John LOCKE FOUNDATION

SPOTLIGHT

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Socialism for Capitalists

New Incentives Won't Aid North Carolina Economy

Summary: Gov. Easley's new incentives proposal would put political appointees into the position of doling out special tax breaks that amount to grants of taxpayer money to private businesses. Because of the unpredictable nature of a free-market economy, such a policy cannot claim to boost overall economic growth. A better policy would be to reduce North Carolina sky-high marginal tax rates on personal income, investment, and capital gains — which are among the highest in the country.

The headline in the August 1 Greensboro *News & Record* read "Easley offers incentives scheme," and "scheme" is exactly what the governor's new economic development plan is. It combines all the worst elements of corporate welfare or what might more appropriately be called "socialism for capitalists."

At the core of Easley's proposal, titled "The N.C. Stimulus and Job Creation Act," is a perverse plan to use the taxes paid by a company's workers to reward the company's owners for their decision to locate in North Carolina. Subsidies to qualifying businesses will be based on the amount of taxes that are withheld from employees' paychecks. As stated in the legislation, "the amount of the grant awarded in each case shall be a percentage of the withholdings of eligible positions. The percentage shall be no less than 10 percent and no more than 80 percent of the withholdings of the eligible positions for a period of years." In other words if the subsidy is the full 80 percent, for every dollar that the employing company withholds from a qualifying worker's paycheck it will, in effect, only have to send in 20 cents to the N.C. Department of Revenue. The company will actually keep 80 cents of that dollar, which was supposed to be part of the employee's compensation. In reality, Easley's scheme sets up a system where the employee is giving up a part of his salary, not to the state in the form of taxes, but to the company he is working for, for the privilege of working there. It would be hard to imagine a more poorly conceived and oppressive policy.

Who Gets the Slush and Who Runs the Fund

While the legislation lays out some guidelines (discussed below) the ultimate decisions concerning what companies get to bilk the taxpayers and which don't will go to

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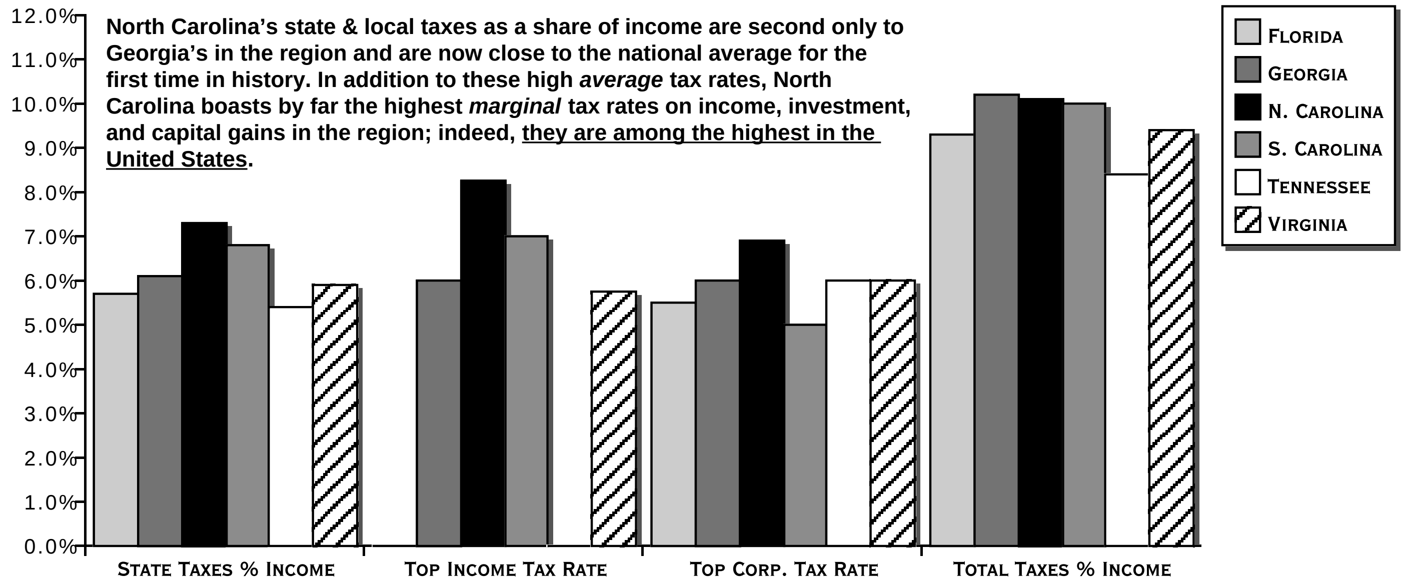
North Carolina's Real Economic Problem: High Overall Tax Rates



	State Taxes % Income	Top Income Tax Rate	Top Corp. Tax Rate	Total Taxes % Income
Florida	5.7%	0.00%	5.5%	9.3%
Georgia	6.1%	6.00%	6.0%	10.2%
N. Carolina	7.3%	8.25%	6.9%	10.1%
S. Carolina	6.8%	7.00%	5.0%	10.0%
Tennessee	5.4%	0.00%	6.0%	8.4%
Virginia	5.9%	5.75%	6.0%	9.4%

NOTE: "Total Taxes % Income" measure includes all state and local taxes, including income, sales, business, and property. It does not include the full value of the 2001 tax increases, and thus understates the competitiveness problem facing North Carolina.

SOURCES: U.S. Census Bureau, Tax Foundation

the "Economic Investment Committee" (EIC). The EIC is made up of three political appointees — the secretaries of Commerce and Revenue and the director of the Office of State Budget, Planning, and Management. The only objective and clear-cut guidelines facing the committee are that the companies receiving the largess cannot be in the retail business and that their compensation package must include a health insurance benefit that covers at least 50 percent of the insurance premiums.

