Spotlight

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Corporate Tax Incentives

What's the harm?

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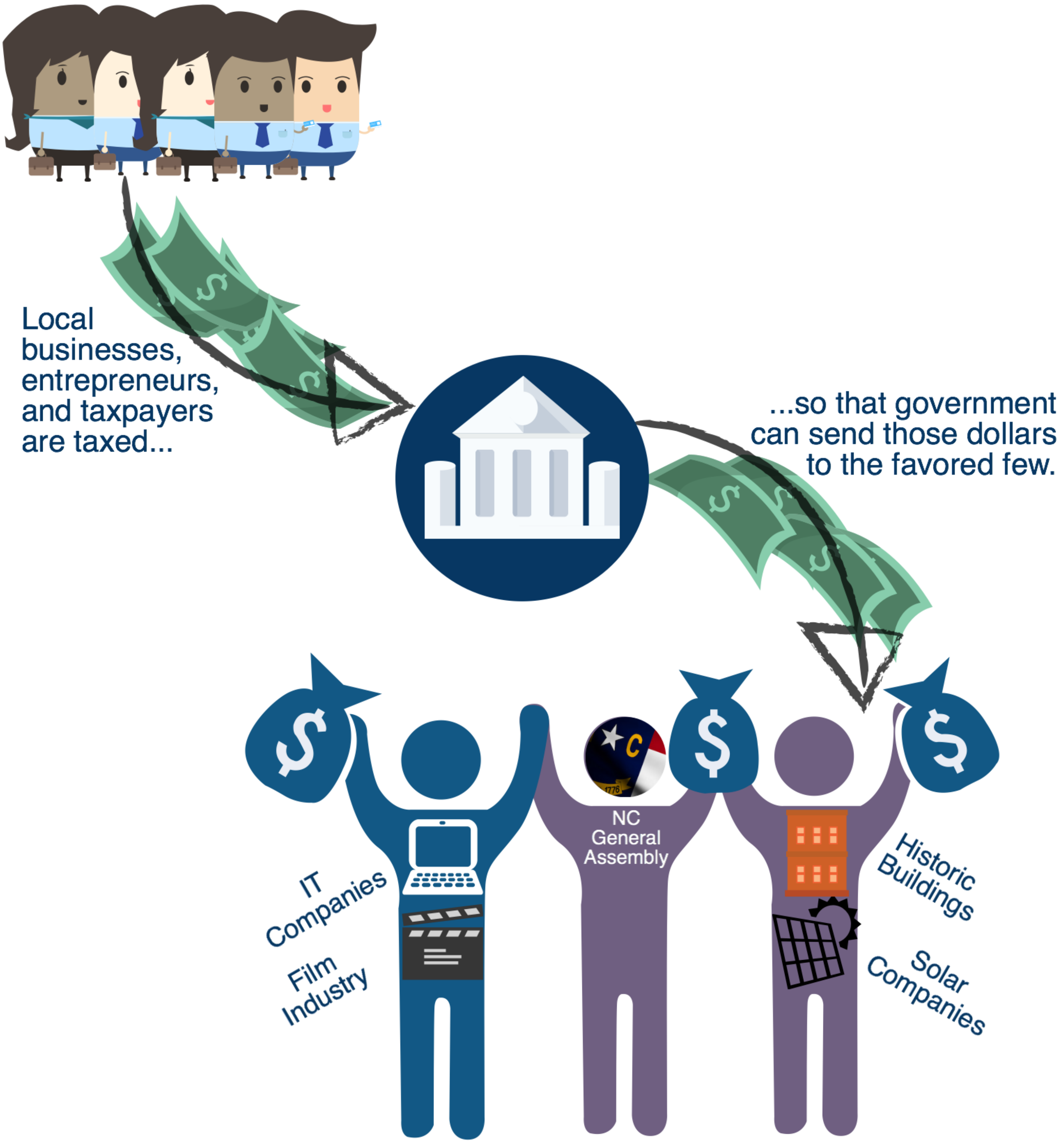


Since the beginning of this year's legislative session, it appears that Republicans, who once had an aversion to special tax incentives for business, have had a complete change in philosophy. In 2013, their tax reform removed many special exemptions and subsidies from the tax code, and language in that year's Republican Party Platform supported that position.[1] But now, the governor and Republican members of the state legislature are advocating for a host of new incentive programs and the extension and/or expansion of others. These include, but are not limited to, proposals to expand or extend tax credits for preserving older buildings, for renewable energy, for the movie industry, and to expand the Job Development and Investment Grant (JDIG) program,[2] which provides tax rebates to companies based on the amount of taxes they withhold from their employees' paychecks.

