

TEXAS

—BUSINESS—♦—REVIEW—

Bureau of Business Research • McCombs School of Business • The University of Texas at Austin

FEBRUARY 2001

An Integrated Economic Development Budget

Putting Apples and Oranges in the Same Basket

by Dick Lavine

Senior Fiscal Analyst
Center for Public Policy
Priorities
Austin, Texas

The Texas Legislature appropriates hundreds of millions of dollars each year to various programs intended to promote economic development in the state. Scattered throughout the state budget, these programs surface not only in the Texas Department of Economic Development and the Texas Workforce Commission, but also in agencies as disparate as the Texas Agricultural Extension Service, the Texas Department of Criminal Justice, and most institutions of higher education.

The Legislature also grants tax incentives to businesses that undertake certain desired forms of investment intended to stimulate economic growth. In 1999, for instance, the 76th Legislature created new tax provisions to reward research and development, job creation, and capital investment and to maintain low-production “stripper” oil wells.¹

Each program and incentive may be backed by the best of intentions, but good will alone cannot guarantee that Texas government is using scarce public resources wisely. Historically, economic development efforts in Texas have lacked coordination: the apples (direct appropriations) are separated from the oranges (tax incentives). Maximizing the efficient allocation of state funds requires that policymakers gain a comprehensive understanding of all economic development efforts taking place in the state.

The creation of an integrated (or unified) economic development budget offers one strategy for addressing this knowledge gap. Such a budget could be prepared easily from existing sources and would be invaluable in informing future consideration of development activities.

Scattered Funds

In an integrated economic development budget, all state economic development activity would be presented in a single document, *regardless of the agency involved*. Currently, it is very difficult to determine quickly from an examination of current budget documents how state economic development funds are being allocated.

An examination of the Appropriations Act for fiscal 2000-01 (House Bill 1, 76th Legislature) demonstrates this problem. Article VII of the Act, which is labeled “Business and Economic Development,” includes spending on the Department of Economic Development (formerly the Department of Commerce), the Texas Workforce Commission, and the Department of Housing and Community Affairs. However, this same article does not include many other expenditures that should be considered in any examination of economic development spending. For instance, the section of the Act that funds institutions of higher education includes special items for each institution that are clearly economic development expenditures. To cite two examples: the 2000-01 state budget allocates \$1.9 million to the University of Texas at El Paso to operate the Texas Centers for Economic and Enterprise Development and \$4.3 million over two years to the University of Houston for its Small Business Development Center. Virtually every institution of higher education has similar items in its budget.

Economic development activities are also carried out by agencies not usually considered in economic development planning.

Tax incentives often have a greater fiscal impact than direct expenditures, but the costs to the state in lost revenue are almost never compared directly to the costs of program expenditures.

For example, the Texas Agricultural Extension Service expects to spend \$46.4 million to “conduct educational programs that contribute to the economic competitiveness of agricultural producers, the economic viability of rural communities, and the economic stability of individuals and families.” Also, the Office of the Governor houses a program to “market Texas as a film location and promote the Texas music industry,” at a cost of \$1.3 million. Even the General Land Office receives \$391,000 from the state budget to “conduct a market development research and information program designed to aid in expanding markets for recycled products in Texas.”

Excluded from many economic development plans, public education expenditures are nevertheless commonly recognized as important to economic development. Also overlooked often in strategic planning are other institutions with significant budgets for basic educational responsibilities. The Texas Department of Criminal Justice justifies \$154 million of its biennial appropriation as “providing the opportunity for on-the-job training in Texas Correctional Industries” and another \$13.8 million to “offer post-secondary academic and vocational training needed for the further development of mental and job skills.” Similarly, the Texas Youth Commission receives \$48.7 million to “provide or facilitate 12-month academic, GED, and workforce preparation programs” among its juvenile offenders.

All these agencies participate in activities that can legitimately be considered to further economic development. Still, nowhere in any state planning or budget document are these activities brought together in one place for even a simple comparison of relative costs.

Direct Appropriations and Tax Incentives

As important to economic development as the appropriations contained in the state budget are the tax incentives scattered throughout the Texas Tax Code. These tax incentives often have a greater fiscal impact than direct expenditures, but the costs to the state in lost revenue are almost never compared directly to the costs of program expenditures. An integrated economic development budget would ensure that all fiscal support for economic development, *whether through direct appropriation or through tax incentives*, would be brought together for direct comparison.

