AT WHAT COST?

NORTH CAROLINA'S "BUDGET" FOR ECONOMIC DEVELOPMENT

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MAY 2008

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EXECUTIVE SUMMARY

Greater transparency lies at the heart of good government. With fuller disclosure, lawmakers, courts, citizens, and the media can significantly improve their oversight of public policies and spur programs toward higher impact and cost-effectiveness. Nowhere is more "sunshine" needed than in the area of economic development, one of the fastest growing spending areas of state and local governments. Most state policymakers have little information on how much they are spending annually on a variety of on- and off-budget economic development programs.

North Carolina's Good Deed

North Carolina's recent Economic Development Inventory[1] (EDI), is an excellent first step toward providing the tools needed to encourage better legislative and executive oversight of economic development spending. This inventory, which attempts to identify all state-financed economic development programs and their funding trends, *estimates total spending at $1.29 billion last year*.[2] The EDI examines several angles of the issue:

- The specific programs and tax incentives that compose the state's economic development spending and who administers these programs.
- How spending on "direct incentives" (95% of total) compares to "support programs" (5% of total).
- How spending breaks down among tax incentives ($1.1 B), General Fund appropriations ($117 M), and transportation ($67 M).

This type of information is vital for lawmakers and citizens who deserve to know how their state tax dollars are being spent. Only by identifying the full spectrum of programs and itemizing such figures can we begin to assess the appropriateness, efficiency, and effectiveness of the state's economic development spending.

ANOTHER LOOK AT THE DATA

The EDI is an important first step, but more can be done to improve transparency and accountability in economic development. Analysis that looks at the state's economic

[1] The North Carolina Economic Development Inventory was released in January 2008 by the NC General Assembly's Fiscal Research Division.

[2] This counts both tax-based measures and direct spending programs. Likewise, it covers business attraction, retention, expansion, and modernization. This big figure does *not* only represent location incentives.

development by trends, priorities and impact would be a welcome addition for future reports. In the absence of such analysis, our preliminary review of the data revealed the following:

- Tax-based subsidies are a fast growing piece of the economic development pie. Tax incentives currently represent *90% of the state's economic development spending in 2006-2007, up from approximately 77% in 1995-1996*.

- Economic development is a growing state priority. In absolute terms, the state's "budget" for economic development roughly doubled since 1996. ($666 million to $ 1.2 billion – FY 1995-1996 and FY 2006-2007)

- Comparing tax incentives for economic development against other state expenditures such as Smart Start ($200 million) and Earned Income Tax Credit ($50 million) shows the relative importance of the issue.[3] Given the spending associated with tax incentives for economic development, a heightened emphasis should be placed on accountability for these measures.

- In a functional analysis of on-budget spending (General Fund expenditures) from the EDI, industrial development (largely business attraction) is the largest expenditure category. Agriculture and community economic development spending categories appear to have less priority.

- Looking at the types of tax subsidies being used for economic development reveals that certain types of firms may be gaining unfair competitive advantages in the state. These subsidies can advantage large firms over small firms as well as distorting competition between similar sized firms. The latter raises potential market inefficiencies and tax neutralism concerns because benefits are provided to some firms and not others.

- In a comparison of spending by functional categories across the last 10 years, on-budget programs for regional assistance and industrial development appear to have grown, while programs for technology development and industrial training seem to have shrunk.

- Correcting for inflation, the data suggests that fewer state funds are being spent through "on-budget" programs for economic development (FY 2006-2007 compared to 1995-1996).

[3] Programs such as NC Health Choice, water and waste water grants, Housing Trust Fund and child care subsidies are all dwarfed by economic development tax incentives (See Figure 1 on page 10).

RECOMMENDATIONS

North Carolina has an opportunity to step to the forefront of this issue and become a national leader in best fiscal accountability practices for economic development expenditures. A brief summary of recommendations:

- Make the Economic Development Inventory a systematic report that is presented to standing committees in the NC legislature such as the Commerce, Appropriations and/or Finance committees.

- Expand the scope of analysis in future inventories to look at spending by functional categories and trend-lines across time that could help reveal changing priorities. Analysis that looks at recruitment/ attraction efforts compared to retention/expansion activities would also be useful for future reports.

- Form a task group that would develop an appropriate set of performance measures for evaluating incentives. Last year, the State Auditor raised similar issues in a report focusing on the NC Department of Commerce. Likewise, develop evaluation measures to understand what purpose these subsidies have played in terms of bringing a business to the state or generating economic growth.

