

**An Evaluation of North Carolina's Economic Development Incentive Programs:  
A Summary of Findings**

**Prepared for**

**North Carolina General Assembly  
Select Committee on Economic Development Incentives**

**by**

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In March 2007, the President Pro Tempore of the North Carolina State Senate and the Speaker of the North Carolina House of Representatives established a Joint Select Committee on Economic Development Incentives to examine the state's economic incentive programs. In January 2008, the North Carolina General Assembly contracted with the University of North Carolina's Center for Competitive Economies (C<sup>3</sup>E) to assist the Joint Select Committee on Economic Development Incentives in evaluating the performance North Carolina's economic development incentive programs. C<sup>3</sup>E undertook this 18 month research program with the goal of addressing a set of questions deemed key to the committee's efforts:

1. What is an economic incentive and which ones are most appropriate for the committee to assess?
2. How can the success of economic incentives be judged and which measures are the highest priorities for North Carolina?
3. What companies have received economic incentives, how much have they gotten, and how much more will be granted under current policies?
4. What have been the benefits from economic incentives and how do programs and types of recipients differ in their economic impact?
5. To what extent do North Carolina's economic incentives affect the state's economy?
6. How do economic incentives factor into company location decisions, and what is the process operating today?
7. Who are North Carolina's competitors and how do they use economic incentives?
8. How do economic developers, business owners and citizens perceive the effectiveness and importance of economic incentives?
9. How would the economic impact of reducing the state's corporate tax rate compare to that of current economic incentives?

This summary of findings discusses the importance of each critical research question under examination, reviews the research approaches utilized to examine these questions, and highlights key findings from the research. More detailed analysis and secondary research findings can be found in the complete report and appendices. To assist C<sup>3</sup>E in effectively answering these questions, the General Assembly passed legislation authorizing the Department of Revenue to release tax filings for William S. Lee tax credit recipients to C<sup>3</sup>E to complete the study. Electronic tax filings were available for companies receiving Lee tax credits from 1996-2006, and hard copies of tax returns, which included additional information on type of credit claimed, were released for 2002-2006 returns. The North Carolina Department of Commerce provided information on Job Development Investment Grant (JDIG) and One North Carolina Fund (One NC) incentive recipients. The North Carolina Employment Security Commission provided quarterly employment history from 1990-2006 for incented firms based on information provided by the North Carolina Department of Revenue and Department of Commerce. In total, this database exceeds 250,000 observations used to track the pre and post employment performance of incented companies.

Quantitative employment and incentive data was then augmented by qualitative data from the case studies and surveys. Executives from 36 companies receiving Lee Act incentives

participated in confidential interviews to discuss the impact of the Lee Act on their company's business expansion and location decisions. Sixteen detailed case studies were conducted on JDIG/One NC Fund companies, including documentation of local and state incentives received. Four case studies (two in South Carolina and two in Virginia) were utilized to examine companies North Carolina unsuccessfully competed to locate into the state. Additionally, a survey was utilized to determine the perspective of incented and non-incented companies on the importance of economic development incentives to their business expansion and location decisions and importance to the state's business climate.

**1) What is an economic incentive and which ones are most appropriate for the committee to assess?**

C<sup>3</sup>E worked closely with the Joint Select Committee and the legislative staff to define the relevant population of economic development incentives to be addressed in the study. The study limited the analysis to the state's statutory programs in the form of the William S. Lee Act (later replaced by Article 3J) and the discretionary programs in the form of the Job Development Investment Grant (JDIG) and One North Carolina Fund. The state's Research and Development tax credits were also included in the study.

The study did not measure or examine the effectiveness of local economic development incentive packages, although some data were collected on the types and amounts of local incentives in the JDIG/One NC Fund case studies and surveys of incented companies.

**2) How can the success of economic incentives be judged and which measures are the highest priorities for North Carolina?**

North Carolina was a late entrant in establishing an economic development incentive program relative to many other southern states. The William S. Lee Act was created in 1996 and has undergone multiple revisions to expand eligibility, refine criteria, and modify thresholds since the original legislation. The One North Carolina Fund and Job Development Investment Grants are also economic development incentive tools utilized by the state for economic development purposes. As North Carolina's palette of economic incentives has expanded, often in response to unanticipated circumstances, the core goals of the adoption of economic incentives may have come to be perceived as muddled, inconsistent, or even contradictory. Therefore, to assess the performance of North Carolina's economic incentives it was first necessary to freshly define the standards by which such performance was to be measured.

The justification for economic incentives in the public arena is typically and simplistically presented as "job creation". But there are a wide range of other legitimate desired outcomes to consider in judging performance. The relevance and priority of these outcomes is a function of public policy as articulated by the General Assembly.

Working closely with the Joint Select Committee and supported by legislative staff, C<sup>3</sup>E defined four parameters to utilize in measuring the effectiveness of the state's economic development incentive programs:

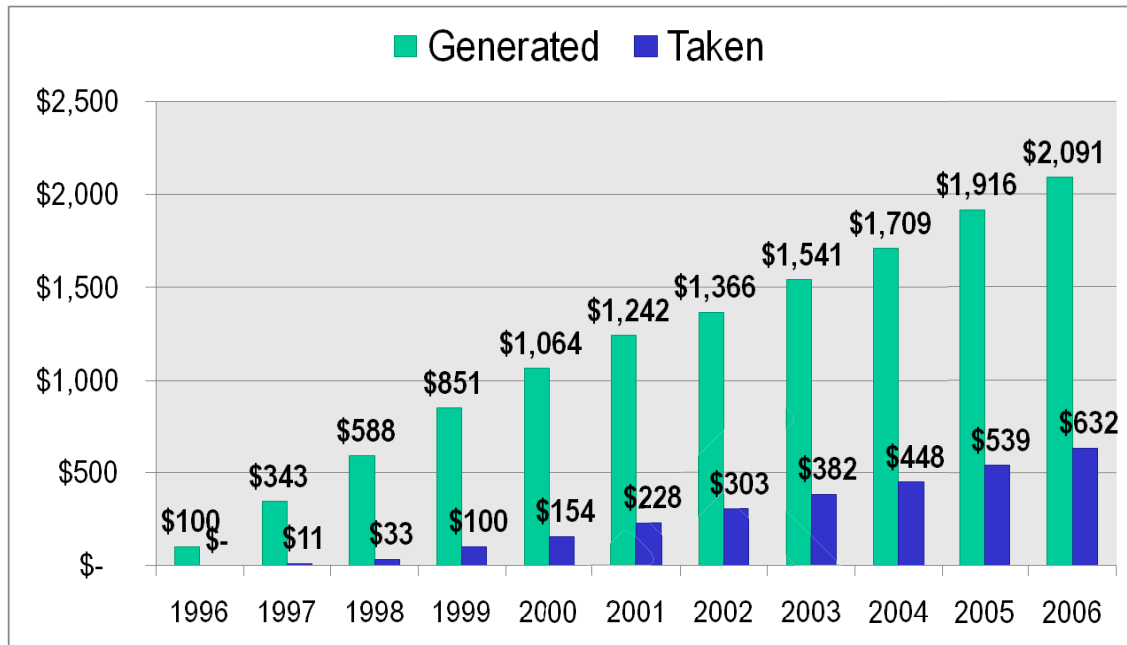
1. Job creation
2. Benefit to distress areas
3. Quality of life impact
4. Impact on economic competitiveness

Job creation measures included examining the number of new jobs created and/or existing jobs maintained after receiving an incentive, the wage level of created jobs, whether or not the job was in a targeted industry sector/cluster, and the location of the job. Distress area benefits measures included examining the share of new job creation in distressed areas and the wage levels associated with those jobs. Additional prospective measures included reemployment of displaced workers and replacement of declining industries.