A recent study of eight large states concluded that tax provisions prompt an average of 80 percent of economic development activities. Among the states studied, Michigan and Massachusetts relied on tax provisions for more than 90 percent of development incentives.² A similar analysis in North Carolina concluded that economic development tax items accounted for almost 80 percent of the total economic development budget.³ Even more striking, tax preferences were expected to be one of that state’s fastest growing fiscal categories, exceeded only by growth in Medicaid spending.

A number of states currently analyze these provisions through “tax expenditure budgets” that list all tax provisions and estimate the fiscal impact of each on state revenue. (The term “tax expenditure” highlights the fact that tax incentives have the same effect on a state’s budget as a direct appropriation—each reduces revenue available for other purposes.) The information from the tax expenditure budget concerning economic development provisions could be incorporated into an integrated development budget.

The Texas Comptroller of Public Accounts is required to release a biennial report, *Tax Exemptions and Tax Incidence*, that lists the cost in foregone state revenue of many economic development tax provisions.⁴ The provision with the largest cost is the sales tax exemption for manufacturing machinery and equipment, which, as estimated by the comptroller, will cost the state an estimated \$497.9 million in foregone revenue in fiscal year 2001 and is projected to increase in cost to \$692.8 million in fiscal 2006 (table 1). The newest major economic development incentive, a franchise tax credit for research and development expenses, is estimated to cost \$67.7 million in fiscal year 2001 and \$168.7 million in fiscal year 2006 (table 2). The comptroller also estimates the impact of certain property tax provisions, which impose a cost through school-finance formulas that require the state to replace local property tax revenue lost to certain exemptions. For instance, school property tax abatements and tax increment financing agreements will cost the state \$47.7 million in fiscal 2001, but are expected to diminish to \$25.1 million in fiscal year 2006. However, the cost of the freeport exemption for goods transported out of state within 175 days of acquisition is forecast to climb from \$101.4 million in tax year 2001 to \$131.6 million in tax year 2006 (table 3).

No provision exists for the regular reexamination of the relative costs and benefits of the provisions of the Texas Tax Code.

Table 1
Cost of Selected Sales Tax Exemptions
fiscal 2001-2006
(millions of dollars)

Exemption	2001	2002	2003	2004	2005	2006
Timber operations (equipment)	2.6	5.2	6.5	8.8	10.6	13.7
Manufacturing machinery & equipment	497.9	529.9	563.1	603.7	647.6	692.8
Data processing & info. services (partial)	14.9	17.8	21.0	24.4	28.3	30.4

Table 2
Cost of Selected Franchise Tax Deductions and Selected Credits and Refunds
fiscal 2001-2006
(millions of dollars)

Deductions	2001	2002	2003	2004	2005	2006
Small business exception	46.4	49.1	52.2	55.5	59.4	63.7
Enterprise zone investment	3.9	3.9	3.9	3.9	3.9	3.9
Credits & refunds	2001	2002	2003	2004	2005	2006
Child care credit	3.9	4.7	5.0	5.3	5.7	6.1
Research & development credit	67.7	128.8	137.0	147.1	157.4	168.7
Job creation credit	22.7	28.1	29.9	34.3	36.7	39.3
Investment credit	45.2	56.1	59.6	68.5	73.3	78.5
Before- and after-school care contributions	4.3	5.2	5.5	5.9	6.3	6.8
Refund for job creation in enterprise zone	*	*	*	*	*	*

* Amount is negligible.

Table 3
Cost of Selected School Property Tax Exemptions
tax year 2001-2006
(millions of dollars)

Item	2001	2002	2003	2004	2005	2006
Freeport property	101.4	106.8	112.6	118.6	124.9	131.6
Tax abatement	25.5	20.6	16.6	13.4	10.9	8.8
Pollution control property	40.3	42.2	44.1	46.2	48.3	50.6
Tax increment financing	22.2	20.9	19.6	18.4	17.3	16.3

Note: Tax year means calendar year.

Source: Texas Comptroller of Public Accounts, *Window on State Government*, <http://www.window.state.tx.us>.

More comprehensive measures of the actual outcomes of economic development programs would have to be developed so that the state could make informed strategic economic development spending decisions and concentrate resources on programs that efficiently provide the desired results.

Other economic development tax provisions are not detailed in the comptroller's report. For instance, the natural gas and crude oil tax codes contain several incentives aimed at stimulating production. The incentives target gas production from high-cost gas wells, gas production from an oil lease that was vented or flared, production from both oil and gas wells that have been idle over a specified period of time, oil production from enhanced oil recovery programs, and incremental oil production from low-producing oil leases. The cost to the state in foregone tax revenue from these reductions is not calculated.