- Require Management Information Systems (MIS) and sunset reviews for economic development programs (including those "off-budget") to improve accountability and effectiveness. Economic development spending dwarfs other state commitments and should be subject to similar if not more rigorous accountability.

- Given all the complexities, unfairness, and "gaming" that occurs using a myriad of specialized tax subsidies, we urge policymakers and the citizenry to explore eliminating almost all of these loopholes in exchange for an across the board cut in the business tax rates that would equal roughly the same amount of revenues lost. Or, policy makers might decide some of the foregone revenue should be used for other state priorities. Either way, this would create a much more level playing field for all types of business enterprises.

INTRODUCTION

State governments operate in an increasingly competitive economic environment, with elected officials and state agencies expected to drive economic growth year in and year out. The policies and programs that encompass economic development are numerous and diverse, ranging from entrepreneurship initiatives and workforce training, to investments in technology and modernization, to a wide range of tax incentives meant to attract and retain businesses. Given the growing scope and importance of economic development, surprisingly few states have systematic budgeting and review procedures in place to measure what they are getting in return for economic development spending, or even have an accurate guess at the total fiscal out-go. This means they are flying in the dark without needed lights or radar.

Texas and Illinois are the only states that have institutionalized a regular reporting process that tracks spending across numerous organizations and agencies that perform economic development.[4] In January, 2008, North Carolina's Fiscal Research Division released an Economic Development Inventory (EDI) which attempts to identify all state-financed economic development programs and their funding trends. This is an excellent first step toward providing the tools needed to encourage better legislative and executive oversight of this growing category of state expenditures.

The goals of this paper are to:

1. Expand on the EDI report's analysis.
2. Attempt to understand what North Carolina's economic development spending says about the state's implicit development priorities.
3. Suggest how these investments can be better managed for higher returns.[5]

[4] There have been comprehensive reports done in CA, MA, TX, KY, and NC by nonprofits. The most recent in NC was put together by CFED's Schweke and Carl Rist, with help on the tax issues from Dan Gerlach (at that time, working for the NC Justice Center.) NC Economic Development Board's *1997 Review of North Carolina's Economic Development* Budget was also used in this report for its data on the on-budget spending programs and its classification of the state's wide range of development programs. Despite differences between the current EDI and the 1997 report, key tax preferences (sales & use, corporate income, etc.) are justifiably included in both reports. The 97 report was called: "Managing for Higher Returns: What does North Carolina actually spend on economic development and how can these investments be better managed?" March 1997.

[5] Special thanks to the Z. Smith Reynolds Foundation for their support of this project and paper.

WHAT DOES THE EDI EXAMINE?

The EDI takes both a big-picture and program-level look at the state's economic development spending. The big-picture analysis examines economic development spending by "direct incentives" versus "support programs."[6] Direct incentives (funds provided directly to a company or to a county/municipality for a specific company) accounted for 95% of the state's development spending, while support programs (services offered to any businesses in the state or those considering re-location to the state) accounted for 5% of spending.

The inventory study specifically looks at 2006-2007 economic development spending by three general categories: tax incentives ($1.1 billion), General Fund appropriations ($117 million), and transportation ($67 million). This categorization is useful because it allows us to see the difference between "on-budget" spending (programs included in the state budget and allocated from the General Fund) and "off-budget" spending such as tax incentives.[7][8]

In addition, the inventory provides specific data on the individual programs that compose the state's "on-budget" spending. For instance, funding for economic development activities ranging from small business centers to industrial development funds are outlined in an appendix arranged by the groups that administer these funds (i.e. Department of Commerce, University of North Carolina, or NC Community College System).

WHAT WERE THE LIMITS OF THE EDI?

While the inventory took no stand regarding a particular program's efficacy, it was never designed to do so. The goal was to get good data first, and to withhold judgment until after a thoughtful and rigorous analysis of the findings. There were also some charges that the tax preferences listed in the inventory were exaggerated. This criticism goes hand in hand with the general confusion around the terms and definitions used in

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[6] These terms come from the Fiscal Research Division

[7] "On-budget" simply refers to the fact that general spending programs appear in a state's budget. "Off-budget" measures, such as tax expenditures do not. Any revenue losses due to tax exclusions, exemptions, deductions, credits and so forth, at best, appear in specialized reports – Tax Expenditure Reports. These reports receive less scrutiny than a proposed budget, are more speculative in predicting revenues, and come out less often.

[8] The study only looks at state generated monies. There are significant amounts of federal economic development, workforce development, and community development dollars that the state receives. This should be looked at as well to fill out the picture.

trying to account for economic development spending.[9] What should really be counted as an incentive, for instance? We attempt to add some clarity to these questions in Appendix 1.

