John LOCKE FOUNDATION

SPOTLIGHT

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State of Emergency

Time to Rework Economic Development Policy

Summary: North Carolina's approach to economic development policy has failed, with the state's high tax burden, lack of industrial diversity, and hostility to entrepreneurial effort contributing to a painful decline in employment and competitiveness. Public policymakers should rethink their reliance on central-planning models and schemes to subsidize specific businesses or regions. Instead, the state should lower taxes and avoid costly regulatory mistakes like the "Clean Smokestacks" bill.

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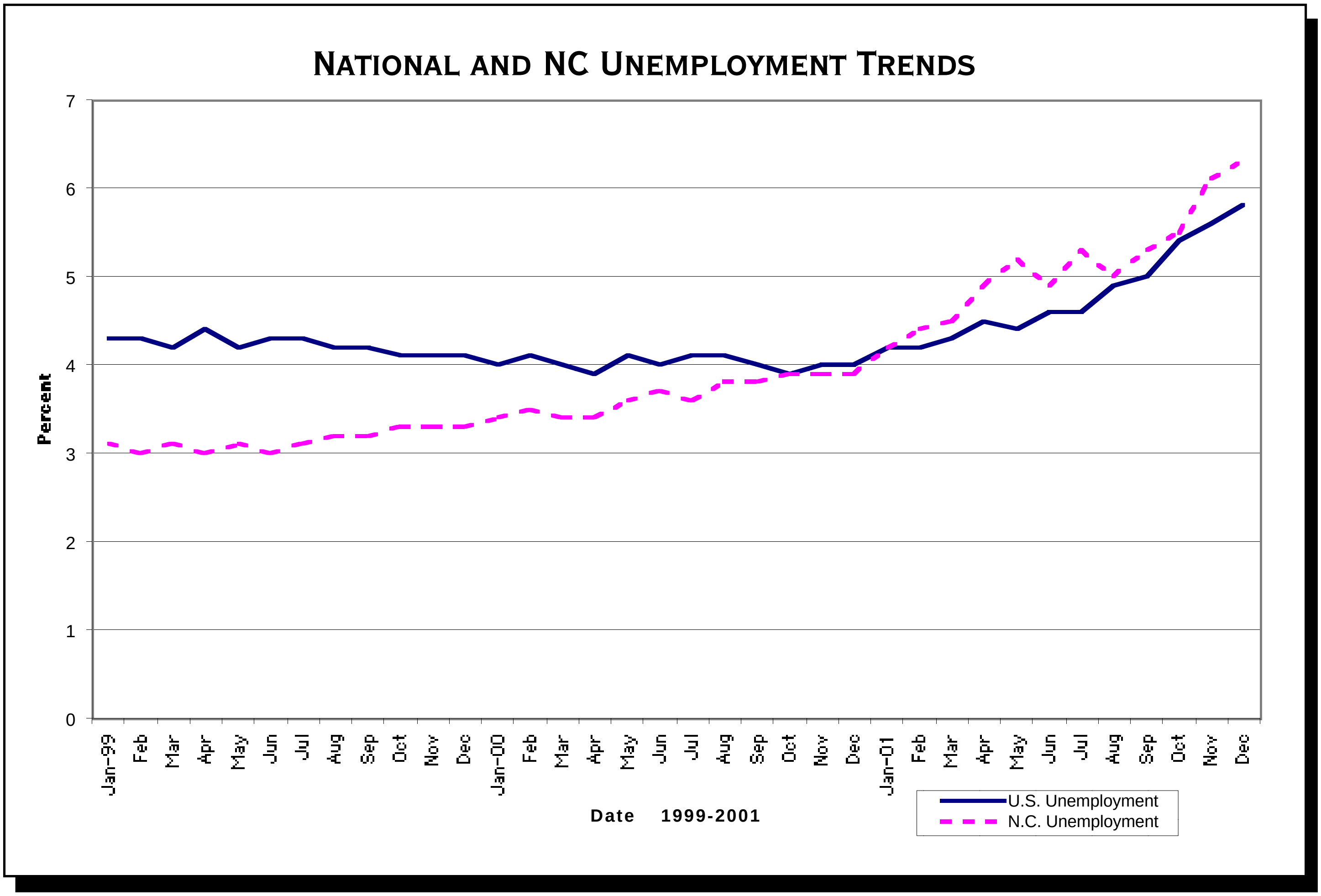
North Carolina is being hit harder by this recession than almost any other state in the nation. Unemployment in the state has risen from 3.9 percent a year ago to 6.3 percent today, which is the third largest increase in unemployment in the United States.[1] Indeed, N.C.'s unemployment rate has been rising steadily since June of 1999, well before there was any sign of recession and even while the national rate was declining.