Also noteworthy are the less obvious costs of certain aspects of the Tax Code. Perhaps the largest overlooked tax expenditure is the formula in Sec. 171.106 of the Tax Code that determines a firm's corporate franchise tax liability according to the percentage of its sales that take place within Texas. Texas adopted this "single-factor apportionment" in 1991 to replace the standard "three-factor apportionment" that allocates liability according to a formula that weights equally a firm's property, payroll, and sales within a state. A tax expenditure study by the state of Minnesota concluded that that state's weighted apportionment reduced state revenue by \$118 million in fiscal 2000 by lowering taxes on companies that exported the bulk of their products.⁵

Tax provisions are, in general, not evaluated after their initial enactment. Every agency of Texas state government is subject to "sunset" review roughly once each decade, during which its effectiveness and efficiency are carefully examined. In addition, each agency faces a regular review of its budget every legislative session. In contrast, no provision exists for the regular reexamination of the relative costs and benefits of the provisions of the Texas Tax Code.

Performance Measures

The final assurance of accountability in a unified economic development budget comes from complete and accurate *performance measures* assigned to each program. A comprehensive evaluation system would demonstrate the public benefits from the use of state funds and how effectively the funds were used.

The performance-based state budget currently requires a full complement of output measures for each goal of each state agency. These measures are intended to determine the effectiveness of programs. The Legislative Budget Board and the state auditor have worked to improve this system, but many of the programs that would be included in an economic development budget currently report only simple output indicators that do not reflect the actual results achieved by the program. For example, the Texas Department of Economic Development measures the number of Smart Jobs participants trained for new jobs, but the agency does not report any increases in wages or benefits for the participants because of the training or their later advancement within a company. More comprehensive measures of the actual outcomes of economic development programs would have to be developed so that the state could make informed strategic economic development spending decisions and concentrate resources on programs that efficiently provide the desired results.

In 1999, the Texas Legislature enacted for the first time a tax incentive bill (Senate Bill 441) that included reporting of performance measures. The comptroller must report every two years on the impact of the largest tax credits created by the bill on employment, capital investment, personal income, and state tax revenue. The statute mandating the comptroller's biennial tax expenditure budget permits her to include an assessment of the intended provision of each tax provision and to determine whether the provision is achieving that objective. (The comptroller has not chosen to make any recommendations concerning exemptions in either of the two reports released so far.)

Although these recent reporting requirements are important steps in the right direction, a more detailed analysis of the effect of tax provisions, similar to outcome measures for appropriations, would be required to permit policymakers and the public to judge fairly the relative impact of direct budget appropriations and tax provisions.

Adding Local Efforts

Local governments also participate in promoting economic development through both direct expenditures and tax incentives.

Cities, counties, and occasionally school districts grant tax abatements and create tax increment financing (TIF) districts to reduce property taxes in return for specified improvements. Economic development corporations controlled by city councils collect dedicated sales taxes to fund improvements to attract new business investment.

To obtain a truly accurate picture of economic development activities in Texas, these local efforts should be incorporated into a master integrated budget. At this time, state oversight of local programs remains sketchy. Since 1997 the comptroller has maintained a registry of local tax abatement agreements.⁶ The registry currently includes summary information on both the number of new jobs and the amount of payroll expected to be created each year. Bills filed in the past two legislative sessions (Senate Bill 746, 75th Legislature and House Bill 1973, 76th Legislature) would have required more extensive reporting by local governments, including an estimate of capital investment and a cost/benefit analysis of any abatement. The bills also would have necessitated a biennial report by the comptroller on the use of abatements in encouraging economic development, which could be expanded to include the detailed information necessary for a statewide integrated budget. TIFs are not currently subject to any statewide reporting or information collection requirements.

Texas cities may impose a local sales tax of up to one-half of one percent to finance local economic development efforts.⁷ Tax proceeds may be used to acquire land, buildings, and equipment for manufacturing and industrial development or job creation and retention, as well as for affordable housing, streets, sewers, parks, and sports facilities. Local authorities administering these funds must report their economic development objectives, revenues, and expenditures annually to the comptroller, who summarizes the information for the Legislature each biennium.⁸

In fiscal 1999, these local economic development corporations took in \$373.9 million, but they were not required to measure the effectiveness of their expenditures in creating new jobs or attracting private investment. More detailed reporting would be required to incorporate these extensive local economic development efforts into a statewide budget.

