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SPOTLIGHT

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THE BEST INCENTIVES

Targeted policies fail while tax rates, services matter

Summary: The North Carolina General Assembly is returning to Raleigh for a special session on economic development. Rather than rush to push targeted tax credits and incentives for a few, lawmakers should pursue a broader examination of the factors under their control that really influence state economic growth. The wrong direction is to enact any set of policies that increase the state bureaucracy or the ranks of lobbyists seeking to arrange special "deals" for their industrial clients.

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At this writing, the North Carolina General Assembly is expected to come to Raleigh on Tuesday, Dec. 9 for a special session devoted to economic development. In what legislative leaders say will be a brief session, lawmakers will be asked to approve a set of new and expanded incentive programs intended to help North Carolina attract or retain jobs associated with three industrial projects: an expansion in Winston-Salem related to a merger between R.J. Reynolds Tobacco and Brown & Williamson Tobacco, a possible Boeing manufacturing facility at the Global TransPark in Kinston, and a possible Merck pharmaceutical manufacturing facility at Durham's Treyburn development. Gov. Mike Easley called the session and his administration is the driving force behind the expected recommendations.[1]

While the details of the package are not yet available, it would reportedly[2] include:

• Raising the annual cap to $10 million from $6 million on an existing tax credit for the export of cigarettes.

• Creating a sales-tax exemption for the purchase of plant construction materials, which is intended to help both the Boeing and Merck projects.

• Expanding the governor's ability to offer land grants to industrial prospects, which could be used to offer a part of the GTP to Boeing and for the state to purchase land to give to Merck in Treyburn.

• Expansion or adjustment of the William S. Lee Act, which offers per-job tax credits, and the Job Development Investment Grants, in which the state pays companies a portion of the payroll taxes collected from their employees.

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Findings of Kenan Institute Survey, 1999

What Matters to International Firms	Average Rank
1. Labor Force (availability, wages)	8.839
2. Transportation (highways, airports)	8.144
3. Quality of Life (schools, living cost)	8.000
4. Business Climate (taxes, regulation)	7.627
5. Education (community college, K-12)	6.711
6. Proximity to Markets, Vendors	6.678
7. Plant Location Services	5.711
8. Tax Incentives (investment, jobs)	5.550
9. Government Assistance (local, state)	4.076
10. Government Financing (loans, bonds)	2.898
11. State Marketing (offices, trade trips)	1.694

Findings of Business Execs Survey, 2002

What Most Affects NC Competitiveness	Average Rank
1. State and Local Tax Rates	3.86
2. Labor Skills and Availability	4.27
3. Education System	4.35
4. Regulatory Burden	5.11
5. Government Incentives or Subsidies	5.23
6. Highway System	6.47
7. Access to Capital	6.65
8. Airport Service	7.01
9. Port or Rail Service	7.56
10. Recreational and Leisure Amenities	8.83

SOURCES: Rondinelli & Burpitt, Kenan Institute of Private Enterprise, UNC-Chapel Hill, 1999; John Locke Foundation, 2002

The emergency nature of the special session and the lack of specificity ahead of time for lawmakers to study and consider should serve as red flags for policymakers seeking to make good long-term decisions. Any economic-development policy worth doing is worth doing well — and deliberately. This is particularly true with regard to decisions involving state taxpayer dollars or state taxing authority that have the potential to set a precedent for future demands for subsidies by existing or prospective employers in North Carolina.

Policymakers should also keep in mind the recent history of "economic-development" programs in North Carolina. In the mid- to late-1990s, when state legislators were fashioning the Bill Lee Act, creating development zones, preparing a statewide referendum on natural-gas bonds, and funding projects such as the Global TransPark, there was little information available about the likely impact of these policies on the real economy. That left stated intentions and promises as the motivating factors for many. But such excuses no longer exist. Experience and subsequent reporting and research have revealed the shortcomings and drawbacks of these initiatives:

• On the Bill Lee Act tax credits, several reports and a Commerce Department survey of North Carolina manufacturers have demonstrated that the program has fallen far short of its original promise. A 2001 assessment by the N.C. Department of Revenue argued that the tax credits were unlikely to change dramatically the economic fortunes of distressed areas of the state that already enjoyed lower production costs and were unlikely to affect business decisions enough to justify the cost.[3] A March 2003 study by UNC-Chapel Hill's Michael Luger and Suho Bae estimated that only 4 percent of the jobs for which Lee Act credits were credited were actually induced by the legislation, meaning that virtually all of the employment would have occurred anyway.[4] Combined with Luger's finding[5] that most Lee Act credits were awarded to a relatively few companies in just a few large counties already enjoying relatively low unemployment, the research represented a devastating blow against the case for maintaining or expanding the Lee Act.