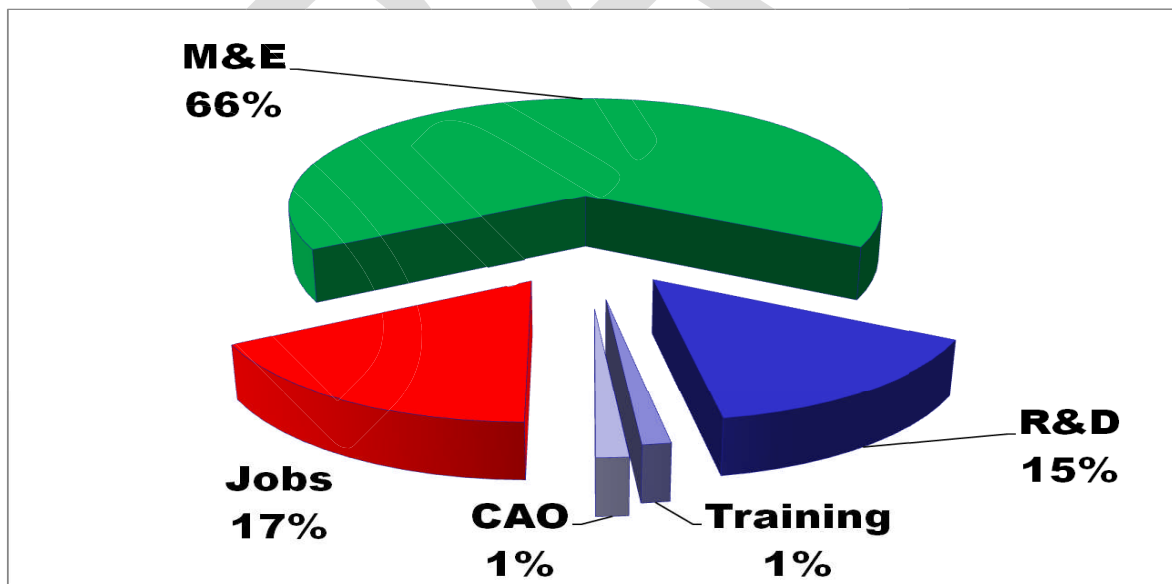
The primary quality of life measures included determining whether incented companies were hiring existing residents for new jobs and creating upward employment opportunities. Economic competitiveness was examined through the lens of economic diversification and insulation from any negative effects of globalization. Focusing on the location of headquarters, entrepreneurship, and high value industry clusters were also prospective measures. These key measures were examined through a portfolio approach designed to determine which economic incentive programs were offering the best return on investment.

### **3) What companies have received economic incentives, how much have they gotten, and how much more will be granted under current policies?**

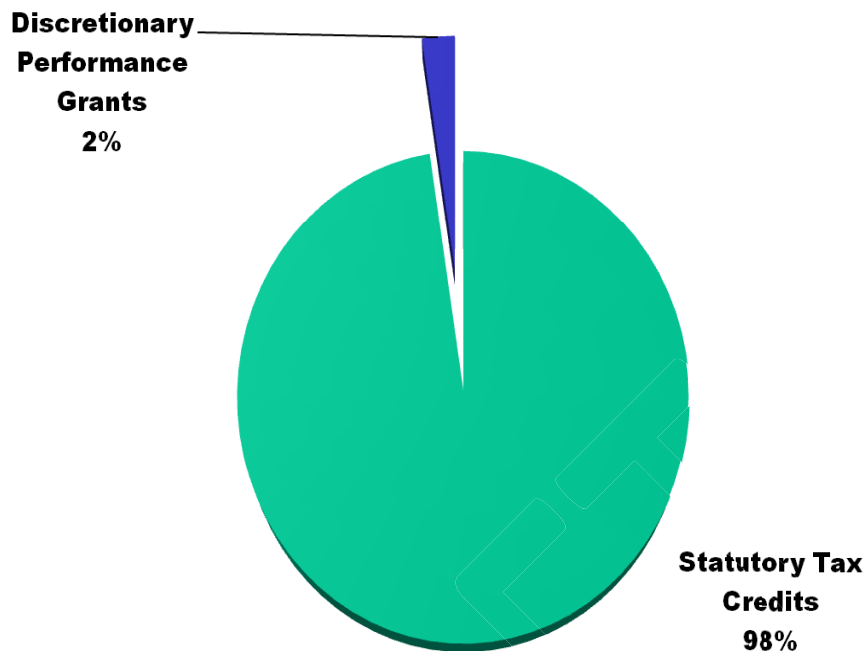
An examination of the statutory and discretionary incentive programs reveals that the majority of economic development incentives go to the least distressed counties (Tier 5 under Lee Act) while fewer go to the states most distressed counties (Tier 1). This distribution mirrors the location of both existing economic activity and population. Additionally, the amount of credits generated under the Lee Act greatly exceeds the amount of the credits actually claimed or taken. The cumulative amounts of credits generated under the Lee Act exceed \$2 billion in 2006, yet the amount of credits actually claimed was much smaller at approximately \$632 million.



The popular perception is that job creation is the major focus on economic development incentives, yet only a small amount of Lee Act tax credits are directly attributed to job creation activities. Approximately 17% of Lee Act tax credits are utilized for job creations. The vast majority are used for machinery and equipment investment, which may be positively or negatively correlated with job growth.



The Lee Act tax credits consume the majority of North Carolina's incentive "portfolio" allocation, representing 98% of the allocation, while discretionary incentives only comprise 2%.



Of the 1,967 companies generating Lee Act Tax Credits from 2002-2006 (total \$875 million), 46 companies (just 2%) generated a total \$523 million (39% of the total) while 860 companies (44%) received less than \$25k each. The effectiveness of such small amounts on business decisions is suspect.