Future inventories would likely also benefit from adding more context and background into the rationale for definitions and decisions regarding what should be included as economic development spending. In fact, this issue of "what to count" is a major policy choice that must not be taken lightly, because it sets the scene for all that is to follow. The same goes for re-organizing the spending data into a range of categories and seeing if the picture changes when you look at the data via the following "polarities": attraction versus homegrown, discretionary versus entitlement, small versus large firms, "gap" financing versus cost subsidization, statutory-based incentives versus deal-by-deal ad hoc approaches (Dell project, for instance) and so forth.

Given the complexity and scale of trying to categorize every economic development program, it's not surprising that the EDI did not delve into additional issues that could be of some significance. For instance, how do business incentive and attraction programs fare in the budgetary process compared to North Carolina's "homegrown" economic development/capacity building activities? Are there certain spending categories within on-budget programs (i.e. agriculture, technology development, entrepreneurship, etc.) that might reveal the state's implicit priorities for economic development?

A COMPLEX ISSUE WITH MULTIPLE APPROACHES

Economic development is not a "one-trick-pony." After all, there are many ways to grow an economy, and recruiting industry through tax preferences and location incentives is only one such strategy. Other examples include:

- Investing in workforce development programs to prepare a population with skills needed to compete in a changing economy.

- Nurturing innovation and technology to stay on the cutting edge of products and processes. Examples include investments in research and development and programs that foster technology development.

- Small Business development/ support programs. Examples include small business networks, start-up assistance for small businesses, and programs that equip small businesses with skills/tools to compete in a global economy.

[9] See Appendix 1 for additional discussion on the issue of what should be included as economic development spending, as well as clarification around terms and definitions used for this purpose.

The difficulty for policy makers exists in trying to prioritize and implement economic development strategies that are productive, innovative, market expanding, and cost effective. Fundamentally, the ultimate "players" in this arena are private investors and entrepreneurs. It is they who create jobs and launch better ways of meeting our economic needs and raising our standard of living. Governments and nonprofits can only help by improving the climate for doing business and by creating initiatives that build the capacity of firms to not just survive, but flourish.

It's important for us to remember that there are alternatives to the business attraction contest. The default answer is not always to join every bidding battle that appears. Besides, these contests threaten participant governments with over-bidding due to the fact that the business prospect has the most critical information regarding what would be an acceptable bid.

A DIFFERENT LOOK AT THE DATA

The purpose of this paper is not to seek discrepancies or programs that were left out of the EDI, but rather to suggest improvements to the overall process. By looking at the data through a slightly different lens, we can begin to expand on the findings from the work done in the EDI. These expanded findings relate to the growing role of incentives and the implicit priorities that might be revealed in the state's economic development spending. Findings from our analysis are limited in that few economic development inventories have been performed in North Carolina. The 1997 and 2008 reports each attempt to provide comprehensive inventories of the state's economic development. We acknowledge that data from systematic reports conducted by the same agency would provide stronger comparisons and conclusions across time. Nonetheless, the analysis and recommendations drawn from this data can provide relevant insight towards improving current practice.

WHAT DID WE FIND?

In absolute terms, *the state's economic development "budget" has roughly doubled since 1996.* This budget growth is to a large degree fueled by the fast growth of tax-based subsidies as an emphasis for economic development in the state. *Tax incentives currently represent 90% of the state's economic development spending in 2006-2007; up from approximately 77% in 1995-1996.*[10] North Carolina's tax subsidies, given for the purpose of economic development totaled roughly $1.1 billion in 2006-2007.

[10] See Appendix 2 for 2006-2007 data and Appendix 3 for 1995-1996 data.

Based on this data, the first issue we looked at was the role "tax preferences" play in North Carolina's total economic development strategy.

The role of "tax preferences" in North Carolina's economic development strategy

The $1.1B in tax preferences listed in the EDI can seem like a staggering number. As mentioned above, only a portion of this amount goes toward the more controversial recruitment and attraction tax breaks that we read in the headlines. However, even the portion of this amount that goes toward retention/ expansion activities should not be taken for granted. In some cases, the subsidies are providing unfair competitive advantages to certain firms. Likewise, incentives that have been "on the books" for many years may unfairly favor certain industries over others. Our conclusion is that all different types of incentives (expansion, recruitment, long standing tax breaks) should be considered a piece of the economic development pie. After all, if there would be a move to close down these credits, the first response by the firms affected and their supporters in the community would be that it would discourage economic development and damage the business climate. Examining some of the more recent changes in tax preferences can help better explain the reasons for the apparent shift toward tax preferences in economic development strategy.

