Report of the Special Committee on Commerce to the 2018 Kansas Legislature

Chairperson: Senator Julia Lynn

Vice-chairperson: Representative Les Mason

Other Members: Senators Tom Holland and Gene Suellentrop; and Representatives J. R. Claeys, Bradley Ralph, and Jerry Stogsdill

Study Topic

The Committee is to study the effectiveness of the Sales Tax and Revenue (STAR) Bond Financing Act and other incentive programs with a similar purpose, as identified by the Committee, and may make any recommendations to ensure Kansas continues to provide a framework for future economic growth.

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Special Committee on Commerce

Report

Conclusions and Recommendations

The Committee recommends STAR Bonds be further studied. Any new legislation should be focused towards reforming the program so that it returns to its original goal: increase economic development geared towards major, destination tourism. Other non-retail sources of revenue may have to be utilized to finance future STAR Bonds.

The Committee concludes the State must determine whether initiatives and incentives, specifically tax expenditures, are accomplishing their intended goals. It is important for the State to set up a process for regular evaluation of economic development initiatives and tax incentives. The Committee recommends the Senate Committee on Commerce and the House Committee on Commerce, Labor and Economic Development meet jointly to further discuss the matter of evaluations. The Committee further recommends a joint subcommittee be appointed to develop legislation that will allow for a routine, regular evaluation of initiatives and incentives. An outline for the proposed legislation is detailed in this report. Finally, the Committee recommends the resources and technical expertise of the Pew Charitable Trusts be used to develop a new evaluation policy.

Proposed Legislation: None

Background

The Legislative Coordinating Council appointed a Special Committee on Commerce and charged it to study the effectiveness of the Sales Tax and Revenue (STAR) Bond Financing Act and other incentive programs, as identified by the Committee, and to make any recommendations to ensure Kansas continues to provide a framework for future economic growth. The Committee was granted two meeting days.

Committee Activities

The Committee met on December 5 and 6, 2017, to discuss STAR Bonds, community improvement districts (CIDs), transportation development districts (TDDs), and the evaluation of tax expenditures and economic development incentives.

STAR Bonds

Staff from the Kansas Legislative Research Department (KLRD) and the Office of Revisor of Statutes briefed the Committee on STAR Bonds, which is a form of tax increment financing (TIF) that allows city governments to issue special revenue bonds that are repaid by the revenues received by the city or county from incremental increases in transient guest taxes, local sales taxes, and use taxes collected from taxpayers doing business within the designated portion of the city's STAR Bond district. Unlike traditional TIF financing, which does not involve state resources, all or a portion of the increased state sales and use tax revenue also may be used to repay the bonds, which typically have a 20-year repayment period.

The following types of projects may use STAR Bond financing:

- A project with at least $50.0 million in capital investment and $50.0 million in projected gross annual sales;

- A project located outside of a metropolitan statistical area that has been found by the Secretary of Commerce (Secretary) to be eligible under TIF law and of regional or statewide importance;

- A major commercial entertainment and tourism area as determined by the Secretary;

- Auto racetrack facilities, multi-sport athletic complexes, river walk canal facilities, historic theaters, the Manhattan Discovery Center, the Wyandotte County Schlitterbahn project, museum facilities, or a major motorsports complex in Shawnee County; or

- A project involving buildings 65 years old or older and including contiguous lots that are vacant or condemned.

The law allows the governing body of a city to establish one or more special bond districts with the written approval of the Secretary, based on a feasibility study.

Reauthorized in 2017, the authority to issue debt pursuant to the STAR Bond Financing Act will sunset on July 1, 2020. During FY 2018, there is a 12-month moratorium on the approval of new STAR Bond districts, but cities with existing districts may continue to develop projects.

Administration of STAR Bonds

Representatives from the departments of Commerce and Revenue briefed the Committee on their roles in the administration of STAR Bonds. The Interim Secretary of Commerce, explaining that the program remains a valuable tool to metropolitan areas and rural communities, suggested a series of reforms that could address several expressed concerns:

- Concerning cannibalism by retail in the STAR Bond district, a restriction on “box stores” or “anchor stores” locating within a specified mile radius of the STAR Bond district;

- Concerning project costs, remove landscaping from the list of allowable STAR Bond expenses;

- Concerning the need for the definition of a “tourist,” a “tourist” is a person traveling for pleasure, culture, or for regional sports competition. For cities with over 50,000 population, a tourist must travel over 100 miles. For cities with under 50,000 population, a tourist must be from over 50 miles. This would encourage a larger fiscal benefit with probable overnight stays. Smaller communities would need different thresholds;

- Concerning feasibility and market studies, consideration be given for the studies to be commissioned by the Department of Commerce (Department) but paid for by the developer;

- Concerning the statutory list of eligible projects, current approved projects should be grandfathered in, but future projects must fit the definitions of a tourist destination to qualify;

- Concerning local input, the Department could require a letter of support (or non-support) from the local tourism marketing organization, stating whether the project is a tourist destination. This could be done by Department policy or statute; and

- Concerning proportional fiscal commitment from the State and community, if a community pledged a portion of sales tax or transient guest tax to STAR Bonds, then the State would offer the same proportion, which could be accomplished by Department policy or statute.