North Carolina now has its highest unemployment rate since 1984. This means that unemployment in the state is higher than it was at any point during the recession of the early 1990s, which nationally was more severe. The state's unemployment rate is the highest in the Southeast and is well above the national average.[2] Significant layoffs have occurred in almost all sectors, from textiles and manufacturing to high tech industries in RTP. The only exception is state government, which has refused to consider significant labor cutbacks in spite of severe budget deficits.

Unfortunately Gov. Mike Easley's approach to addressing the problem will not make things better and, in all likelihood, will make the economy worse. His first instinct seems to be to invoke an old style central-planning approach that will have the state picking winners and losers and using its powers to bail out inefficient industries. All this will necessarily occur at the expense of industries that are efficient and are not part of the government's largesse. As noted by Rob Christensen, a columnist for *The News & Observer* of Raleigh, "the governor and his advisors face myriad questions: Can the textile industry be saved? How can tourists be lured back?…What businesses should the state recruit? How deeply should North Carolina get into a bidding war for industries by using tax dollars? And what can be done about the growing gap between urban and rural North Carolina?"[3] In other words, what's the best way for the governor and his advisors to micromanage the state's economic activity?



The Evidence

According to all the evidence, the state should not be involved in this process at all. There is a standard joke that you can lay all the economists in the world end to end and never reach a conclusion. But when it comes to assessing the efficacy of state development policies such as tax incentives and subsidies to attract new businesses or aid faltering ones, economists speak with one voice. Government economic development policies don't work. This has been the conclusion of nearly all studies of the issue. As recognized by the Council of State Governments, "A comprehensive review of past studies reveals no statistical evidence that business incentives actually create jobs…They are not the primary or sole influence on business location-decision making and…they do not have a primary effect on state employment growth."[4]

A recent study in the journal *Policy Sciences* of the effectiveness of North Carolina's economic development policies to attract international business noted that "North Carolina has developed one of the most aggressive programs in the United States for attracting and retaining industry."[5] In spite of this, when internationally owned companies in NC were asked to rank factors that attracted them to the state or would keep them from relocating, they typically ranked economic development policies as the least important. These include tax incentives, government assistance programs, government financing programs (low interest loans, industrial revenue bonds, etc.), and state marketing assistance programs. Ranked highest by the companies were factors such as labor force availability; quality transportation and quality of life factors such as K-12 education and recreational and cultural activities; and business climate, which included tax burden, the level of regulation, and the attitude of local government officials toward business in general.[6]

The Theory

This is one instance in which economic theory matches up perfectly with the empirical evidence. There is a very simple principle that goes a long way toward explaining why government subsidies and tax breaks, either to attract new businesses or to subsidize faltering ones, cannot work. The state cannot put anything into the economy that it doesn't first take out. It can't encourage one particular business activity without displacing others. This principle, under the heading of *opportunity cost*, is taught in the first weeks of every introductory economics class and yet it goes completely unacknowledged by both the governor and his (presumably) well-schooled economic advisors.

The principle holds true whether the government favoritism comes in the form of a direct subsidy, a special tax break, or even a loan guarantee. It is illustrated most clearly with a direct subsidy. In order for the state to appropriate money for some business or industry subsidy, it must first take it out of the state's private sector through taxation. This means that businesses and consumers in other parts of the state's economy can purchase or produce less. As Nobel Laureate Milton Friedman is so famous for saying, "There ain't no such thing as a free lunch" (TANSTAAFL). The same story can be told for tax breaks. If it is assumed that the state government is to maintain the same level of spending with or without the business tax incentive, then in order to grant the tax incentive to one business, other businesses and consumers must be taxed more. If the government is constrained to spend less because of special tax incentives, it means that the tax breaks could have been spread over the population at large. In either case, the rest of the state's economy is being shortchanged.

Application of the TANSTAAFL principle is more subtle in the case of government loan guarantees or subsidized low interest. This usually happens when a business is faltering and needs financing that it could not otherwise receive to stay alive. The most famous case on a national level is the Chrysler bailout in the early 1980s. In these cases, the state reduces the risk to lending institutions by guaranteeing the loans at market interest rates. This is a form of interest-rate subsidization. Such programs are assumed to be costless so long as the business pays the loan back. But this is not true. The funds that go to the subsidized business would have gone to someone else — an entrepreneur starting a new business, a couple wanting to buy a new home, etc. The point is that even if the loan is paid back it is not "free." It is displacing other economic activity that would have been taking place.

The Politics

If economists are in agreement on this issue, why are so many politicians anxious to pursue economic recruitment policies knowing full well that they will fail? The answer is clear. The real costs of these programs are hidden from the general population while the benefits are obvious. The economic activity that is stifled, by definition, never occurs. This means that the real cost, which is not the money but the forgone economic activity, is invisible. In the years to come, no one will see the people that do not get hired because North Carolina's sales and income taxes have gone up, in part to pay for the hundreds of millions of dollars that recruitment and incentive programs are costing the state. But the fact is that consumers with disposable income create business opportunities and taxes that reduce disposable income destroy them.

