John LOCKE FOUNDATION

SPOTLIGHT

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Getting a Dell?

Targeted Tax Breaks Don't Increase Job Creation

Summary: State lawmakers are scheduled to meet in Raleigh today to consider a package of tax breaks and other incentives designed to lure a Dell Computers plant to North Carolina. While politicians often portray such deals as necessary to promote growth and job creation, they serve to transfer resources from existing firms, sometimes even competitors, while failing to address tax and other problems afflicting businesses of all sizes in the state. A good place to start in improving the state's business climate would be to reduce marginal tax rates.

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On Thursday, the North Carolina General Assembly will convene for a special session to consider an incentives package worth hundreds of millions of dollars to help persuade Dell Computers to locate a distribution plant in the Triad. According to *The News & Observer* of Raleigh, Dell has a history of demanding large sums of taxpayer money before making an investment. In the late 1990s, Dell extracted $160 million from the taxpayers of Tennessee in exchange for building a plant in that state.[1] The upper limit of the subsidy being discussed in North Carolina is $250 million. This is considerably more than the entire cost of the facility Dell intends to build and is reportedly in exchange for 2,000 new jobs created.

Once again the Easley administration has apparently decided that it makes sense to penalize businesses and entreprenuers who believe they can make it on their own without receiving taxpayer subsidies. His approach to economic development policy has consistently been one that penalizes the broad base of business that already exists in the state while attempting to attract specific industries from beyond North Carolina's borders with targeted subsidies. From the perspective of sound economic policy, this makes no sense — but as a political strategy there may be great advantages for the governor and state legislators who follow his lead.

Since 2001 North Carolina's top marginal income tax rate has risen to 8.25 percent. This is the highest in the region and the sixth-highest in the country. The state's corporate tax now stands at 6.9 percent, which is the highest in the Southeast.[2] The point is that both of these taxes impose a severe penalty on existing businesses in the state. In particular, the egregious personal tax rate is a direct assault on small businesses

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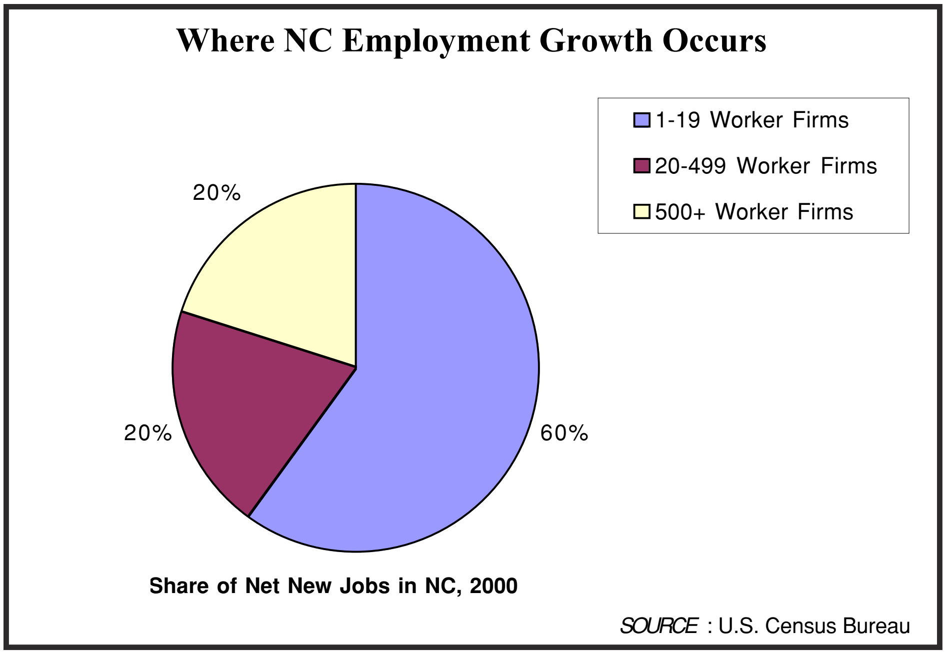

and entrepreneurs. The owners of firms such as sole proprietorships, partnerships, and S corporations are all taxed via the personal income tax. In addition, most of the state's job growth comes from these smaller companies. According to the U.S. Census Bureau data, employers with fewer than 500 workers account for roughly half of all jobs in North Carolina and generate 80 percent of new jobs in the state. Businesses with fewer than 20 workers are responsible for 60 percent of job creation.[3] It is these smaller, mostly unincorporated firms that are being hit the hardest by North Carolina's high personal income tax rates. These rates are increasing the cost of doing business and depressing job creation.

What is even more disconcerting is that the revenues being extracted from these companies are being used to subsidize newly arrived and typically much larger businesses such as Dell who demand massive amounts of taxpayer money to set up shop. The reason why this *cannot* create net new jobs, and will likely retard employment growth, is that it amounts to a wealth and investment transfer scheme. Business investment and job growth may expand in the targeted areas but it shrinks in countless numbers of businesses throughout the state as they are forced to pay higher taxes to cover the cost of providing government services to firms receiving special tax breaks or giveaways.

This exchange of investment and jobs is not likely to be one-to-one but a net loser for the state. The money is being transferred from firms that are already operating profitably, and are proven job creators, to speculative ventures that may not last. In other words, the investment choices of politicians are being substituted for the choices of entrepreneurs whose business sense has been validated in the market place. Not only is this objectionable on economic grounds, but it raises a clear question of fairness. Why should companies who are operating successfully in the state, strictly on the basis of their entrepreneurial ability to raise private capital, have to subsidize their potential competitors? Regarding the proposed incentives for Dell, a spokesman for IBM said last week that "we would have no objection to Dell coming to the state, as long as the incentives would not give them an unfair advantage."[4]

While it makes no economic sense, such schemes can *look* like economic development. The jobs that are created by companies receiving subsidies, such as Dell, are highly visible and easy to exploit by politicians looking to claim credit. On the other hand, the potential employment and investment losses — at IBM for example — are not so easily identified. Much of it comes in the form of investments that *would have been made* had it not been for the higher taxes, and it affects many different firms, each to a relatively small degree. This makes it easy for politicians to take the credit at the ribbon-cutting for the newly subsidized business while escaping the blame for layoffs or jobs never created in other parts of the state.

The best way to generate net new investment and job creation, both from the entrance of new firms and the expansion of existing ones, is by creating a tax and regulatory environment that is not only good for a politically connected few, but for all businesses in the state. According to the nonpartisan Tax Foundation, North Carolina has one of the least attractive business tax climates in the Southeast, ranking 30th among all 50 states in its *State Business Tax Climate Index, 2004*.[5] If the governor wants to maximize job creation for North Carolina, he should call a special session of the legislature to discuss ways to reduce personal and corporate income taxes for *all* of North Carolina's businesses.

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

NOTES

[1] "Value of Dell plant questioned," *The News & Observer*, November 3, 2004.
[2] *Facts and Figure: How Does Your State Compare?*, (Washington, D.C.: The Tax Foundation) 2004.
[3] "2003 State Small Business Profile: North Carolina," U.S. Small Business Administration," Office of Advocacy, p. 2.
[4] "Dell plant could lead to competition between Guilford, Forsyth," *The News & Observer*, October 29, 2004.
[5] See www.taxfoundation.org/sbtci.html.