of Directors of the Kansas Enterprise Technology Corporation, Kansas Bioscience Authority, Network Kansas; and the chair of the Advisory Board of the Small Business Development Center. Make the Secretary of Commerce a non-voting member of the Kansas, Inc. Board of Directors.

Over the past two decades, Kansas has chosen to build an economic development model that primarily relies on free-standing agencies governed by independent Boards of Directors. This model offers a sound operational foundation: it provides for strong stakeholder input and offers continuity in the context of the transient executive leadership inherent to the state government of Kansas. However, the Governor's Office may not have a degree of influence over the operation of the overall model commensurate with its presumed level of accountability. Figure 8 provides a snapshot of the current economic development model in Kansas.

Kansas, Inc., established in 1986 in connection with the Redwood-Krider report, was created to operate as the primary coordinating agency, as indicated by the statutory appointment of the Governor to co-chair the Board of Directors. The original vision for Kansas, Inc. remains sound: it is an independent, public-private instrumentality responsible for crafting research-driven economic development policy ideas and monitoring the effectiveness of the ideas (and delivery models) that the state implements. Kansas, Inc. is the only agency in the state in which the sitting Governor is statutorily appointed to co-chair the Board of Directors. This appointment is intended to facilitate coordination across industries and agencies, and to put executive strength behind the Kansas, Inc. evaluations of other economic development agencies—including the Department of Commerce, which is why the recommendation acknowledges the importance of the Secretary of Commerce serving on the Kansas, Inc. Board but suggests removing the Secretary's current voting privileges.

The Department of Commerce, as inferred from a reading of economic development-related statutes, holds the position in the state's model as the lead agency with regard to the implementation of economic development policy. Yet the Department of Commerce appears as an oddity in the Kansas economic development model. It is the only executive agency and it has limited official means to act as the lead economic development agency with respect to the Board-directed agencies.

The current model presumes that the agencies will undertake effective voluntarily coordination. Agency evaluations by Kansas, Inc. indicate that some cooperation takes place. However, the evaluations also indicate that the agencies operate too much as independent “silos.”

Aside from the power of appointment to Boards, the Governor of Kansas has no formal mechanism to direct the focus and coordination of the agencies based on state strategies or shifting priorities. Naming the Secretary of Commerce as the chair of each of the Boards of the free-standing agencies offers a simple step that can:

1. Formalize the somewhat informal presumption that the Department of Commerce acts as the lead economic development agency (under the direction of the Governor).
2. Maintain the continuity of purpose offered by agencies under the direction of independent Boards.
3. Provide a management model capable of evaluating and motivating continuity and coordination of action from a statewide policy perspective.
4. Improve accountability to the citizens of Kansas through the oversight functions provided by their elected state representatives.

Figure 8: Current Economic Development “Model”

Kansas, Inc.
<ul style="list-style-type: none"> • Strategic Planning, Policy Development, Agency Evaluation • 3 FTEs, \$350,000 Budget (excludes Information Network of KS) • 17 Member Governing Board <ul style="list-style-type: none"> ○ Governor = Co-Chair by Statute ○ Secretary of Commerce has seat on Board ○ Specific industries must have Board representation
Department of Commerce
<ul style="list-style-type: none"> • Business Development, Trade Development, Rural Development, Travel & Tourism, Operations, Workforce Services • 301 FTEs, \$109.5 Million Budget • Workforce Services is about 95% federally funded and represents about 60% of FTEs and 56% of budget. • Regional and International Offices • Cabinet Secretary
Kansas Technology Enterprise Corporation
<ul style="list-style-type: none"> • Venture Funding, Research Funding, Entrepreneurship Support • 13 FTEs, \$12.7 Million Budget (about 18% federally funded) • Affiliated Regional Business Incubators • 20 Member Governing Board <ul style="list-style-type: none"> ○ Governor has a seat on Board, participation optional ○ Specific industries must have Board representation
Kansas Bioscience Authority
<ul style="list-style-type: none"> • Venture Funding, Research Funding, Entrepreneurship Support • 18 FTEs, Approximately \$45 Million Budget • 11 Member Governing Board <ul style="list-style-type: none"> ○ Governor has appointment authority only ○ Specific industries must have Board representation
Network Kansas
<ul style="list-style-type: none"> • Information Clearinghouse, Entrepreneurship Support • 5 FTEs, \$400,000 Budget (via Commerce) • 11 Member Governing Board <ul style="list-style-type: none"> ○ Secretary of Commerce has appointment authority ○ Specific industries must have Board representation
Small Business Development Center
<ul style="list-style-type: none"> • Business Consulting and Management Training • 37 FTEs, \$1.2 Million Budget (40%) from State (via Commerce) • Regional Offices • 16 Member Board of Advisors