On the other hand, the economic activity that is generated by the subsidies, the businesses that are attracted to the state or kept from having to lay people off, is very visible. Everyone can see the new subsidized company that comes into the state, builds a new factory, and begins to hire people. This gives politicians a chance to point to jobs that their policies allegedly have created while not having to take the blame for job losses that are the result of those same policies.

As was pointed out in the journal *Policy Review* "A few big employers may move to a state offering lavish incentive packages, thereby providing photo opportunities and ribbon-cutting ceremonies for local politicians. But the majority of the creators of job and productivity gains throughout a state's economy are hurt as their taxes go up to pay for infrastructure improvements, job training subsidies, and other enticements…Creating jobs is not the goal of these programs. The goal of these programs is to create job announcements."[7]

The Right Policy

There is no secret about what kinds of policies create economic growth and allow for a healthy and prosperous economy. The state should provide an overall environment that is conducive to business activity and entrepreneurship. This is an environment where businesses are left free to take advantage of new opportunities and where consumers are left with the maximum amount of disposable income, so that those opportunities can be created in the first place. This means that the overall tax and regulatory burden for all citizens in the state should be kept low.

At the present time, the best policy would be for Easley to announce first that he will not continue the policy of previous administrations to target specific businesses or industries for subsidies of any kind. Furthermore he should begin to dismantle the corporate welfare state. A good place to start would be abolishing the William S. Lee Act, the Global TransPark Authority, and the Golden LEAF Foundation. He should also order a complete assessment and overhaul of all departments, beginning with the Department of Commerce, in order to eliminate programs that subsidize some businesses and industries at the expense of others. This would include subsidies to the tourism industry, professional and semi-professional sports, the seafood industry, and subsidies for international trade. The money that is saved by not pursuing these activities should be given back to the taxpayers in the form of generalized tax cuts.

The governor should also appoint a commission to find ways to reduce the specific tax and regulatory burden on business. Self-employment taxes and the corporate income tax, which is ultimately paid for with lower wages and higher prices, hinder entrepreneurial activity and should be completely abolished. Also the governor should reconsider his support for new regulations like the "Clean Smokestacks" legislation which will raise the cost of production for all businesses in the state while providing very few benefits for the environment.

At present, the administration seems unwilling to do what is necessary to promote real economic growth. Indeed its policies have taken the state in a direction that is the opposite of what is needed. Every school of economic thought teaches the same lesson — do not raise taxes during an economic recession. But unlike other states facing fiscal problems, that is exactly what North Carolina did, pushing its combined state and local tax burden above the national average (see below). It is not surprising then that the state is underperforming the rest of the country during this recession. Furthermore, instead of seeking to reduce the size of the corporate welfare state, last year's so-called "lean" budget increased spending in this area by more than $15 million. Also, as noted, the governor is supporting the Clean Smokestacks bill, currently before the General Assembly, which, if passed, will be the equivalent of placing a new energy-usage tax on all industries in the state.

If the governor reversed himself and pursued the policies outlined above, he would signal to businesses, both inside and outside the state, that North Carolina is breaking the mold. He would be telling the world that the state is serious about providing an atmosphere that is friendly to business activity in general rather than being a state that is willing to punish some businesses so that others may flourish.

— Dr. Roy E. Cordato, Vice President for Research and Resident Scholar

NOTES

[1] "Regional and State Employment and Unemployment Summary" U.S. Department of Labor, Bureau of Labor Statistics, www.bls.gov/news.release.laus.nr0.htm.
[2] All unemployment data is from the U.S. Dept. Labor, Bureau of Labor Statistics, Local Area Unemployment Statistics, www.bls.gov.
[3] Rob Christensen, "Hard Times Grip State, Region" *The Raleigh News and Observer*, Dec. 2, 2001, p.A1.
[4] Roger Wilson, *State Business Incentives and Economic Growth: Are They Effective? A Review of the Literature,"* (Lexington, KY: Council of State Governments) 1989, as quoted in Lawrence W. Reed, "Time to End Economic War Between the States" *Regulation*, Vol. 19, No. 2, 1996.
[5] Dennis A. Rondinelli and William J. Burpitt, "Do government Incentives Attract and Retain International Investment? A Study of Foreign Owned Firms in North Carolina," *Policy Sciences*, Vol. 33, No. 2, 2000.
[6] Ibid.
[7] John Hood, "Ante Freeze: Stop the State Bidding Wars for Big Business," *Policy Review*, Spring 1994, p. 64..

HOW TAX HIKES WILL LIKELY AFFECT NC TAX BURDEN RANKING (ANNUALIZED 2001)