

## PUBLIC DEBT, PUBLIC VOTE

### *Tax-Increment Finance the Wrong Approach for NC*

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**Summary:** State lawmakers are considering a proposed constitutional amendment to allow local governments to issue bonds without a public vote to construct convention centers, sports arenas, and other “economic development” projects. Careful research of these programs in other states reveals that they do not enhance a community’s economic growth over time. Moreover, they weaken governmental accountability to a voting public that does not favor subsidizing private businesses.

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**T**he North Carolina Senate has passed a bill authorizing a public vote on a constitutional amendment that would allow local governments to use what is called “tax increment financing” (TIF) to fund local development projects. TIF allows counties and municipalities to issue bonds without the explicit consent of the voters, a practice that is now constitutionally forbidden. The resulting debt would be repaid from tax revenue increases that would presumably result from the new development. The logic is that government-subsidized new business ventures will result in higher property values in the area and therefore higher property tax revenues from those properties. The debt holders will be repaid using only revenues from property tax payers who benefit from the subsidies.

This amendment would promote both bad economic policy and bad public finance.

#### *A Faulty Premise on Economic Development*

“[T]he State of North Carolina and local governments in North Carolina are and should be actively engaged in economic development efforts to attract and stimulate private sector job creation and capital investors in their areas...”<sup>1</sup>

This is the opening statement and ultimate justification of Senate Bill 725, amending the N.C. Constitution to allow localities to use tax incremental financing. It is this premise that is at the heart of why this bill is fundamentally flawed.

According to all the evidence, neither state nor local governments should be involved in subsidizing business activity. In fact, the best thing that government at any level can do to aid entrepreneurship and economic growth is to stay out of the way.

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When it comes to tax incentives and subsidies to attract new businesses or aid faltering ones economists speak with one voice. They don't work. And this includes those funded through TIF programs. 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."<sup>2</sup>

A recent study in the journal *Policy Sciences* of the effectiveness of North Carolina's economic incentives to attract international business noted, "North Carolina has developed one of the most aggressive programs in the United States for attracting and retaining industry."<sup>3</sup> In spite of this, when internationally owned companies in N.C. 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 government 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.<sup>4</sup>

### ***Research on TIFs Shows No Net Economic Gain***

There is no reason to think that the mode of financing should make a difference in these conclusions. Studies of TIF-funded programs bear this out. As with most government programs, except for anecdotal evidence chosen to promote their alleged success, there is not a great deal of serious economic analysis of the use of TIF programs per se. But two Iowa State University economists have done an assessment of that state's program, which seems to be almost identical to that being proposed in North Carolina. Their conclusions should give all NC legislators pause.

"[E]xisting taxpayers, its householders, wage earners, and retirees are aggressively subsidizing business growth and population via this practice," they wrote. "We found virtually no statistically meaningful economic, fiscal, and social correlates with this practice in our assessments; consequently, the evidence that we analyzed suggests that net position are not being enhanced — that the overall expected benefits do not exceed the public's costs."<sup>5</sup>

This conclusion does not mean that property values in the TIF areas did not grow. In fact they grew quite significantly, as one would expect when large amounts of government subsidies are poured into an area's development. But this highlights the flaw in the entire scheme — namely that the change in property values in one area says nothing about overall economic growth. What happened in Iowa is what one would expect to see with any such program. There are hidden costs imposed on those living both inside and outside of the TIF area which means that the true subsidy that is occurring is from these groups who were in the area prior to the program to the subsidized businesses and projects.

Economic analysis suggests a number of reasons to expect this kind of outcome. First of all, any new businesses that are attracted by the subsidies are likely to pose a competitive threat to existing businesses both in terms of products being sold and, more likely, use of the existing labor force and other resources. The new businesses will drive up labor and other resource costs both in and outside of the TIF region, reducing business activity in other areas and possibly putting marginal firms out of business. To the extent that this happens, existing firms that are harmed are, in effect, paying the subsidy that is going to the businesses favored by the TIF. If property values go up, previously existing businesses and homeowners simply have to pay additional taxes while not receiving the direct benefits of the program. And these higher tax payments are not going to improve the schools in the area or provide higher-quality services, but to pay back the bond holders.