Sources: Governor’s Budget (2009 actual, all funding sources); Agency web sites and Annual Reports.

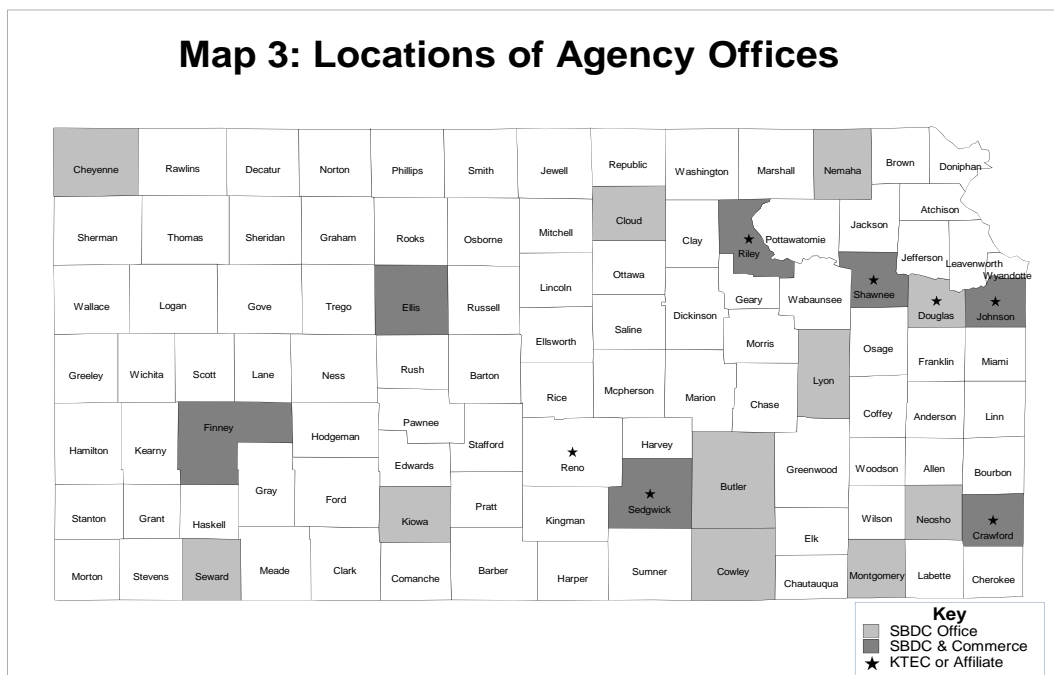
Recommendation #4: Develop a task force to better align and manage the resources, activities, and geographical accessibility of the regional components of the Kansas economic development model. The end goal, as suggested by a strategy of embracing dynamism, should be to create a nationally-recognized system of business consulting, training, networking, and incubation services to induce as much business formation and expansion as possible—in the context of the many unique regional economies in Kansas.

The strategy of embracing dynamism places stress on the many hands-on business services related to inducing business start-ups and expansions. These services are captured by the:

- Small Business Development Center offices that provide business consulting and training services to thousands of current and aspiring small business owners.
- Network Kansas Entrepreneurial Communities (“E-Communities”) Partnerships that strive to “create a more entrepreneurial environment in each community.”
- Department of Commerce regional offices—especially in the context of Commerce’s Rural Development Division and Trade Development Division. According to the Department of Commerce, the “Rural Development Division is designed to elevate Commerce’s focus on rural development and encourage seamless collaboration among existing rural development organizations. The Division comprises an array of technical and financial assistance programs and services for rural developers and agricultural producers.” The Trade Development Division “provides individualized counseling and expertise to Kansas companies expanding their export markets.”
- The regional business incubators affiliated with the Kansas Technology Enterprise Corporation—including Pipeline (a creative entrepreneurship fellowship program).