The Bill Lee Act (now called Article 3J credits) is one factor that helps explain the state's shift towards tax preferences for economic development. The Lee Act consists of a series of tax credits aimed at reducing the tax liability of businesses involved in specific activities. Annual tax credits taken under the Bill Lee act amounted to roughly $94 million in 2006-07.[11] While significant, this amount doesn't show the full potential costs of the program because it reflects only credits *taken*, not those *generated*. Although the number of credits generated each year appear to be leveling off, the number of credits taken each year continue to increase.[12] The amount of credits that will be taken in the future remains largely uncertain, and could potentially represent a growing expenditure.

The Lee tax credits have been a somewhat controversial as a tool for business recruitment, job creation and expansion. A 2003 University of North Carolina study, produced for the NC Department of Commerce, found that "only four percent of the

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11 Most Lee act credits have gone toward expanding existing businesses within the state, as opposed to recruiting new business. But this fact does not mean that this is better than providing tax credits to attraction projects. It all depends on the program design and whether the firm would have expanded without the credit. Although the credits were designed to help bring business to distressed areas of the state, they have probably resulted in a competitive advantage to larger firms in wealthier counties.

12 Between 1997 (the first year for the credits) and 2001, $1.16 billion credits were generated and $208 million credits were claimed. Between 2002 and 2007, $924 million credits were generated and $404 million credits were taken.

jobs claimed to be created with Lee Act incentives actually were induced[13]." Critics also note that the Lee Act has predominantly benefited the most developed areas of the state[14]. Businesses in Tiers 1 and 2, which are the most rural and economically distressed counties, have claimed only a small percentage of the total credits awarded[15].

Another factor that may be contributing to the shift towards tax preference is the growth of tailored incentive packages for individual companies. These packages are put together in a somewhat ad-hoc fashion, often approved without allowing sufficient discussion and debate. Custom incentive packages (i.e. Dell, Google and Firestone) can give companies a competitive advantage over existing firms and leave large, uncertain liabilities that cut into the state's future revenue. For example, a recent deal with Dell essentially eliminated its corporate tax payments to the state. These deals emerge from negotiations that put state governments in a weak bargaining position with limited information. Such negotiations may lead to over-bidding by the "winning" state.

Outside of the Lee credits and customized incentive packages, tax incentives more broadly have been controversial as a tool for economic development. Critics point to the fact that tax incentives for the purpose of economic development have grown to over $1.1 billion a year but have less oversight/ performance requirements compared to other state programs. Although state spending for economic development tax incentives is large, the process and outcomes for this area of spending remain relatively unclear and unreported.

To show the relative significance of tax incentives for economic development, we can compare this category of spending against other state expenditures such as Smart Start and Earned Income Tax Credit (see Figure 1 below). Given the scale of spending for economic development, there is a heightened need for sufficient accountability. *In short, economic development spending dwarfs other state commitments and should be subject to similar (if not more rigorous) accountability.*

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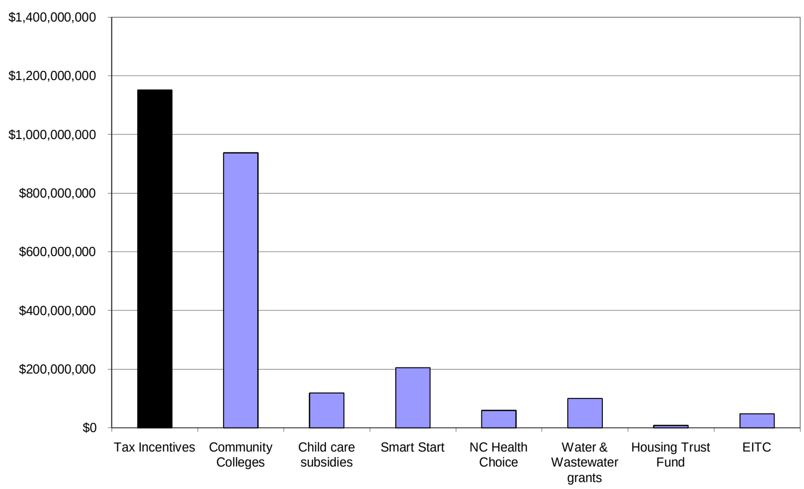
13 Michael Luger, 2003 Assessment of William S. Lee Tax Act. Office of Economic Development, Kenan Institute of Private Enterprise. This is one scholar's estimate based on a complex methodology. This paper's authors believe that this figure may be a bit low. We estimate that perhaps 10 percent were induced by the subsidy.