The problem with these kinds of policies is that even though they are promoted under the rubric of "economic development" there are no sound economic arguments to be made on their behalf. In fact, economic analysis suggests that they are likely to harm consumers, investors, and entrepreneurs who are not privy to the subsidies.

I. Support based on the world's oldest economic fallacy

Support for tax and spending subsidies to attract business to North Carolina is based on what is quite likely the oldest and most common economic fallacy ever invoked, namely that the only economic effects that count are those that are obvious and visible.

For example, if an auto company from Ohio is incentivized with taxpayer money to relocate to North Carolina, build a plant, and hire some workers, these activities are highly visible and can be viewed on TV, written about in newspaper cover stories, and counted or measured in some way by statisticians. Supporters of subsidies point to these very visible economic activities as justification for their support. Furthermore, statisticians and analysts are hired by interest groups and government agencies that benefit from these programs to attach dollar amounts or job counts to the company's activities. Typically this is done without even considering whether the calculations should be put into a benefit column or a cost column. They are all counted simply as "economic impact," and it is implied that all impacts are beneficial. This is the kind of thinking that lies behind a recent comment by Secretary of Commerce John Skvarla, who said, "We need these incentives...They are targeted, discretionary and represent a positive return on investment."[3] What goes unsaid, and maybe even unrealized, is that the thinking and analysis behind this statement only allows for "a positive return on investment." This is because they assume that the labor and other resources being used by the subsidized company would otherwise lay idle.

We have seen this occur with subsidies for solar power plants, the film industry, projects attracted with JDIG grants, and most other programs. By examining only the economic effects of what can be seen and then counting all of those impacts as benefits, rather than trying to discern which represent economic benefits for the state and which represent costs, politicians see no downside to these subsidy programs. The alternative to economic activity that is generated by the subsidized entity is an absence of economic activity, and there is no consideration of the idea that what is being subsidized is actually displacing economic activity that would otherwise be occurring. To make such an assumption is to believe that entrepreneurs and consumers, without the encouragement of state government to do otherwise, will leave potentially profit-making resources in the state untapped.

The table on the following page summarizing the effects of several of the state's corporate giveaway programs is an example. This is from a document published by the Department of Commerce, a bureaucracy that benefits, both in terms of its budget and its power, from the existence and further expansion of these programs.[4]

So here we have it—the number and amounts of awards, the amounts of those awards that have been paid out so far, and the numbers of jobs and dollar amounts of investments the grants have stimulated—spelled out for all to see.

The problem is that none of these numbers say anything about whether or not the programs are on net beneficial to the state. The number of jobs "created" tells us nothing about the number of employment opportunities that may have been displaced or forgone or the extent to which investment from other business entities may have been reduced as a result of the incentives dolled out by the state as part of these programs.

II. The reality of negative economic impacts from corporate subsidy programs

Possibly the most oft quoted "law" or "truth" of economics is that "there's no such thing as a free lunch." This stems from the economic fact of scarcity, which implies that if there is an increase in the use of resources, either monetary or physical, in the direction of some uses, there has to be a reduction in other uses. The value that would have been obtained if it were not for the reduction in these other uses is known as opportunity cost. Market decisions based on consumer demands, the real cost of inputs, and the system of profit and loss ensure that these shifts in resource usage will tend to move them toward production decisions that are more highly valued by consumers, i.e., in the direction of economic growth. This is bedrock economics, yet it is ignored, in fact implicitly denied, by supporters of North Carolina's economic incentives programs.

There are several ways that this truth plays out, or should play out, when discussing the rationale of such programs.

The crowding out effect

In several different ways, corporate subsidy programs to attract some businesses unfairly crowd out the business and economic activities of others. And this occurs regardless of the form that the subsidies take. Whether they are direct payments or through various kinds of tax breaks—corporate, property, payroll, sales—makes no difference. The "lunch" has to be paid for, either directly through higher taxes or indirectly through diminished access to real resources.