These services are inherent to the “platform-caretaker” approach to economic development. They should receive sound and stable funding and be available conveniently to Kansans in all regions of the state—so as to help induce as much commercial experimentation as possible. These services should excel at providing: core strategy analysis, understanding market dynamics, systems thinking, finance tools, research tools, business transitions, compliance, database searching, and geographical information systems.

Map 3 shows the current geography associated with the Kansas economic development agencies. The recommendation defers to a task force to better synthesize the activity implied by Map 3 because the large number of people involved will have the best knowledge about how existing resources can be better used to improve the cost-effectiveness and overall quality—on a regional basis—of the full package of services provided.



Appendix A: Reprint of Legislative Testimony on HB 2751 (2008 Session)

Implementation of Expensing in Kansas: A Primer on the Expensing Proposal in the Kansas, Inc. Strategic Plan

Prepared for Kansas, Inc. by
Art Hall, Executive Director
Center for Applied Economics, KU School of Business

Presented to the House Committee on Taxation
February 5, 2008

Overarching Goals:

- Every business matters—strive for inclusive policies and a level playing field among businesses of all types and sizes.
- Build on the pro-investment initiatives passed in recent legislative sessions—namely, the exclusion of business machinery and equipment from property taxation and the phase-out of the franchise tax. These policies apply to all businesses equally—and automatically.
- Minimize the cost and complexity of accessing pro-investment tax policies. Kansas, Inc. proposes expensing as an automatic **option** in lieu of other, select investment tax credits, which typically have restrictions or require application procedures with state agencies.

What is “Expensing”?

- Expensing is a procedure related to the calculation of business income tax. Whenever a business makes a capital investment (whether equipment or structure), it is allowed to take a deduction against income tax for the depreciation of the investment. Expensing is one form of depreciation deduction. Expensing allows for an immediate deduction of the full investment amount instead of requiring a prescribed schedule of smaller deductions over multiple years.
- Expensing is a pro-investment tax policy that does not subsidize businesses. Expensing improves the expected rate of return on almost any investment relative to other types of depreciation procedures, because it allows the taxpayer to capture the time value of money embedded in the investment. Importantly, from a tax policy perspective, expensing generates a higher expected investment return by removing a tax bias built into the current depreciation rules rather than granting the business taxpayer a special privilege.
- Expensing, properly implemented, is a tax policy that treats *all* businesses equally. By allowing business taxpayers to capture the time value of money related to an investment, expensing results in uniform income tax treatment for investments of all types and sizes, given the tax rate faced by the business taxpayer.

What is the Kansas, Inc. Proposal?

- Kansas, Inc. suggests that Kansas, as of date certain, offer business taxpayers the automatic **option** of choosing to expense capital investments made within the state. This policy change will make Kansas unique among the states (with income taxes).
- Kansas, Inc. suggests that the expensing proposal offer business taxpayers a **mutually-exclusive option** between expensing and other investment-related tax credits available under Kansas law. The table below lists those tax credits that a Kansas taxpayer could not take on a particular investment if they choose the expensing option for that investment.

Taxpayer Option: Automatically Expense an Investment or Take the Allowable Tax Credit(s)

Type of Credit	2004 Process Year		2006 Process Year	
	Returns	Dollars	Returns	Dollars
Alternative-Fuel Tax Credit (K-62)*	15	12,000	68	54,793
Business and Job Development Credit (K-34)	1,193	8,485,000	2,114	14,046,665
Cellulosic Alcohol Plant Credit (K-79)	n/a	n/a	n/a	n/a
Disabled Access Credit (K-37)**	9	2,000	6	1,321
Nitrogen Fertilizer Plant Credit (K-78)	n/a	n/a	n/a	n/a
High Performance Incentive Program Credits (K-59)	276	16,993,000	1,265	24,098,727
Integrated Coal Gasification Power Plant Credit (K-80)	n/a	n/a	n/a	n/a
Petroleum Refinery Credit (K-73)	n/a	n/a	n/a	n/a
Qualifying Pipeline Credit (K-77)	n/a	n/a	n/a	n/a
Research and Development Credit (K-53)***	154	554,000	223	833,891
Swine Facility Improvement Credit (K-38)	0	0	0	0
Environmental Compliance Credit (K-81)	New in 2007			
Electric Cogeneration Facility Credit (K-83)	New in 2008			
Storage and Blending Equipment Credit (K-82)	New in 2008			
Total	1,647	26,046,000	3,676	39,035,397