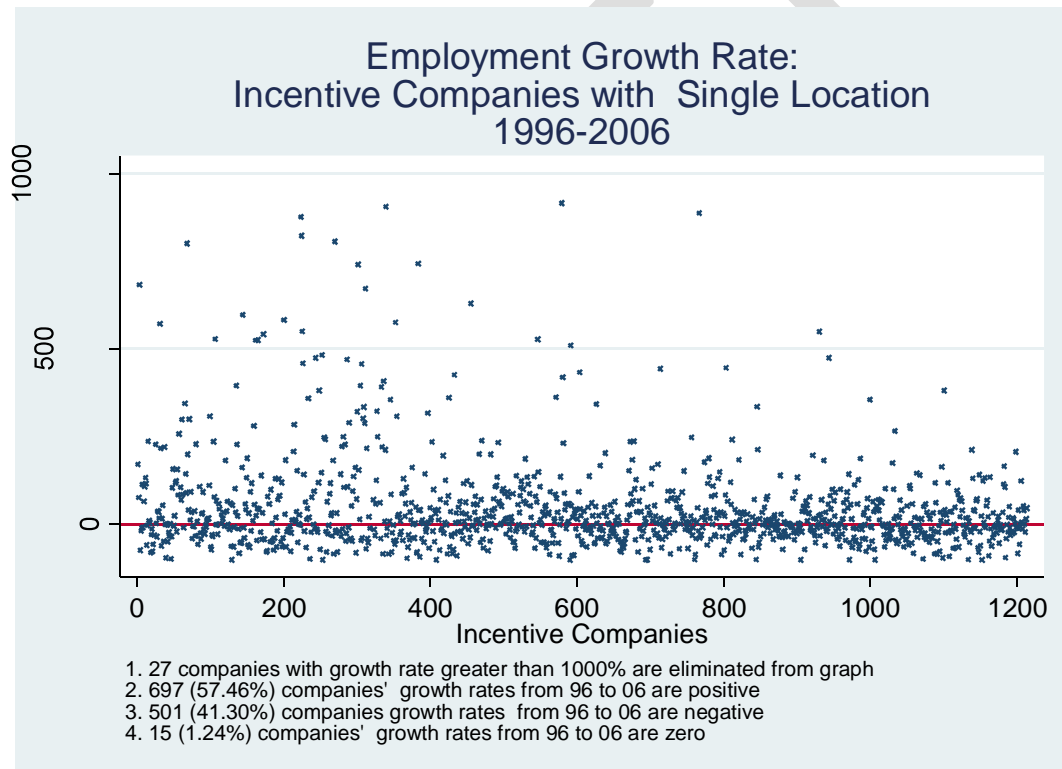
#### **4) What have been the benefits from economic incentives and how do programs and types of recipients differ in their economic impact?**

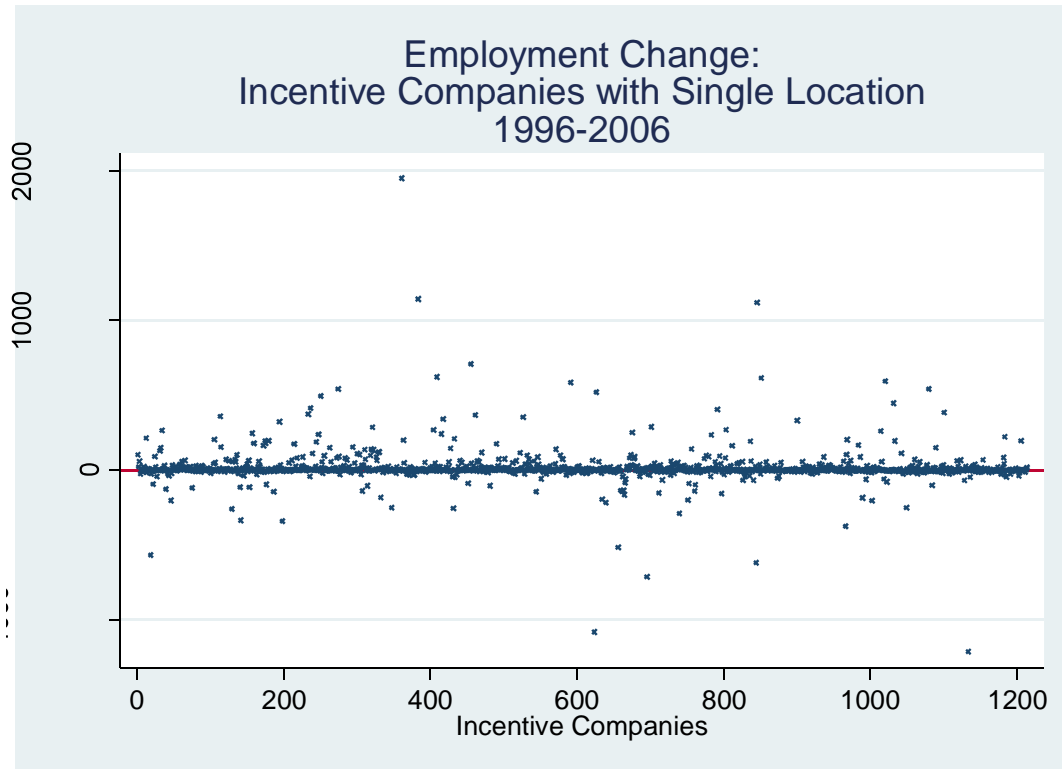
The economic and job creation impact of tax credits is an issue of much debate for policymakers. Most academic studies have demonstrated that economic development incentives, particularly statutory tax credits, have limited effectiveness in job creation and usually only under competitive scenario where other factors are deemed equal among competing areas. Dr. Michael Luger, Dean of the Manchester Business School (UK) and former UNC professor, conducted several prior assessments of the William S. Lee and created a simulation model to examine the possible job creation impacts of the Lee Act. Dr. Luger's simulations found that the Lee Act had a modest impact on job creation in North Carolina.

This study is unique in that the General Assembly legislatively empowered C<sup>3</sup>E to obtain and analysis confidential data unavailable to previous analysts. C<sup>3</sup>E obtained quarterly employment history for all firms receiving a Lee Act tax credit that report employment levels to the NC Employment Security Commission. These data were analyzed to examine the pre and post employment trends of incented companies. Data analysis

required that C<sup>3</sup>E hold the tier status of counties constant across the analysis using 2006 tier designations and limit some of the analysis to companies with single locations and/or companies existing throughout the study period. Additionally, data on the type of credit claimed by companies under the Lee Act was only available from 2002-2006. These methodological procedures are not expected to significantly alter the findings or trends.