Once bonds have been approved, the Kansas Department of Revenue (KDOR) administers the collections of pledged taxes based on the tax distribution agreement (TDA) approved by the municipality, trustee, State Treasurer, and the escrow agent. The TDA specifies the tax revenues committed to the project by the municipality, the tax baseline amount (if any), and the time periods established for collection. If a district contains existing businesses, a tax baseline will need to be established. KDOR works with the city to determine the businesses located within the district during the baseline period. Historic sales tax returns are utilized to determine the amount of sales taxes collected during the baseline period by the identified businesses. The base year is considered to be the 12-month period immediately prior to the month in which the STAR bond district was approved by the Secretary. Certification of the state and local baseline amounts are included in the TDA. For all projects with a baseline, the base amount must be paid to the State each year, with the year beginning January 1, before applicable state and local taxes will be set aside for payment of bonds. Publication of a new STAR Bond district follows the same time table as a local sales tax. Sales tax rates can be imposed, changed, or repealed on the first day of each calendar quarter: January 1, April 1, July 1, and October 1. Ninety-day prior notification is required for all sales tax rate or addressing changes, with the changes published at least 60 days prior to change.

KDOR currently administers 11 active STAR Bond projects. In the most recently completed fiscal year, FY 2017, the State remitted over $35.0 million in sales and use tax revenues back to communities. Since the inception of STAR Bonds, the State has distributed $557.4 million.

History of Sales Tax Revenue, FY 1997-FY 2017

Staff from KLRD briefed the Committee on the history of sales and use tax revenue over the past 20 years from FY 1997 through FY 2017. Twenty years ago, sales and use tax collections were normally expected to grow by 3.0 percent or greater; in the past five years, however, annual revenue growth has averaged approximately 2.6 percent. Twenty years ago, sales and use tax collections accounted for approximately 39.0 percent of the revenues to the State General Fund; now they provide nearly 46.0 percent of the revenues.

Newly Proposed STAR Bond Districts or Projects

A representative of the City of Atchison provided an overview of Atchison's proposed STAR Bond project, which includes $2.0 million in proposed STAR Bond financing that will support the development of a tourist attraction, the last remaining Lockheed Electra L-10E aircraft, the same model Amelia Earhart flew on her final flight. The plane was the catalyst for pursuing STAR Bond funding to develop an aviation museum at the Amelia Earhart Airport. In addition to showcasing the plane, the museum will offer displays and exhibits focused on history, aviation, and Amelia Earhart. The museum will provide programming in science, technology, engineering, and math education, creating a regional draw for school groups. The draft feasibility study estimates the museum will draw 11,500 visitors annually, and increase the visitors to Atchison's other attractions by 25.0 percent. Although the $10.5 million project is considerably smaller than any existing STAR Bond project, the total planned district investment of nearly $21.0 million will impact the community, and economic benefits will be experienced across the state.

Atchison's STAR Bond project also includes installation of shelters at the Atchison Farmer's Market and other downtown improvements, which will capitalize on both the new visitors generated by the museum and the growing agritourism opportunities in the region. The shelters will make the market a regional attraction, extend the market's season to nine months, attract more vendors, and allow the market to host more events.

The draft feasibility study estimates the three primary sources of STAR Bond debt repayment (a hotel, restaurant, and museum) should generate $73.0 million in taxable sales and provide $5.95 million in revenues available for debt repayment over 20 years. The construction and annual operation of these investments will have a substantial impact on both the state and local economies. The study estimates $25.0 million in economic output, 166 full-time equivalent jobs, and $7.5 million in additional earnings during the construction phase. The state economic impact of annual operations is estimated at $6.0 million in additional economic output, $1.7 million in additional earnings, and 57 new full-time jobs.

Community Improvement Districts and Transportation Development Districts

Staff from KLRD and the Office of Revisor of Statutes briefed the Committee on the CID Act, which is designed to promote and support economic development, including tourism and cultural activities, and the TDD Act, which provides financing for transportation-related projects.