* Any business investment in a vehicle or fueling station would naturally fall under the procedures for expensing.

** Business property modifications would naturally fall under the procedures for expensing; household modifications would not. The dollar figure represents corporate returns only.

*** Expensing would apply to the machinery and equipment component of this credit only.

Source: Kansas Department of Revenue

**Many Businesses in Growth Mode Apparently Do Not Seek Credits
Estimated Number of Kansas Businesses Starting Up or Expanding, 1994-2004**

Year	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	Average
Birth	13,644	8,603	13,229	8,894	10,835	8,843	11,860	18,028	14,984	8,780	9,502	11,564
Expand	2,831	5,051	5,576	6,230	6,699	7,370	4,669	5,779	4,980	5,213	6,067	5,497
Total	16,475	13,654	18,805	15,124	17,534	16,213	16,529	23,807	19,964	13,993	15,569	17,061

Other Important Features of the Kansas, Inc Proposal

- *Definition of eligibility:* The cost of any tangible asset, including fabrication and installation, that is, or under the federal internal revenue code will become, eligible for depreciation, amortization, or accelerated cost recovery for federal income tax purposes.
- Unlimited carry forward of unused balances.
- Taxpayers may elect the expensing deduction on an asset-by-asset basis.
- For multi-state taxpayers, the expensing deduction is directly allocable to Kansas income and not subject to apportionment.
- Recapture rules for taxpayers that buy eligible property and move it out of Kansas.
- Rules for calculating the gain or loss of an asset that has been expensed and subsequently sold.
- Expensing, because it is a deduction, automatically applies to a "consolidated group" under current Kansas law.

How Does Expensing Compare with Investment Tax Credits?

- Expensing is an “above the line” deduction from taxable income. The economic value of an income tax deduction equals the deduction amount times the tax rate.
- An investment tax credit is a “below the line” subtraction from income tax liability. The economic value of an income tax credit equals the investment amount times the tax credit percentage.
- All else equal, if a taxpayer faces an income tax rate of 10%, the expensing option and a 10% investment tax credit will have the same economic value.

Comparison of Expensing and Tax Credits Hypothetical Business Operating Solely within Kansas

Assume a \$100,000 Investment in 7-Year Property

Examples:

Furniture and fixtures for a call center
Agricultural machinery
A new natural gas gathering pipeline
Manufacturing equipment for many industries

	Year 1 Income Tax Calculation		
	Full Expensing	Kansas, Inc. Expensing	HPIP Tax Credit
Gross Receipts	500,000	500,000	500,000
Less: Cost of Goods Sold	310,000	310,000	310,000
Less: Federal Depreciation (on above investment)	14,290	14,290	14,290
Equals: Net Profit (Federal Taxable Income)	175,710	175,710	175,710
Plus: Kansas Additions to Federal Taxable Income	0	0	0
Less: Kansas Deductions from Federal Taxable Income	0	0	0
Equals: Apportionable Business Income to Kansas	175,710	175,710	175,710
Less: Kansas Expensing Deduction	100,000	22,300 *	0
Equals: Kansas Taxable Income	75,710	153,410	175,710
Kansas Income Tax (at 4% + 3.35% Surtax over \$50,000)	3,928	9,756	11,428
Less: HPIP Tax Credit (10%)	0	0	5,000
Equals: Kansas Tax Liability	3,928	9,756	6,428

* The adjustment factor is explained below: "What is the Kansas, Inc. Solution for Implementing Expensing?"