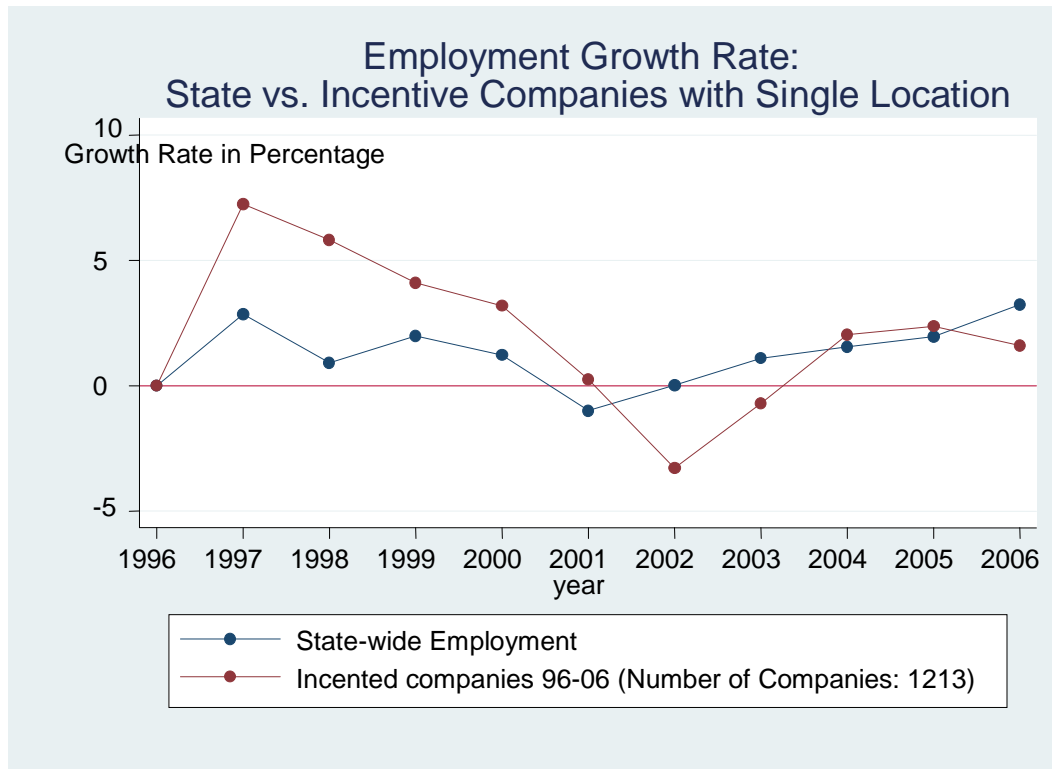
First, single location companies in the study period were examined to determine the growth rate and levels of employment change of companies receiving one or more Lee Act tax credit from 1996-2006. Surprisingly, the examination revealed that only 57.46% of companies receiving a Lee Act tax credit had a positive growth rate (i.e. more employees) in 2006 than they did in 1996. Over 41% of the companies had a declining growth rate leading to fewer employees in 2006 than the business had in 1996. These trends were also analyzed for each tier (see the full report for charts/tables).





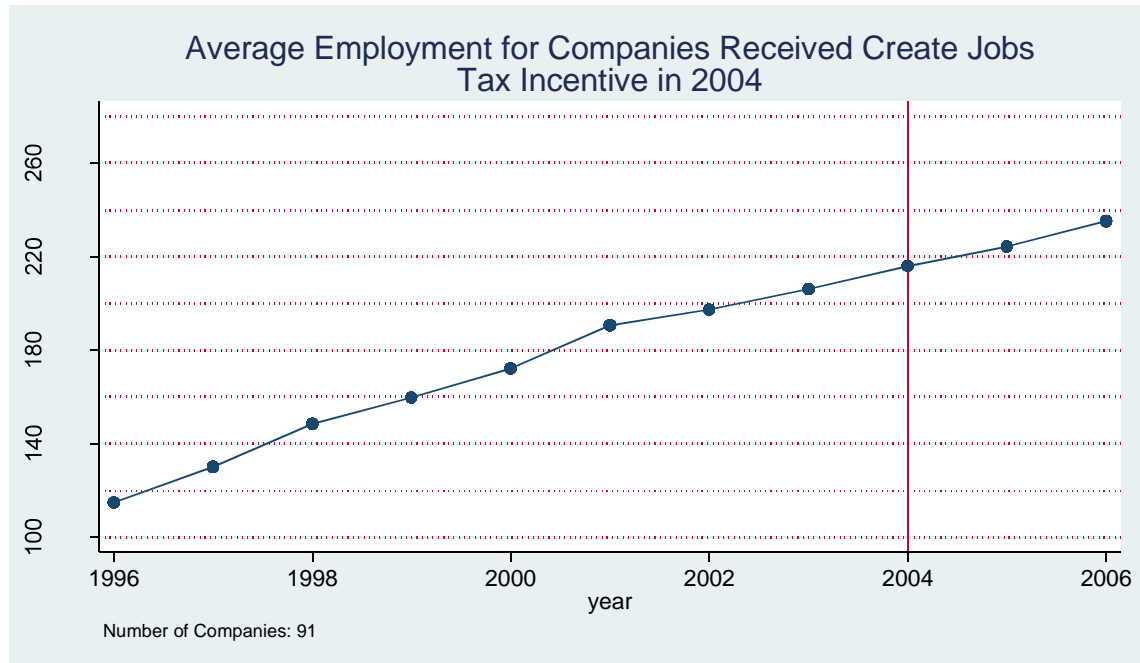
Next, the employment growth rates of incented firms existing from 1996-2006 and existing from 2002-2006 were examined against the overall employment growth for the state. Data on the growth rate comparison for each tier is available in the full report. Incented companies did demonstrate a slightly higher employment growth rate in the 1990s, yet the gap between incented companies and the state average closed over time and is nearly negligible now.