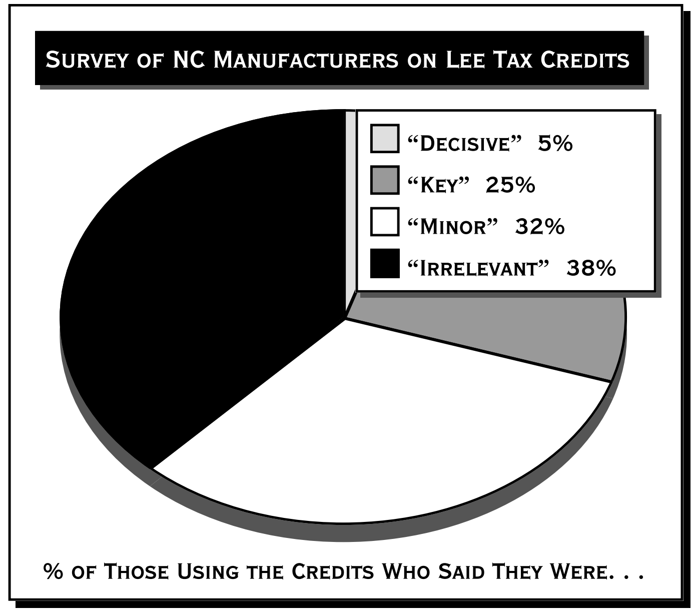
Furthermore, as a separate analysis by the Corporation for Enterprise Development in September 2003 showed, even Luger's research may be too charitable to the Lee Act's benefits, in that it "bend[s] over backwards to avoid drawing a real conclusion with regard to this very basic question."[6] The CED analysts concluded that the Lee Act was likely "a fiscal loser for the state." This finding was buttressed by the revelation that a December 2002 Commerce Department survey of North Carolina employers found that only 5 percent of the companies participating in the Lee Act said that the tax credits were "decisive" in their decision-making process, with fully 70 percent saying the credits were either a "minor" or "irrelevant" factor.[7]

•On economic-incentive programs more generally, the available research suggests caution in assuming their value, if not outright skepticism. A 1999 survey of internationally owned firms in North Carolina found that state incentive and marketing programs ranked low in importance, far below such bread-and-butter issues as the cost and quality of available workers, transportation access, education, taxes, and regulations.[8] Similarly, a 2002 survey by the John Locke Foundation of 435 business executives from across North Carolina found that overall state and local tax rates, labor skills and availability, education, and regulations were considered the factors that most reduced the state's economic competitiveness.[9]

Academic studies of targeted tax incentives generally conclude that they do not have a large and demonstrable impact on job creation or economic growth[10] , and that incentive policies typically arise from political rather than economic considerations.[11] Indeed, a 2002 study of Ohio firms by professors Todd Gabe and David Kraybill found that while incentives had very little — or even a negative — effect on actual job growth, they had a substantial positive impact on *announcements* of job growth, announcements that usually failed to materialize later on.[12]

Taxes, Lobbyists, and Why State Economies Grow

While studies of targeted economic-development incentives typically found no significant benefits for workers or taxpayers, other research suggests that government policies can and do influence the rate of economic growth. For example, the direction of the economic literature over the past three decades has been to find statistically significant correlations between economic growth measures and overall state tax policy, particularly when measured as the marginal rate of taxation on new income earned.[13] Similarly, some recent studies have found that state or local investments in public services boost economic growth, though some may find it surprising that the services most often found to foster better economic outcomes are police and fire protection.[14]

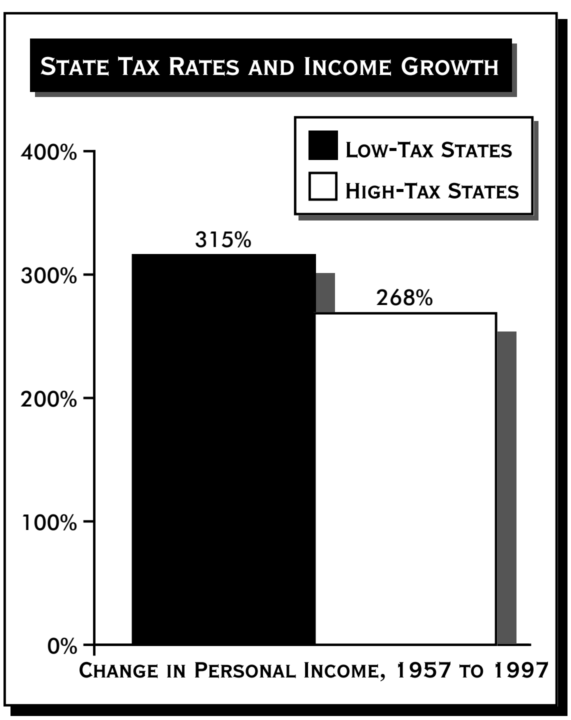


SOURCE: N.C. Commerce Department survey, Dec. 2002

How can these research findings be reconciled with those estimating little or no benefit from economic-development incentives? The answer lies in at least two areas: 1) the "opportunity cost," or inevitable tradeoff, that occurs when scarce public dollars are devoted to incentive or marketing programs instead of lower taxes or improving public services; and 2) the fact that incentive programs essentially constitute a "bet" by state officials on the success of specific companies or industries, often those with political or lobbying heft, while the unpredictable nature of a market economy would lead thoughtful policymakers to eschew such gambles and focus on offerings and amenities that are broadly available to all firms and individuals.