**Expected Rate of Return on Identical Hypothetical Investments
(7-Year Property, Full Value of Incentive Captured in Year 1)**

	\$1 Million Investment	\$100,000 Investment	\$50,000 Investment
No Credit or Expensing	9.20%	9.20%	9.20%
Full Expensing (7.35% Tax Rate)	11.28%	11.28%	11.28%
Kansas Inc. Expensing (7.35% Tax Rate)	9.78%	9.78%	9.78%
HPIP Investment Credit	11.92%	10.60%	9.20%
Business & Jobs Credit (Rural, 5 Jobs)	9.20% (9.82%)	9.20% (13.14%)	9.20% (17.27%)

Formulas for Calculating Taxpayer Value

Full Expensing	Investment Amount x Tax Rate
Kansas, Inc. Expensing	Investment Amount x Kansas Adjustment Factor x Tax Rate
HPIP Investment Tax Credit	(Qualifying Investment Expenditure - \$50,000) x 10%
Business & Jobs Credit	(Qualifying Investment Expenditure x 1%) + (Number of qualifying employees x credit per employee)

What is the Kansas, Inc. Solution for Implementing Expensing?

Kansas, like many states, piggybacks on the procedures in the federal income tax code. This fact makes the implementation of expensing in Kansas slightly more complicated than it would be at the federal level. In brief, it would require a Kansas business tax preparer to spend about 5-10 minutes to perform one additional calculation.

The purpose of the additional calculation is to keep undisturbed the Kansas procedure of using federal taxable income as the starting point for Kansas corporate income tax calculations (and federal adjusted gross income as the starting point for proprietorships, partnerships, and S-Corporations). These starting-point measures of income already have federal depreciation built in. The Kansas, Inc. expensing proposal does not seek to double-count the federal deductions; it seeks to allow Kansas business electing the expensing option to capture the additional time value of money generated by expensing.

An Example

- Federal depreciation procedures rely on a set of prescribed rules.
- When a business taxpayer makes a capital investment, the tax preparer must make a decision about (1) how to classify the property for depreciation purposes and (2) what depreciation method to use. Once the tax preparer makes those decisions, all of the details about the depreciation schedule become known.
- Kansas, Inc.'s suggested implementation plan for expensing in Kansas relies on the decision that the tax preparer makes for federal depreciation purposes.

Acme Call Centers has a state-of-the-art facility in Hays, Kansas. Acme purchases \$100,000 worth of new furniture to expand its call center. The CFO of Acme knows that furniture is classified as a 7-year form of property for federal depreciation purposes. She decides to use the 200% Declining Balance depreciation method (employing the half-year convention).

Acme Call Centers' Federal Depreciation Deduction Schedule								
Year	1	2	3	4	5	6	7	8
Amount (\$)	14,290	24,490	17,490	12,490	8,930	8,920	8,930	4,460

- Kansas expensing amount if there were no federal depreciation rules: \$100,000
- Kansas expensing amount under Kansas, Inc. proposal: $\$100,000 \times 0.223 = \$22,300$.

The Kansas, Inc. proposal would provide Acme an additional \$22,300 income tax deduction—in Year 1 only. That amount captures the time value of money difference between the federal depreciation schedule and the full expensing amount of \$100,000.

Where did the 0.223 number come from? It was (hypothetically) published by the Kansas Department of Revenue. It was calculated by taking the difference between the investment amount (\$100,000, in this case) and the discounted present value of the federal depreciation schedule (years 2-8) using an interest rate of eight percent (8%). Mathematically, the adjustment factor of 0.223 remains invariant for any investment in 7-year property that a taxpayer depreciates using the 200% Declining Balance method under the half-year convention.

The same procedure used in the Acme Call Centers example would apply for any investment made in Kansas. Different adjustment factors would apply to the several different combinations of property classifications and depreciation methods available to taxpayers under the federal tax rules.

What is the Fiscal Note for the Kansas, Inc. Expensing Proposal?

- The table below illustrates a likely range of revenue (tax liability) reductions that would result from implementing the expensing system suggested by Kansas, Inc.—assuming that every business opted to expense its investments.
- The calculations assume that a fully mature expensing system applied to the actual Kansas income tax data recorded for the years 2005 and 2004.
- The estimates do not include the revenue offsets that would result from replacing the tax credits specified above with the expensing option—about \$39 million in 2006.