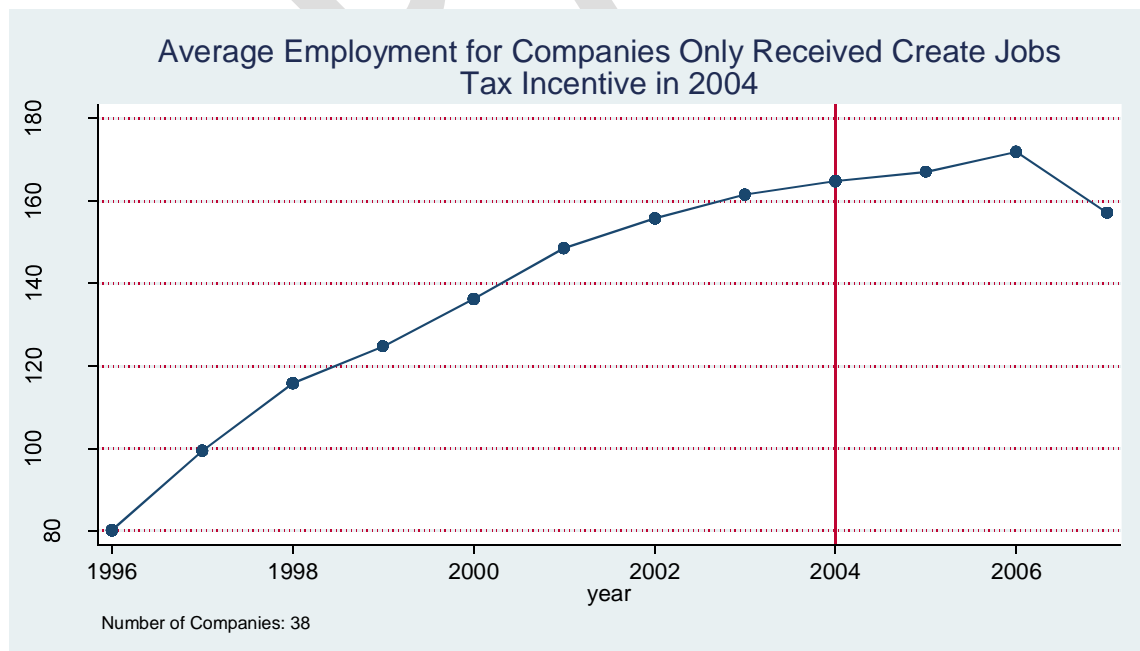


To fully assess the Lee Act's impact on employment levels, it was important to contrast the pre and post incentive employment levels of incented firms. An analysis was conducted to examine the difference in pre and post incentive employment by both tier and credit type. As an illustration, data on companies receiving a Lee Tax credit in 2004 are provided as an example. Yearly performance by credit and tier are available in the full report.

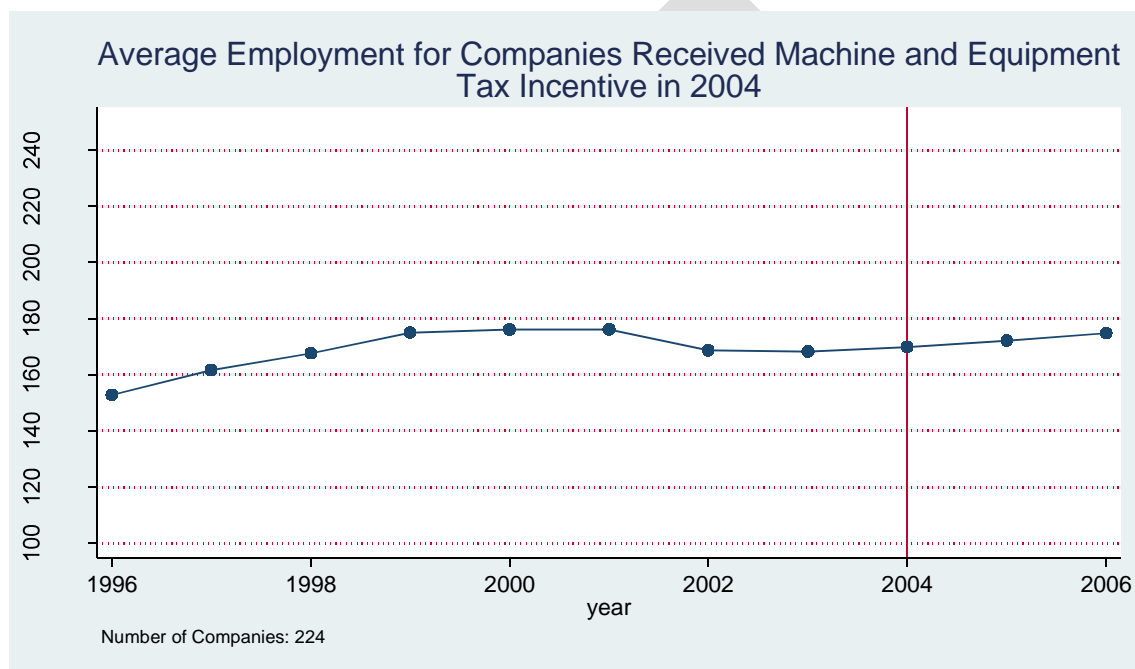
This graph illustrates the average employment for companies receiving a jobs creation tax credit in 2004 for the William S. Lee Act. Companies are not excluded if they also received another type of tax credit. On average, job creation after the tax credit is positive, yet the tax credit does not appear to cause an increase in the rate of job growth.

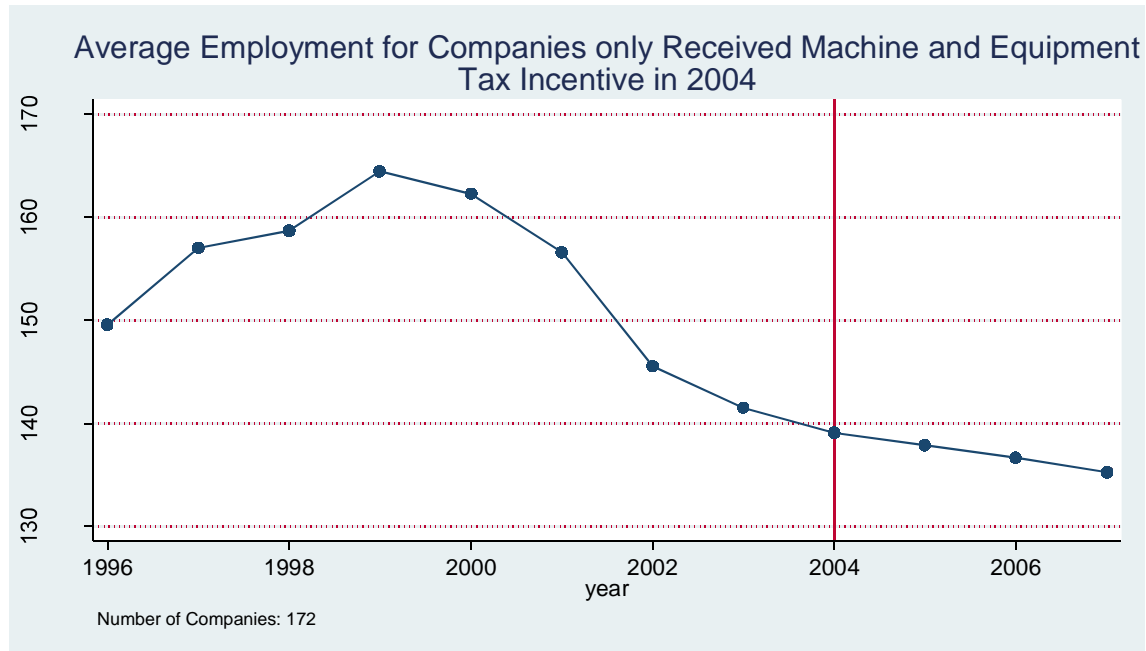


In an effort to isolate the impact of just the job creation tax credit, firms *only* receiving a jobs creation tax credit and no other tax credits in 2004 were also examined. Again, the slope of average employment after the tax credit was generally positive, but the credit does not appear to impact the rate of job creation.