Crowding out revenues from the private and public sectors

With direct payments or tax incentives, there are funds—either money paid out or lost revenue—that will have to be accounted for. Assuming that the overall size of the state budget remains the same, taxes for existing businesses, consumers, and income earners generally will have to be higher. For example, as reported in the Department of Revenue's Incentive Report for 2015, during 2014 well over $400 million was allocated in corporate incentives.[5] This money would have to have come out of the pockets of North Carolinians generally. Economic activities throughout the economy—spending, investing, and entrepreneurship—would have to have been similarly curtailed, putting a dent in economic growth. In other words, there was a coercive wealth transfer from existing taxpayers to all of the business entities that received these awards. As an aside, this amount is over three and a half times the $111 million being proposed in Governor McCrory's 2015-2017 budget for teacher pay increases, including increases in base pay for entry level teachers to $35,000, moving all teachers to the next tier on the state's salary schedule, and retaining bonuses that were granted to experienced teachers. It also should be noted that the figure for corporate welfare is over one year, 2014, while the amount for teacher pay is over two years.

Some argue that in the long run the new businesses that receive the $400 million will end up more than paying for themselves because of the higher taxes that they and their employees will pay. But in making this claim, the lost economic activity caused by the wealth transfer is

Table 1A: Summary of Economic Development Grants by Commerce Job Creation or Retention Programs, 2007-2014

Commerce Program	Number of Awards	Total Initial Awards	Disbursements to Awardees	Jobs Created	Jobs Retained	Private Investment Made
JDIG (only)	93	$551,681,975	$21,833,785	9,050	19,451	$983,267,365
One NC (only)	339	$62,496,250	$13,195,199	8,961	38,249	$2,021,126,244
JDIG and One NC*	86	$458,195,608	$20,523,217	4,601	9,043	$1,449,336,948
JMAC	3	$67,000,000	$31,341,376	Not Required	4,628	$528,949,129
Total	**521**	**$1,139,373,833**	**$86,893,577**	**22,612**	**71,371**	**$4,982,679,686**

Note: Job Creation and Retention totals do not include grants that have closed with $0 disbursed.

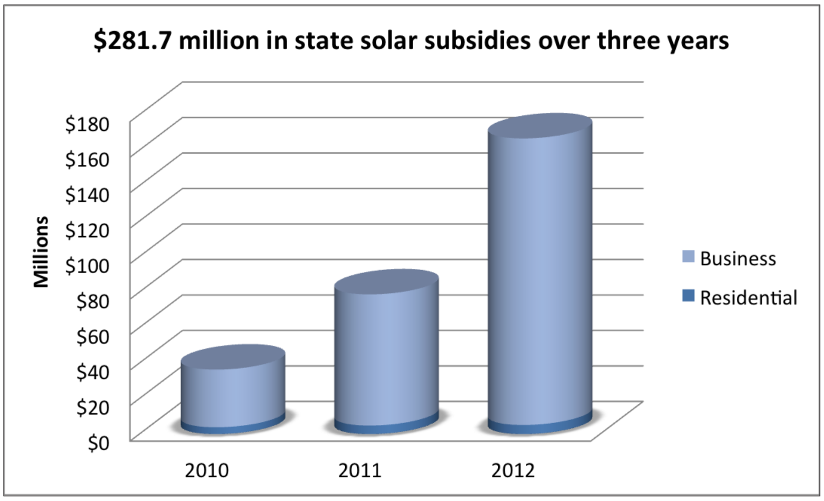
*Forty-three projects were awarded both JDIG and One NC grants for a total of 86 awards. For projects receiving both JDIG and One NC awards, Job Creation and Retention reflect JDIG reporting and Private Investment comes from One NC reports.

Source: NC Department of Commerce, September 2014. Date Range for Awards is 1/1/2007 to 6/30/2014.

never accounted for. In order for the claim to be true, it would have to be shown that the new revenue generated in the future by the subsidy-wooed businesses will not only more than compensate for any higher taxes imposed on others in the short run, allowing those taxes to fall at a later point, but also that it will compensate for the revenues that would have been generated by the lost economic activity. In other words, the analysis would have to show that the new economic ventures are more valuable to the state's economy, and therefore the state's coffers, than the spending, investments, and entrepreneurship that would have occurred if that money had never been transferred. Needless to say, that case is never made.

The crowding out of real resources

Incentives not only preempt the use of revenues that are transferred to the incentivized businesses but also the use of real resources, which is what actually counts from the perspective of economic growth. All dollars represent claims on economic resources.