Both issues can be better understood by examining the results of two econometric models of state economic growth developed by researchers in 1999 and 2002. In the first, economist Harold Brumm of the General Accounting Office constructed a model that examined economic performance from 1985 to 1994 across American states. Brumm studied many variables with a potential effect on growth in gross state product, including the starting size of a state economy, population growth, educational levels, investment in public and private capital, and marginal tax rates.[15] His findings are summarized on Page Four. In 2002, two other researchers — Ismail Cole and Arshad Chawdhry — refined Brumm's model to test additional variables and looked at the 1980-90 period.[16] Their findings are also summarized on Page Four.

In both cases, what leaps out is the strong negative impact on economic growth that comes from what the researchers call "rent-seeking behavior" — meaning the amount of effort put into securing government jobs, subsidies, tax breaks, or other special treatment from states. Rent-seeking behavior manifested itself in the share of employment found in state government, in the legal profession, and in lobbying. Cole and Chawdhry further examining the concentration of lobbying by comparing the number of organizations with lobbyists to the size of the state's economy. In explaining their results, Cole and Chawdhry noted that as rent-seeking activities in a state rose, the state spending on programs their model suggested to be economically valuable — such as police and fire protection (again) and public capital, primarily highways — tended to fall. For economic development, the implication is obvious. As businesses secure special subsidies or tax breaks, the state is left unable either to reduce taxes elsewhere or to spend tax dollars on broadly available and economically productive services.



SOURCE: Dr. Richard Vedder, Ohio University

Advocates of incentives deny the possibility of this effect, arguing that there is no opportunity cost, at least for tax incentives, because the "foregone revenue" would not have accrued to the state. The recruited company wouldn't have been around to pay the taxes, they say. But the previously noted research disproves their argument. Most recipients of incentives would, indeed, have come to the state or added the jobs, anyway. But because of incentives, they do not generate as much tax revenue as they would have — even though service needs associated with their relocation or expansion remain, such as infrastructure, schools for employee's children, and more policing needs. These are either skimped on or financed by higher taxes on existing businesses and households.

1999 Findings on State Economic Impact

Significant Impact on Economic Growth	Stand. Coefficient
Starting Size of State Economy (Less-Affluent States Tend to Grow More Rapidly Than Affluent Ones Do)	-0.5306
Marginal State & Local Tax Rates	-0.2218
Index of "Rent-Seeking Activity," Comprising the Share of State Work Force in Government, Law, and Lobbying	-0.8523
No Significant Impact on Growth	
Rate of Growth in the State's Total Resident Population	
State's Real Investment in Public and Private Capital as a Share of Real GSP	
Percentage of State Workers With At Least 12 Years of Formal Education	

2002 Findings on State Economic Impact

Significant Impact on Economic Growth	Stand. Coefficient
Starting Size of State Economy	-0.149
State's Real Investment in Public Capital (ex. Highways) as a Share of Real GSP	0.022
Real State Expenditures on Police and Fire Protection Services Per Capita	0.190
State Employees as Share of Total	-0.008
Number of Lobbying Organizations in Proportion to the State's Economy	-1.328
No Significant Impact on Growth	
Manufacturing Output as a Share of GSP	
State's Real Investment in Private Capital as Share of Real GSP	
Percentage of State Workers With At Least 16 Years of Formal Education	

Lawmakers need to consider carefully the other side of the argument, since they are often asked to improve incentive packages for specific employers, in this case Boeing, RJR, and Merck. Given the fact that targeted tax incentives and land grants are necessarily specific — if they were generally available to any firm anywhere, they would either constitute simply a tax cut or likely be deemed unaffordable — they inevitably require governments to guess which firms or industries are worth "investing" in. Private investors make these difficult and sometimes speculative determinations all the time, but they are doing so with their own money or with money entrusted to them by willing clients. The taxpayers of North Carolina, on the other hand, are not willing investors in a venture-capital fund operated by their elected representatives. Given the fact that past "bets" by North Carolina officials — on the viability and benefits of natural-gas service in rural counties[17], the much-vaunted "North Carolina Information Highway" project of the mid-1990s, various past recipients of state incentive dollars that no longer exist, and the Global TransPark itself — have proven to be worse than useless, why should one assume that a new round of economic-development gambling would be more fruitful? Already, there are serious questions about whether Boeing will actually make the investment it currently envisions in a new aircraft line, and whether this aircraft will prove to be a success in an increasingly competitive international market.[18] Obviously, reasonable people might also question whether the future of the domestic cigarette industry is one that the taxpayers of North Carolina should be *compelled* to wish well.

North Carolina's climate for economic growth does need improvement, but a misguided set of targeted subsidies for a few corporations, enacted in a rush to satisfy the apparent demands of consultants engaged in secretive dealings with state officials, is not the right approach.

— John Hood, President

NOTES

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