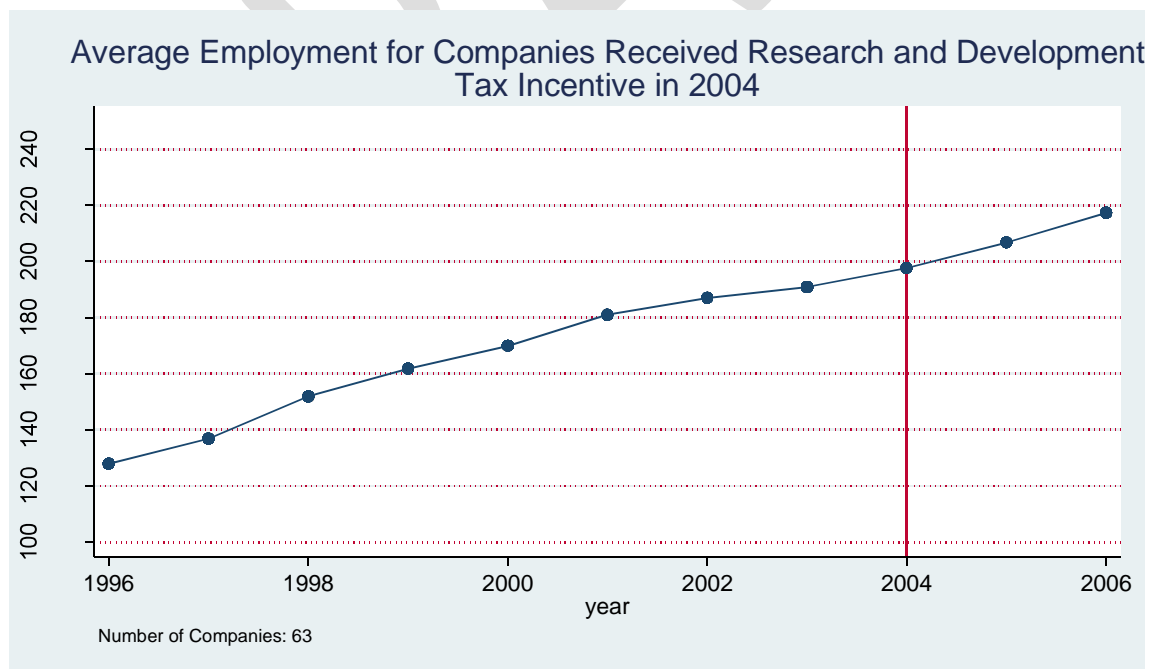


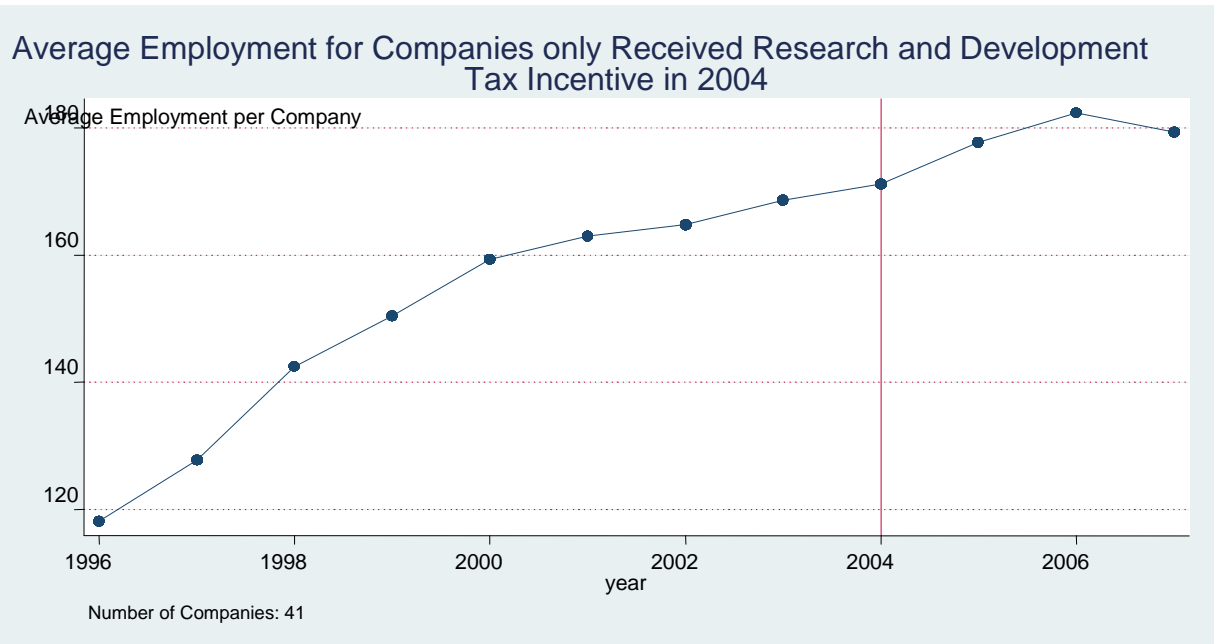
A similar analysis is presented for machinery and equipment and research and development tax credits for 2004. The first graph demonstrates the average pre and post employment levels for businesses receiving a machinery and equipment tax credit in 2004, but does not exclude the company if it received other tax credits. The second graph focuses on companies only receiving a machinery and equipment tax credit in 2004. Taken in conjunction with other tax credits, the M&E credit does not appear to increase average employment levels at all. Companies only taking the M&E tax credit in 2004 demonstrate a employment loss in subsequent years, which may illustrate that companies taking the M&E credit are more susceptible to economic downturns or that these companies are engaging in capitalization—the substitution of labor with capital (i.e. machinery and equipment).





An examination of research and development tax credits for 2004 reveals positive employment growth for companies taking an R&D tax credit with other credits (first graph) and only R&D tax credits (second graph).





This illustrative snapshot of 2004 is indicative of the general findings on the performance of the William S. Lee Act. Statutory tax credits are having little to no effect on employment growth and or a limited impact on company expansion/location decisions in North Carolina.

Unlike statutory tax credits, the state's discretionary programs are better targeted to the state's targeted industry clusters and are more likely to influence a company's location or expansion decision. In remarks to the Joint Select Committee on Economic Development Incentives, North Carolina Secretary of Commerce Jim Fain informed the committee that in the JDIG program "81% of the jobs induced to date have been in our targeted sectors."