The CID Act provides authority for a local sales tax of up to 2.0 percent to be imposed on the sales by retail businesses located within those districts in order to fund the costs for commercial development or redevelopment projects in the district. The total number of CIDs has grown to 123, and likely will continue to grow as this program is popular with municipalities and developers. In FY 2017, KDOR distributed over $11.8 million in CID sales tax revenues to finance CID projects. The law allows 2.0 percent of the CID taxes collected, up to $200,000 per fiscal year, to be used by KDOR to defray administration and enforcement expenses.

The TDD Act provides authority to municipalities for a 1.0 percent local sales tax. Currently, there are 36 TDDs. During FY 2017, almost $10.0 million in TDD sales tax revenue was distributed to finance TDD projects. Since the creation of the CID Act, creation of new CIDs has outpaced the creation of new TDDs.

KDOR administers the collection of sales taxes for CIDs and TDDs. The notification process of a new CID or TDD follows the same publication time table as local sales tax rates. Sales tax rates can be imposed, changed, or repealed on the first day of each calendar quarter: January 1, April 1, July 1, and October 1. Prior notification of 90 days is required for all sales tax rate or addressing changes, with the changes published at least 60 days prior to the change.

KDOR works with a city to identify the address range encompassing a district. Once the district's addressing has been determined, a unique five-character jurisdiction code is assigned to the district by KDOR so the collected taxes can be properly distributed. Jurisdiction codes are included on all sales tax returns to indicate where the tax was collected. KDOR's Accounting Division further breaks down the jurisdiction code into new entity codes for the district and incorporates them into the accounting system so all funds are distributed correctly. Existing businesses in the district are identified, and KDOR Customer Relations labels the business' sales tax account with the new jurisdiction code to assist in determining if the businesses are remitting sales tax collections to the proper jurisdiction. KDOR's online address directory system is updated so businesses and consumers can obtain the correct sales tax rate and code for the district. Streamlined sales tax systems are updated so that businesses using the streamlined system are reporting correctly. The KDOR website and Customer Service Center must be updated to provide notification of the new rates. Once the district is established, the KDOR Accounting Division processes distributions for the district on a monthly basis.

A representative of KDOR noted a CID, in a few instances, has encompassed a single business establishment. Often times once a STAR Bond district is created, overlapping CIDs or TDDs are created. There are 17 CIDs and TDDs that overlap STAR Bond districts.

Evaluation of Tax Credits

Staff with the Legislative Division of Post Audit (LPA) briefed the Committee on a recently completed audit focused on the evaluation of Kansas tax credits and exemptions compared to other states. The State forgoes about $6.0 billion each year through tax credits and exemptions. Most of this forgone revenue stems from exemptions and credits required by federal law or the *Kansas Constitution*, or to avoid double taxation. However, many tax credits and exemptions are policy choices intended to influence taxpayer behavior. Two agencies are primarily responsible for administering the State's tax credits and exemptions. KDOR administers nearly all tax credits in Kansas, estimates the value of sales tax exemptions, and collects property tax exemption data. The Kansas Insurance Department tracks information on tax credits that are claimed by insurance companies.

According to The Pew Charitable Trusts (Pew), Kansas trails other states in following best practices for evaluating tax incentives. A Pew report, published in May 2017, identified best practices for state tax incentive evaluation, which included formal evaluation policies, evaluations that address economic impact, and lawmaker review of evaluation results. Pew compared each state's tax incentive evaluation process to these best practices and determined Kansas was in the lowest performance category.

Between KDOR and the Kansas Insurance Department, the State has a comprehensive inventory of all available tax credits and exemptions. However, Kansas does not have a formal policy to require any state agency to routinely evaluate the State's major tax incentives. The limited evaluations that are conducted do not necessarily address the cost or economic impact of tax incentives. At least three agencies—the State Historical Society, KDOR, and LPA—conduct limited or *ad hoc* assessments related to tax incentives. Kansas does not have formal processes to ensure lawmakers consider the results of tax incentive evaluations. However, KDOR does provide basic tax incentive information to the Legislature, and legislative committees receive LPA reports on tax incentives. Several other states, including Kansas' neighbors, meet many of Pew's best practices. According to the Pew report, Indiana, Iowa, Nebraska, Oklahoma, and Washington are "leading" states, while Colorado and Missouri are classified as "making progress." Each of these states has formal policies that require regular, systematic evaluation of all major tax credits and exemptions, and most regularly evaluate the costs and economic impacts of tax incentives. Most of these states have formal processes in place to ensure lawmakers consider the results of tax incentive evaluations.

A representative of Pew Trusts, which is a public charity that provides research and technical assistance to governments at the local, state, and federal levels, said lawmakers across the country are looking for ways to create jobs, raise wages, and help the local economy thrive long-term. Tax incentives are one of the primary tools that states and communities use to achieve these goals. These incentives also cost state and local governments an estimated $45.0 billion, annually.