Estimated Fiscal Note for Kansas, Inc. Expensing Proposal (Assumes a Fully Mature System Applied to Tax Years 2005 and 2004)		
Dollars in Millions	2005	2004
KS Business Income Tax Collections	\$474.4	\$315.1
Fiscal Note Estimates*		
Low Range	44.1	34.5
Medium Range (Likely)	55.1	43.2
High Range	69.1	54.4
* Includes machinery and equipment investments only. If structures are also included, which Kansas, Inc. suggests, add to an estimate: \$35 million for 2005 or \$23.3 million for 2004.		
Source: Center for Applied Economics, KU School of Business using data from the Kansas Department of Revenue, the U.S. Internal Revenue Service, the U.S. Census Bureau, and the U.S. Bureau of Economic Analysis. (The Kansas Department of Revenue reported income and privilege tax collections for corporations and financial institutions. The Center for Applied Economics estimated the income taxes paid by proprietorships, partnerships, and S-Corporations.)		

Methodological Points Related to the Fiscal Note Calculations

- The calculations for machinery and equipment use data compiled for the U.S. by the U.S. Census Bureau's Annual Capital Expenditure Survey. This data is reported for many different industry sectors. Census categorizes capital expenditures as either Equipment or Structures.
- The U.S. Capital Expenditure Survey equipment data is allocated to Kansas, by industry sector, based on the Kansas share of U.S. gross domestic product in each industry sector. In effect, this procedure assumes that Kansas businesses invest at the U.S. average rate, based on value-added. (Note: Based on the data for structures reported by the Kansas Department of Revenue for property tax purposes, as discussed below, this is a conservative assumption, because Kansas invests substantially below what the average rate would suggest.)
- For structures, the fiscal note calculations rely on property tax data collected and reported by the Kansas Department of Revenue; specifically, the appraised value of new commercial and industrial real property placed in service in 2005 and 2004. The U.S. Capital Expenditure Survey data for structures was used to gross-up the new-property amount to account for business investment in "used" structures.
- Capital expenditure amounts are allocated to businesses based on reported income. Guided by IRS data, 5-15 percent of capital expenditure amounts are allocated to businesses with no *taxable* income, depending on industry sector.
- The fiscal note estimates explicitly ignore the limited expensing rules allowed by Section 179 of the federal tax code. Incorporating this element into the calculations would *reduce* the Kansas fiscal note associated with expensing. Public data is too imprecise to warrant including Section 179 elections in the analysis.
- Federal tax rules allow for several choices of depreciation method for equipment-like property. Further, equipment-like property is classified into several categories: 3-, 5-, 7-, 10-, 15-, and 20-years. There is less flexibility regarding structures.

For the equipment calculation, the fiscal note used the 200% Declining Balance method. Under each scenario, utility property was assumed to be 15-year property for depreciation purposes. Otherwise, Low Range assumed 5-year property, Medium Range assumed 7-year property, and High Range assumed 10-year property.

For structures, the fiscal note assumed the straight-line depreciation method. Structures related to commercial residential real estate used a 27.5-year life. All other structures assumed a 39-year life.

A discount rate of eight percent (8%) applied to all adjustment calculations. In each case, year-1 depreciation deductions were not discounted to keep them time-consistent with the full-expensing option.

Appendix B: About the Center for Applied Economics

About the Center for Applied Economics

The mission of the Center for Applied Economics at the University of Kansas School of Business is to help advance the economic development of the state and region by offering economic analysis and economic education relevant for policy makers, community leaders, and other interested citizens. When elected officials, community leaders, and citizens discuss issues that may have an impact on the economic development potential of the state or region, they can benefit from a wide array of perspectives. The Center focuses on the contributions that markets and economic institutions can make to economic development. Because credibility is, in part, a function of economic literacy, the Center also promotes economics education.