A panel of economic development scholars assembled by the C<sup>3</sup>E for a Symposium on Economic Development Incentives also acknowledged that discretionary programs are more likely to allow for economic development targeting to key industry clusters and are more likely to assist in economic transformation of distressed regions. Like the statutory tax credits, the majority of discretionary economic development incentives are utilized in the state's less distressed counties. Scholars also acknowledge that incented job creation in growing metropolitan areas must generate a sufficiently large wages and investment levels to offset the fiscal costs incurred by local and state governments by the influx of new residents. Discretionary incentives leading to investment and job creation have a much large economic impact when existing residents are employed, especially in distressed areas.

##### **5) To what extent do North Carolina's economic incentives affect the state's economy?**

North Carolina is a large state, ranking 10<sup>th</sup> in population (9,061,032). The state's workforce exceeds 4.6 million people and the gross state product (GSP) is \$400 billion (9<sup>th</sup> largest), which exceeds the GSP of Georgia, Virginia, Michigan, and Massachusetts. If North Carolina were a country, it would have the 23<sup>rd</sup> largest national economy.

Currently, North Carolina has over 500,000 businesses and the state is limited to providing direct assistance to only a few thousand companies per year through statutory tax credits and targeted discretionary incentives to a few dozen firms annually. To generate just a 1% gain in employment would require the state incentive the creation of 90,000 new jobs.

The large number of businesses claiming and generating small amounts of Lee Act tax credits suggests that the state's statutory tax credit programs are having a limited effect on the state's economy. The size of the state's economy makes it challenging for an incentive program to greatly stimulate statewide economic growth. However, discretionary programs provide an opportunity for a transformative effect on the state's most distressed regions by laying the groundwork for future growth and employment in areas struggling with economic adjustment and unemployment.

**6) How do economic incentives factor into company location decisions, and what is the process operating today?**

Academic research suggests that economic development incentives play a limited role in influencing company location decisions and usually only when other factors are equal among competing states. A survey of companies receiving the Lee Act tax credit (see question 8 for more information) indicated that incentives ranked low on the list of priorities for business executives. Similar surveys by national site selection magazines also demonstrate that incentives are generally less important than a skilled, well-educated workforce, adequate infrastructure, state tax rates, and regulatory climate.

To the extent incentives influence company location decision, they are most effective when the targeted prospects are highly mobile and the incentives are tailored to the company's specific priorities. Incentives are highly discounted by business executives, and therefore have a greater effect when the benefits are front loaded. States are most successful when they can work to incentive companies prior to the start of an "auction" among competing states.

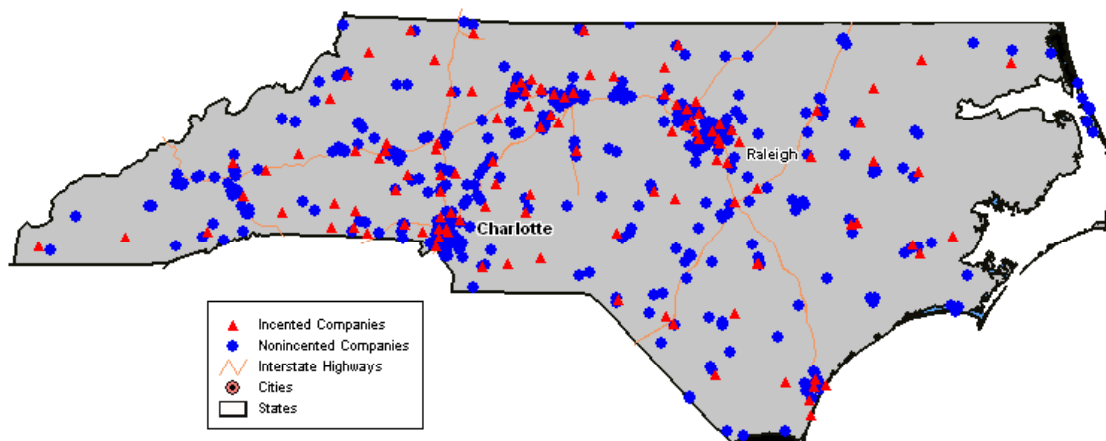
**7) Who are North Carolina's competitors and how do they use economic incentives?**

North Carolina competes with many states, including border states, for companies seeking economic development incentives during their relocation and expansion searches. North Carolina has fared well compared to other states in business climate ranking, ranking first in *Site Selection* magazine's ranking of state business climate seven out of the last eight years.

A model was developed to calculate the average tax burden for companies locating in North Carolina versus competitor states of Alabama, Florida, Georgia, South Carolina, and Tennessee. The model included a variety of tax rates at the state level and averages of some tax rates at the local level. Relevant incentive packages were included for each state. An average company profile was created for six manufacturing firms and three technology firms. Each company's tax burden in the immediate and future years was modeled for each state. The modeling analysis found that North Carolina was very competitive relative to other states in tax burden, especially when utilizing the available incentive programs. A detailed comparison of North Carolina's incentive programs with other states may be found in the full report.

**8) How do economic developers, business owners and citizens perceive the effectiveness and importance of economic incentives?**

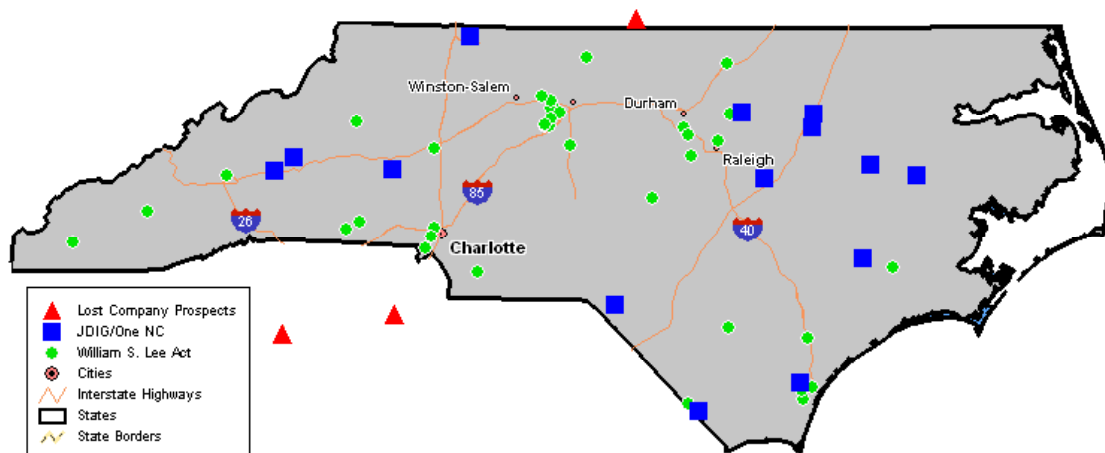
C<sup>3</sup>E surveyed North Carolina companies to determine their perception of the effectiveness and importance of economic development incentives. The survey included 150 Lee Act recipients and 465 non-incented companies. The map outlines the general location of survey respondents.