Furthermore, population growth is likely to grow inside the TIF district at the expense of other parts of the region. With TIF subsidies in one area, people are likely to migrate from other parts of the region to take advantage of the subsidized business environment. This reduces the demand for property outside the TIF district, driving down property values and tax collections in these other jurisdictions. As noted above, this migration would also have the effect of driving up labor costs in the non-TIF districts as the supply is reduced.

What all of this implies is that growth inside the TIF area is likely to occur at the expense of those who are already living, owning businesses, and paying property taxes there and outside the district. This analysis is consistent with the empirical conclusions reached by the Iowa researchers. They concluded that "there is indirect statistical evidence that this profligate practice is resulting in a direct transfer of resources from existing taxpayers to new firms without yielding region-wide economic and social gains to justify the public's investment."<sup>6</sup>

Indeed, the outcome could be worse than simply achieving no net gain. A 2000 study by two researchers for the University of Illinois' Institute for Government and Public Affairs found that cities in that state employing TIF districts actually grew slower than cities not employing TIFs — even after adjusting for other factors with the potential to explain the difference.

"This is consistent with the hypothesis that government subsidies reallocate property improvements in such a way that capital is less productive in its new location," the authors wrote. "A business is induced by the promise of a subsidy to locate in an otherwise less promising area within a municipality. But other businesses that might be attracted to locate near it are deterred by the inferior location and instead go to another municipality. The TIF has reduced growth."<sup>7</sup>

### ***Building Public Finance on Misinformation***

The basic argument of using TIFs to finance business subsidies is that those who benefit will pay the costs and that all others will be "held harmless." This is based on the premise that, if for some reason the businesses that are subsidized are not profitable, all the risk is born by the bond purchasers. This is part of the understanding when the bond is purchased. As is stated in documents published by the North Carolina Metropolitan Coalition, an advocacy organization of mayors promoting the legislation:

"Investors who purchase the bonds assume all financial risks associated with the project. The bond payments are based solely on the increased property values and subsequent increased taxes collected within the project development financing district so the general fund for a county or municipality will not be responsible for payments of the bonds in the event the project fails."<sup>8</sup>

But clearly, in light of the above analysis, this is misleading. Existing businesses and taxpayers, both inside and outside of the TIF district, will be paying the subsidy, regardless of whether the government subsidized venture succeeds. In essence the TIF program imposes a hidden tax on these other groups and is, in this sense, inconsistent with sound principles of public finance and an open democratic process.

### ***Conclusion***

The reason for passing this constitutional amendment seems clear: it is to give local government officials a chance to pursue programs that would not otherwise be approved by the voters. Under current law, the TIF-funded programs that are being contemplated by local government officials could proceed if the citizens in their communities supported them. The problem for spending-hungry politicians is that their constituents would likely vote the projects down if asked directly. Local citizenry are regularly making their position clear by voting down bond referendums to subsidize stadiums, civic centers, and similar, essentially private, ventures. In fact, North Carolina has defeated similar TIF amendments that would have relieved localities from the constraints of voter approval of public debt twice before, in 1982 and 1993. If this amendment passes the full General Assembly, it is hoped the electorate will show the good sense that they have in the past and defeat it once again.

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

### ***Notes***

1. "Local Option Project Development Financing," Senate Bill 725, April 3, 2003.
2. 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.
3. 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.
4. Ibid.
5. David Swenson and Liesl Eathington, "Do Tax Increment Finance Districts in Iowa Spur Regional Economic and Demographic Growth?" Department of Economics, Iowa State University, June, 2002, 1. Found at [www.ag.iastate.edu/aginfo/news/tif.html](http://www.ag.iastate.edu/aginfo/news/tif.html). For analysis of Chicago area TIF districts that has come to similar conclusion see "The Right Tool for the Job? An Analysis of Tax Increment Financing," published by the Developing Neighborhood Alternatives Project. The study can be accessed at [www.heartland.org/Article.cfm?artId=11868](http://www.heartland.org/Article.cfm?artId=11868).
6. Ibid., p. 11.
7. Richard F. Dye and David Merriman, "TIF districts hinder growth: Study finds that cities without TIFs grow faster," *Policy Forum*, Vol. 13, No. 4, 2000, Institute of Government and Public Affairs, University of Illinois, p. 3.
8. "Local Option Project development Financing Q&A's" [sic], Prepared by Beau Mills, NC Metropolitan Coalition, found at [www.ncmetros.org](http://www.ncmetros.org).