Arthur P. Hall
Executive Director
Center for Applied Economics

Art Hall is the founding Executive Director of the Center for Applied Economics at the University of Kansas School of Business. Before joining the KU School of Business, Hall was Chief Economist in the Public Affairs group of Wichita, KS-based Koch Industries, Inc. In that capacity, he worked with business leaders to help define how public policy initiatives would influence the structure of the markets in which the company participates. Koch sponsored Hall's directorship of Kansas Governor Sebelius' Budget Efficiency Savings Teams from April 2003 until his departure from the firm in February 2004.

Before joining Koch Industries in May 1997, Hall was Senior Economist at the Washington, D.C.-based Tax Foundation, where he produced quantitative and qualitative research pertaining to the economics of taxation, and acted as an economic advisor to The National Commission on Economic Growth and Tax Reform. Before that, he worked as a financial economist at the U.S. General Accounting Office. Hall has taught university economics at both the undergraduate and MBA level. He received his Ph.D. in economics from the University of Georgia and his B.A. in economics from Emory University.

Selected Publication List

Academic Journals

"The Challenge of Incentive Alignment in the Application of Information Markets Within an Organization," *The Journal of Prediction Markets*, Vol. 3, No. 1, April 2009, pp. 13-16

Trade Journal Publications

"Investment Climate in the Republic of Kazakhstan," *Tax Notes International*, July 1, 1996, pp. 53-57. (with Daniel A. Witt)

"Compliance Costs of Alternative Tax Systems," *Tax Notes*, May 20, 1996, pp. 1081-1089. (Reprint of Tax Foundation Special Brief (House Ways and Means Committee Testimony), Washington, D.C., March 1996.)

"Issues in the Indexation of Capital Gains," *Tax Notes*, May 1, 1995, pp. 675-678. (Reprint of Tax Foundation Special Report No. 47, Washington, D.C., April 1995.)

"Fifty Years of the Federal Capital Gains Tax Burden," *Tax Notes*, April 24, 1995, pp. 553-562. (Reprint of Tax Foundation Special Report No. 45, Washington, D.C., March 1995.)

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Research Reports

"A Comprehensive Retail Sales Tax as a Single Tax for the State of Kansas," Technical Brief 09-1218, December 2009, Center for Applied Economics, University of Kansas School of Business.

"Technology-Based Economic Development in Kansas: Issues, Opportunities, and Strategies," Kansas, Inc. Research Report, October 2009 (with Lee Lewellen).

"The County-to-County Migration of Taxpayers and their Incomes," Technical Report 09-0360, March 2009, Center for Applied Economics, University of Kansas School of Business (with Scott Moody and Wendy Warcholik).

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"A Brief Economic History of Kansas, 1969-2003," Kansas, Inc. Research Report, August 2005 (with Peter F. Orazem).

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"The Kansas Productivity Puzzle," Center for Applied Economics, School of Business, University of Kansas, Technical Report 04-1118, September 2005 (with Peter F. Orazem).

"A Half Century of Small Business Federal Income Tax Rates and Collections," Tax Foundation Special Report No. 61, October 1996. (with Gary Leff).

"Tax Reform and the Foundations of Federal Taxation," Madison Review, Vol. 1, No. 3 (Spring 1996), pp. 4-12.

"Growth of the Earned Income Tax Credit," Tax Foundation Special Report No. 53, Washington, D.C., September 1995 (with Jeffrey Scott Moody).

"How Will Alternative Tax Reform Plans Affect the Jones Family?" Tax Foundation Special Report No. 49, Washington, D.C., May 1995.

"The Compliance Costs and Regulatory Burden Imposed by the Federal Tax Laws (House Ways and Means Committee Testimony)," Tax Foundation Special Brief, Washington, D.C., January 1995.

"Individual Effective Tax Rates in the United States," Tax Foundation Special Report No. 35, Washington, D.C., June 1994.

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THE CENTER FOR
APPLIED ECONOMICS

University of Kansas School of Business
Summerfield Hall, 1300 Sunnyside Avenue
Lawrence, KS 66045-7585
www.cae.business.ku.edu
(785) 864-5134



632 SW Van Buren, Suite 100
Topeka, KS 66603
(785) 296-1460
(785) 296-1463 (fax)
www.kansasinc.org
ksinc@ink.org