The survey revealed several interesting findings about the perception of incentives among North Carolina businesses. Incentives ranked well below other factors such as access to skilled labor, highway access, tax rates, and regulator climate. Incented businesses ranked incentives 12<sup>th</sup> and non-incented ranked incentives 13<sup>th</sup>, respectively. Surprisingly, 62% of surveyed NC executives were unaware his/her company received an incentive. This indicates that incentives in the form of tax credits have little impact on business decisions if the majority of executives are unaware of incentive receipt.

When asked “Some people believe that it is better for North Carolina’s economy to offer select incentives to certain businesses, while other people believe it is better to reduce taxes impacting business taxpayers and their owners. Which strategy do you think is better for NC’s economy?” Approximately 14.5% of non-incented companies and 21.7% of incented companies stated it was better to offer select incentives to certain businesses, while 85.5% of non-incented companies and 78.3% of incented companies stated it was better to reduce taxes impacting businesses taxpayers and their owners. A majority of companies in both groups favored reduced taxes to incentives. Complete survey results are included in the full report.

Case studies were also conducted with 36 companies receiving a Lee Act tax credit, 16 companies receiving a JDIG or One NC Fund grant, and four companies North Carolina tried to recruit but lost to other states (Virginia and South Carolina). The map below identifies the general location of case study companies.





Brief highlights of case study findings are provided here. In general, interviews with company executives whose company received a Lee Act credit revealed the credit had little impact on the company's decision to engage in economy growth or expansion. Most executives viewed the credit as an "after the fact" accounting function. Many executives solicited for an interview were unaware the company even received an incentive.

JDIG and One NC Fund case studies tracked the investment levels of incented companies using publicly available data and interviews with relevant officials. These case studies documented the amount of local investment utilized to incent the company expansion or location. In most instances, the case studies revealed that consultants played a much smaller role in incentive receipt than popularly perceived. Only one of the 36 Lee Act companies interviewed had been approached by a consultant regarding available incentives. Consultants continue to play a role in some high profile incentive deals, but the case studies revealed that few are compensated as a percentage of the incentive received.

**9) How would the economic impact of reducing the state's corporate tax rate compare to that of current economic incentives?**

The last major task in the study examined the extent to which the corporate tax rate could be reduced if the state abolished economic incentives. An analysis by Dr. Roby Sawyers, a Professor of Accounting at North Carolina State University, revealed that had statutory tax credits been abolished in the respective years listed the corporate tax rate could have been reduced from 6.9% to 6.25% in 2005, 6.24% in 2004 and 6.19% in 2003. Currently, North Carolina has one of the highest corporate tax rates in the southeast which is perceived to be a significant disadvantage in North Carolina attracting companies.

## **Conclusion: Economic Incentives Portfolio Assessment Findings**

### **NC incentives are most effective in influencing business decisions when:**

- Prospects are mobile
- Prospect are well matched to local resources
- Other location factors are competitive
- Tailored to companies' specific priorities
- Benefits are front-loaded and packaged with other assistance
- Used proactively early in a firm's location process

### **NC incentives have the greatest economic benefit when:**

- Company employs local residents, especially displaced workers
- Location has excess capacity in local infrastructure, minimizing public service outlays
- Company has catalytic effect on local suppliers
- Company is in growth mode dependent on local advantage
- Company is a headquarters in an export industry
- Matching NC economic development strategic priorities

### **NC Statutory Tax Credits Findings:**

- Statutory tax credit spending vastly exceeds discretionary incentive spending
- Statutory tax credits are not tied to NC's strategic economic development goals
- Majority of tax credits are claimed by companies in less distressed areas
- Large numbers of claimed tax credits are too small in amount to induce businesses to change behavior
- Majority of tax credits claimed are for machinery and equipment investment and not directly related to job creation
- Lee Act incentives often viewed as an "after the fact" tax credit or accounting function
- Company executives were unaware their company received an incentive
- Statutory tax credits are not significantly benefiting distressed counties
- Tax credits have a positive marketing effect as a program to benefit existing businesses and is utilized as a marketing tool by economic developers

### **Discretionary Incentive Programs Findings:**

- Discretionary incentive program provide a better opportunity for strategic economic development targeting.

- Discretionary incentives are likely more effective than tax credits at inducing companies to create jobs and investment.
- Unlike statutory tax credits, a set of defined metrics are utilized prior to approval and disbursements of discretionary grants
- Absence of wage standard can undermine economic benefit
- Local match requirement is significant burden on distressed counties
- Legislative goal setting and independent oversight would enhance program administration and accountability

#### **Corporate Tax Rate Findings:**

- Reducing North Carolina's corporate tax rate is a viable alternative to statutory tax credits.
- Reducing business taxes is preferred by both incented and non-incented companies as an alternative to selected tax credits.
- Corporate tax rate reduction would bring North Carolina "in-line" with our competitor states.
- Eliminating the William S. Lee Act would have allowed for a revenue neutral offset corporate tax rate reduction of approximately 6.59% (down from 6.9%) in 2005.
- Corporate tax rate reduction has lower transaction costs for tax filings and reporting than statutory tax credits.

#### **Economic Incentives Utilization Findings**

- North Carolina's economic incentives can affect only a few businesses and therefore should be strategically targeted to maximize benefits
- North Carolina can gain competitive advantages over rival states through proactive use of incentives to initiate location decisions by firms in strategic industrial clusters
- Targeting efforts should incorporate emphasis on workforce availability and development capabilities to maximize incumbent worker employment
- North Carolina state leaders lack objective data analysis on the state of North Carolina's economy and the performance of the state's economic development programs
- While the data analysis is complex, North Carolina does have the available data to better track the performance of the state's economy and the state's economic development programs

## **Economic Incentives Portfolio Assessment Recommendations**

1. Retain Research and Development Tax Credit
2. Eliminate statutory tax credits (i.e. Article 3J program) scheduled to “sunset” in 2011
3. Expand JDIG program in number of annual projects and maximum annual threshold with increased amounts targeted to distressed counties.
4. Modify cost-benefit model to emphasize a stronger preference for incumbent workforce utilization, location of corporate headquarters, and consistency with Commerce’s targeted industry clusters.
5. Utilize savings from elimination of statutory tax credits to support phased reduction of corporate tax rate to competitive neutral rate of 6.5%.
6. Institute a legislative oversight function specifically to establish economic development priorities and assess performance of state and regional economic development agencies
7. Provide for ongoing collection and analysis of strategic economic status data at the state and regional levels as basis for economic development performance assessment
8. Increase state and regional economic development research and marketing budgets for proactive targeting of growth stage companies in targeted industry clusters.