The fact is that incentives give the incentivized companies an unfair advantage in competing for North Carolina's scarce resources—labor, building supplies, electricity, land, etc. Every business and entrepreneur is in competition with all other businesses and entrepreneurs, both actual and potential, for the resources available. When one company gets an acre of land or a ton of cement or 100 workers, another business cannot.

Added demand for these resources that results from state-funded special privileges to some and not to others drives up their prices and therefore the costs for all businesses that are seeking access to those resources. So there is a wealth transfer to the favored business not only from taxpayers generally but especially from existing businesses that will reduce their investments because of the higher costs of making them. The subsidized businesses "crowd out," to some degree, existing businesses in this competition for resources.

Due to this "crowding out effect," all corporate welfare implicitly picks both winners and losers. The advantage that the politicians and corporate welfare recipients, like those that were on the receiving end of that $400 million in 2014, have is that the winners are obvious and there for all to see, which works well for the politicians at ribbon cuttings and election time. Meanwhile, the losers are all of those companies and entrepreneurs that never are able to gain access to the resources that flow to the favored and privileged businesses. Because of this, when the state "loses" a bid for a company to which it is making a large subsidy offer, as was the case recently with Volvo, it is not a loss but a win for home-based and homegrown companies that will have greater and lower-cost access to resources.

Conclusion: Incentives as state-based central planning

In reality, the most intellectually honest description of what we are referring to is "state-based central planning." In other words, economic incentives are an attempt by politicians to direct resources that are not their own to investments that they believe will be better for the economy than those that would be chosen if the actual resource owners were left to their own judgments. Simply stated, they substitute the investment decisions of politicians and politically-appointed bureaucrats for the investment decisions of unsubsidized market participants.

Although the claims are much less grandiose, the presumption behind state incentives is exactly the same as it is in the most centrally planned economies in the world—from Cuba and China to the 5 year plans of the former Soviet Union—namely that politicians operating outside the market have better knowledge and can better determine the proper use of resources than the private market itself. This is what economist and Nobel Laureate Friedrich Hayek in his 1974 Nobel address referred to as a "pretense of knowledge."[6] It is an idea and an attitude that animates the entire defense of incentives when it comes to economic policy; experts who face none of the market perils nor stand to reap any of the market rewards are in a better position because of the their expertise to determine what is the best use of resources. Economic growth and prosperity are better promoted by central authorities than by the decentralized decision making of the market.

The implication is that it is justified for politicians and bureaucrats, guided by these experts, to step into the market using their powers of taxing and spending to alter resource allocation and therefore market outcomes. This is at the heart of the central planning mentality and, stated or not, what lies behind all state government incentive programs.

In North Carolina, no less than in the former Soviet Union, legislators, bureaucrats, or secretaries of Commerce have no way of making anything but economically arbitrary decisions when it comes to allocating market resources. They cannot possibly know how those resources would have been used if left to the free decision making of private sector owners. Without this information, which is communicated by price signals and the system of profit and loss, they have no way of knowing how their decisions fit into the larger picture of alternative investment possibilities. They can only pretend to have this information, even if this "game of pretend" is supported by the "research" of highly paid consultants. For this reason, incentives-based economic policies are harmful to economic growth. By definition they transfer control over resource use from the more efficient setting of private sector resource owners and entrepreneurs to the less efficient public sector driven by the choices of politicians and bureaucrats.

Endnotes

1. See The North Carolina Republican Party Platform 2013, Article II, Section 5 at ncgop.org/platform/.
2. The expanded JDIG program is being called North Carolina Competes and would double the JDIG fund for corporate incentives. See "Bill Would Double Fund For Incentives," The Winston Salem Journal, March 3, 2015. journalnow.com/news/local/bill-would-double-fund-for-incentives/article_d21332a6-c211-11e4-ab27-37522e6a003a.html. For my commentary on this legislation see item 2 of the John Locke Foundation Economics and Environment Newsletter at johnlocke.org/newsletters/research/2015-03-05-9j9fogjmu4ac5euifbjn2ne524-enviro-update.html.
3. Ibid.
4. North Carolina Department of Commerce, Economic Development Grant Report, October 1, 2014. nccommerce.com/Portals/0/Incentives/NCDOC-ED-Grant-Report-OCT-2014.pdf.
5. NC Department of Revenue 2015 Economic Incentives Report found at dornc.com/publications/incentives/2015/index.html.
6. See "The Pretense of Knowledge" at nobelprize.org/nobel_prizes/economic-sciences/laureates/1974/hayek-lecture.html.