Summary

An integrated economic development budget would help maximize the efficient allocation of state funds by merging three very important aspects of economic development in a single document. Such a budget would:

- bring together funding information on the state's economic development programs, regardless of the agency involved;
- present the total cost to the state, whether directly through an appropriation or indirectly by a tax incentive; and
- measure the effectiveness of each program through appropriate performance measures.

By collecting apples and oranges into one budget basket and putting a cost/effectiveness price on each piece of fruit, an integrated budget can help direct scarce public resources into activities that offer the best buy. Trade-offs between conflicting priorities will still be required, no doubt generating public controversy and political turmoil. However, in the long term, the public and state policymakers will be more informed purchasers.

Notes

1. Senate Bills 441 and 290, respectively, 76th Legislature.

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

3. William Schweke and Carl Rist, *Managing for Higher Returns: What Does North Carolina Actually Spend on Economic Development and How Can These Investments Be Better Managed?* Corporation for Enterprise Development, March 1997.

4. The report is available at <http://www.cpa.state.tx.us/taxinfo/incidence>. The report is required by Government Code, sec. 403.014, *Report on Effect of Certain Tax Provisions*.

5. Minnesota Department of Revenue, *Tax Expenditure Budget, Fiscal Years 2000-03*, <http://www.taxes.state.mn.us/reports/fiscal/teb2000.html>

6. Tax Code, sec. 312.005. The reporting form is available at <http://window.state.tx.us/taxinfo/taxforms/50-276.pdf>.

7. Vernon's Ann.Civ.St. art. 5190.6, secs. 4A, 4B, *The Development Corporation Act of 1979*.

8. The latest report is for fiscal years 1998-1999. <http://window.state.tx.us/lga/edcr99/index.html>. ♦

To obtain a truly accurate picture of economic development activities in Texas, local efforts should be incorporated into a master integrated budget.

Texas Business Review is published six times a year (February, April, June, August, October, and December) by the Bureau of Business Research, University of Texas at Austin. Subscriptions are available free upon request. Views expressed in this newsletter are those of the authors and do not necessarily reflect the position of the Bureau of Business Research.

Research and service activities of the Bureau of Business Research focus on the ways Texas industries can become nationally and globally competitive. The Bureau is policy oriented and dedicated to public service. The Bureau is located on the sixth floor of the College of Business Administration building.

Editor: Bruce Kellison
kellison@gov.utexas.edu

Managing Editor: Sally Furgeson
sallyf@mail.utexas.edu

Sales Office: (888) 212-4386
(512) 471-1063 fax
rjwright@mail.utexas.edu

General: **bbr@uts.cc.utexas.edu**

WWW:
<http://www.utexas.edu/depts/bbr/tbr/>



BUREAU OF BUSINESS RESEARCH
P.O. Box 7459
Austin, Texas 78713-7459

Change Service Requested

NONPROFIT ORG.
U.S. Postage
P A I D
Austin, Texas
Permit No. 391

Revenues of Economic Development Corporations in Texas, 1998 and 1999

(millions of dollars)

	1998	1999
Sales tax	213.4	241.0
Grants	3.9	3.1
Fee income	10.7	4.8
Bond proceeds	73.0	90.0
Other revenue	25.0	35.2
Total	326.0	373.9

Source: Texas Comptroller of Public Accounts, *Window on State Government*, <http://www.window.state.tx.us>. Totals may not add due to rounding.

Note: Following the Development Corporation Act of 1979, Texas cities formed economic development corporations to attract businesses and create job opportunities. The law was amended in 1989 to allow eligible cities the option of adopting dedicated sales and use tax to fund industrial development projects, and 1991 legislation provided cities with a second form of sales tax to improve their appeal as places to live, work, and visit.

Announcement

Come **EXPLORE UT!** in what is billed as "The Biggest Open House in Texas!" Full of hands-on activities, stimulating lectures, and fascinating demonstrations, the campus-wide event is scheduled for Saturday, March 3, 2001, noon to 6:00 P.M. Visit "State-Wise Roundup," the booth sponsored by the Bureau of Business Research, on the Gregory Gym plaza to test your knowledge of regional and local economies across Texas. For more information, visit the Explore UT web site: www.utexas.edu/events/exploreut or call (512) 475-7813. ♦