These requirements are both arbitrary and discriminatory. First, there is no economic reason to discriminate against the retail industry and those who may seek employment in retail-related businesses. Ultimately it is the retail industry that make our lives convenient and it is competition at the retail level that makes our lives more affordable. There is no economic justification for the idea that retail businesses add less value to a community than manufacturing or any other kind of business. This aspect of the bill is clearly anti-consumer. Second, there is no reason that the legislation should discriminate against workers who would prefer to receive a greater percentage of their compensation in the form of wages rather than health-insurance subsidies. This aspect of the legislation is ignorantly based on the idea that health insurance is a freebie to workers. The fact is that workers *always* pay for employer-based health insurance in the form of lower wages. Forcing workers to accept a portion of their compensation in the form of health insurance makes employees who prefer a different arrangement worse off, not better off.

What might be the most onerous part of this legislation is the arbitrary power that is granted to the EIC. First of all, it needs to be emphasized that all three of the EIC members will be political appointees who will necessarily have very strong ties to the same political party. Given a choice between subsidizing two companies of roughly equal qualifications except that one has a history of making contributions to the party of the EIC members while the other either is apolitical or contributes to the opposing party, is there any question of who would get the subsidy? And even if the EIC ignores all political considerations, the nature of the committee automatically exposes it to suspicion and conflicts of interest. Ultimately, the EIC is likely to devolve into a slush fund management team for the party in power. In addition, the system will create a strong incentive for industries that may be in contention for the state subsidies to tailor their political giving accordingly. This legislation pushes the door wide open for the buying and selling of political favors.

Making this much more likely is the fact that the criterion that is supposed to guide the EIC's decisionmaking process is subjective and arbitrary. The legislation proposed by the governor and being considered by the General Assembly lists five "conditions" that must be met before a project gets the taxpayer money. Three of these cannot be demonstrated using any valid economic analysis.

1. The project will create a net increase in employment in the state.
2. The project will increase opportunities for employment and strengthen the state's economy.
3. The total benefits of the project to the state will outweigh its costs.

Any test of these conditions will necessarily be arbitrary and will be easily manipulated by the EIC to show any result it wants. It would be impossible for the EIC to gather the real-world information that would be needed to determine whether these conditions were met. This is because the process that the bill puts into place automatically is one of robbing Peter to pay Paul. In order to attract the businesses that the EIC divines are the "right" ones for the state, other existing businesses and workers in the state must be punished. Every dollar that goes to a favored business must come out of someone else's pocket. As such, investment, consumption, and job creation in other areas of the state will be reduced and there is no way for the EIC to know how much those reductions would be or where they would occur. Furthermore, the EIC would have to know how many present and future jobs would be eliminated or never come about because of these losses and what the ripple effects in terms of lost retail and other business would be as a result of reduced demand. None of this would be ascertainable because it involves economic activity that would have occurred but cannot because of the wealth transfer.

For example, 18 months ago it might have seemed (based on the information then available) that companies specializing in the manufacture of fiber-optic cable and other telecommunications equipment were destined to play a major role in North Carolina's economy future. Particularly in the Catawba Valley, numerous large-scale manufacturers were going full-tilt and hiring thousands of North Carolinians, creating labor shortages in several counties. If such a company had approached state officials for a grant under the new program, it is likely that they would have viewed it as a good investment. Today, with many of these companies shedding jobs and some at the brink of bankruptcy, the grant would be viewed as a boondoggle, helping to steer resources away from their most productive use.

Given the arbitrariness of the EIC's decisionmaking process, the chances that choices will be based on political considerations becomes much more likely. In any kind of scientific analysis, when there is no firm foundation for making the necessary calculations it becomes very easy to manipulate the data to show the desired result. If the committee is predisposed to subsidizing a given company then the books can easily be cooked to justify its decision. And in fact, there would be no way to "prove" the committee wrong.

Conclusion: The Right Road to Prosperity

The fact is that there is one proven way to attract investment, maximize job growth, and improve the economic well-being of the state's citizens. Unfortunately for the people of North Carolina, it is a route that this governor and General Assembly has shown no interest in pursuing. It involves one simple principle — keep control of revenues and resources in the hands of those who earn it. Government bureaucrats cannot improve on the decisions of free individuals about how to invest and spend their own money. This is the reason why the allocation of resources through the processes of the free enterprise system has always generated more job creation, more economic growth, and more personal and social wealth than any other mechanism ever devised. For state economic policy this means that the best thing the government can do is to get out of the way. Taxes on businesses, consumers, and workers, should be lowered, not raised. Regulations should be reduced, not expanded, as was recently the case with the costly and ineffective Clean Smokestacks legislation. And government subsidies to business should be abolished, not expanded.

While this approach would be consistent with sound economic analysis, it is very unappealing to politicians and bureaucrats whose jobs depend on spending and reallocating other people's money. There is no political glory to be had by keeping your nose out of other people's business and your hands out of other people's wallets. The free enterprise system affords no opportunities for governors and legislators to take credit for the opening of a new factory or the creation of new jobs. Without the ability to rob Peter to pay Paul, especially if Peter doesn't know he's being robbed, the job of politician becomes quite mundane.

Ultimately the governor's scheme has no backing in sound economic analysis and is based on the same flawed belief that doomed other socialist central-planning schemes throughout history. It is the idea that a team of government bureaucrats can allocate resources more efficiently than private investors, consumers, employees, and entrepreneurs making decisions within the context of the free enterprise system. But there is no theoretical or empirical evidence that has ever been presented to support this proposition. It is the height of arrogance for the governor to think that his team of experts will be the one exception to this rule in all of economic history.

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