In many states, incentives were created as permanent parts of state law. While lawmakers regularly debate spending for government functions, incentives often have not been part of the conversation. Since the start of 2012, more than 20 states have enacted laws either requiring evaluation of tax incentives or improving existing evaluation requirements. In 2015 and 2016, 13 states approved such laws.

In Pew's recent report, "How States Are Improving Tax Incentives for Jobs and Growth," it found ten states had well-designed plans for regular reviews, experience producing quality evaluations, and a process for informing policy choices. An additional 17 states and the District of Colombia are making progress in this area. Many of these states have approved laws requiring evaluation and are working on implementation.

Pew has identified key considerations and promising practices for evaluating tax incentives effectively. There are three steps a state can take, which makes it more likely that lawmakers will have consistent high-quality information that they will use to improve the effectiveness of those programs. At a minimum, states should evaluate all major economic development tax incentives. The first step is to make a plan. The second step is to measure the impact of incentives. The third step is to inform policy choices. It is also important to set a review schedule. Next, it is important to determine who will conduct the analyses. The ideal evaluation office has several key traits: it has a non-partisan independent perspective, relevant expertise, and the authority to make recommendations about policy. The most common approach is to use legislative evaluation or audit functions.

Once a plan is in place, the next step is for the evaluations themselves to measure the impact of incentives. Evaluations typically include information on the results of incentives on both state budgets and economies. Evaluations explain the findings and place them in context. By carefully examining the design and administration of incentive programs, along with the economic results, states have drawn valuable conclusions about what is and what is not working.

Once conclusions are drawn, the final step is to connect the findings to the policy-making process. Tools and approaches for accomplishing this goal include: legislative hearings, sunset dates, and executive recommendations. A common approach among states that regularly evaluate incentives is to designate a specific legislative committee to hold hearings and determine whether policy changes are needed.

Other Conferees

The Committee received testimony from economic development professionals and business executives who spoke predominantly about STAR Bonds. A key concern for bond investors is the timeliness of the completion of the project and the reliability of the tenants. Institutional investors understand the risks and are willing to accept them due to higher interest rate expectations. It is common for bond financing to take place at the end of the completion of the project or after the project has been open for a period of time to determine its viability. There is value in having the developer purchase some of the bonds as it provides an incentive for the developer to have a successful project.

The retail trade is changing at a pace faster than ever before. Brick-and-mortar retail development and redevelopment is slowing and cannot be expected to drive sales taxes and property taxes in the future. As sales decline, so does a retailer's ability to pay rent. Retailers budget for new stores so that their first business year will be their best, and sales will decline slightly every year thereafter. It is difficult to redevelop older retail centers due to the cost of meeting new building codes. New development projects will need to be mixed use, including retail, entertainment, offices, or apartments.

Another developer noted that if the right destination is created, it can draw visitors from all over the nation. The future of retail is to create unique experiences for customers, especially young people.

Conclusions and Recommendations

The Committee recommends STAR Bonds be further studied. Any new legislation should be focused towards reforming the program so that it returns to its original goal: increasing economic development geared towards major, destination tourism. Unlike the past 20 years, where retail tourism has served as the economic engine that financed the payment of STAR Bonds, the Committee believes the evolution from brick-and-mortar stores to online retail will continue to diminish state sales and use tax revenues. They will grow at a slower pace and may not be as reliable in the future to finance STAR Bonds. Other non-retail sources of revenue may have to be utilized to finance STAR Bonds.

The STAR Bond Financing Act is just one facet of the economic development initiatives and incentives of the State. The Committee concludes it is necessary for the State to determine whether initiatives and incentives, specifically tax expenditures, are accomplishing their intended goals. It is important for the State to set up a process for regular evaluation of economic development initiatives and tax incentives. Evaluations can provide information about the fiscal and economic impacts, including whether the policy is successfully influencing economic behavior. These studies can also uncover flaws in the design or administration of those policies, recommending improvements that that can help promote economic growth.

The Committee recommends the Senate Committee on Commerce and the House Committee on Commerce, Labor and Economic Development meet jointly to further discuss the matter of evaluations. The Committee further recommends a joint subcommittee be appointed to develop legislation that will allow for a routine, regular evaluation of initiatives and incentives. That proposed legislation should:

- Identify major economic development initiatives and tax credits and exemptions that would be reviewed on a predetermined multi-year schedule;
- Assign one or more state agencies to conduct the evaluations;
- Compare the impacts of the initiatives and incentives on the economy and taxpayer behavior to the public costs; and

- Require appropriate legislative committees to consider evaluation results as part of their policy decisions.

Finally, the Committee recommends the resources and technical expertise of the Pew Charitable Trusts be used to develop a new evaluation policy.