14 This data refers to the pre-Article 3J tier system—there here are now fewer tiers. However, this reorganization does not change the basic argument that Lee tax credits have most benefited wealthier areas of the state.

15 The policy shop of the NC Department of Commerce recently adjusted these figures by the population size of each county. This is meant to recognize the heavy impact of larger populations in the Research Triangle and Charlotte areas. It also made the Tier 1 record look much better and the Lee Act more effective. However, in our opinion this methodological tactic can be misleading and should not be used. .After all, these development subsidies are supposed to compensate for a variety of advantages that more robust economic areas possess.

Figure 1: Economic Development Tax Incentives vs. various other state investments (2007-2008)



* Source: NC Budget and Tax Center

It should also be noted that tax expenditures function a lot like entitlement programs if they have no fiscal cap. Revenues lost are only estimates. North Carolina does a better job than most states of requiring sunset reviews for incentives. However, these reviews should be given greater attention. Currently, incentive programs are subject to much less fiscal accountability than direct spending programs.

WHAT DOES THE STATE'S ON-BUDGET PROGRAM SPENDING TELL US ABOUT IMPLICIT DEVELOPMENT PRIORITIES?

The 2008 EDI provides a program-by-program breakdown of on-budget economic development activities. These programs are generally categorized by the three organizations charged with their implementation; the Department of Commerce (DOC), University of North Carolina (UNC), and North Carolina Community College System (NCCCS). This approach is helpful to see generally who is carrying out the mission of economic development across the state. However, for the purpose of understanding the state's development priorities and tracking those priorities a more comprehensive budgeting/evaluation method is needed.

A more comprehensive "Unified Development Budget"[16] calls for sorting development appropriations into categories which show the primary function for that spending. For example, knowing how much of the state's economic development spending goes toward agriculture versus industrial training can help shed light on the implicit priorities of that state. A list of typical categories for this purpose and programs that might fall into such categories can be found below:

[16] For details on creating a full Unified Development Budget see "Budgeting and Economic Development Performance: A Guide to Unified Development Budgets" CFED, 2000

Economic Development Spending Categories (example)

AGRICULTURAL DEVELOPMENT Agriculture Finance Authority Agronomic Services Aquaculture Development Land Loss Prevention Project Marketing Division and Markets State Coalition of Farm and Rural Families Coastal Seafood Industrial Park **COMMUNITY ECONOMIC DEVELOPMENT** Association of CDCs Commission on Indian Affairs Community Development Initiative State Institute of Minority Economic Development State Minority Business Development Agency **ENTREPRENEURSHIP, SMALL BUSINESS AND EXPORT PROMOTION** Business License Information Office Center for Community Support Entrepreneurial Development Board International Trade Division Small Business and Technology Dev. Center Small Business Centers (including state admin) Small Business Development Programs Technological Development Authority State Germany and Japan Centers **INDUSTRIAL DEVELOPMENT** Business and Industrial Development Division Industrial Finance Center Regional Commissions Other Regional Development Partnerships **INDUSTRIAL TRAINING** Apprenticeship Training and Certification Commission on Workforce Preparedness Focused Industrial Training New and Expanding Industry Occupational Extension	**REGIONAL / LOCAL ASSISTANCE** Coastal Resource Center Councils of Government Division of Community Assistance Mountain Resource Center Rural Economic Development Center Rural Eco Dev Center Pass-Through $ to Programs Rural Electric Authority Administration **TECHNOLOGY DEV & MODERNIZATION** Advanced Technology Center Board of Science and Technology Center for Applied Technology Energy Division Ergonomics Center – Dept. of Labor Industrial Extension Service Regional Development Institute State Biotechnology Center State Center for Advanced Manufacturing State Univ. Institute for Eng., Tech., and Science *Specialized Assistance*: Center for Applied Technology Forest Resources (Genetic Research) Forest Products Manufacturing Center Laser Technology Center Minerals Research Lab Nonwovens Cooperative Research Office of Waste Reduction Pulp and Paper Center State High Technology Center at A&M University Textiles Extension **OTHER** Economic Development Board/Planning

By arranging on-budget programs from the 2008 EDI into relevant spending categories we can learn more about the implicit priorities revealed in the state's economic development spending (see Appendix 4). For example, looking at the 2006-07 economic development spending by category we find:

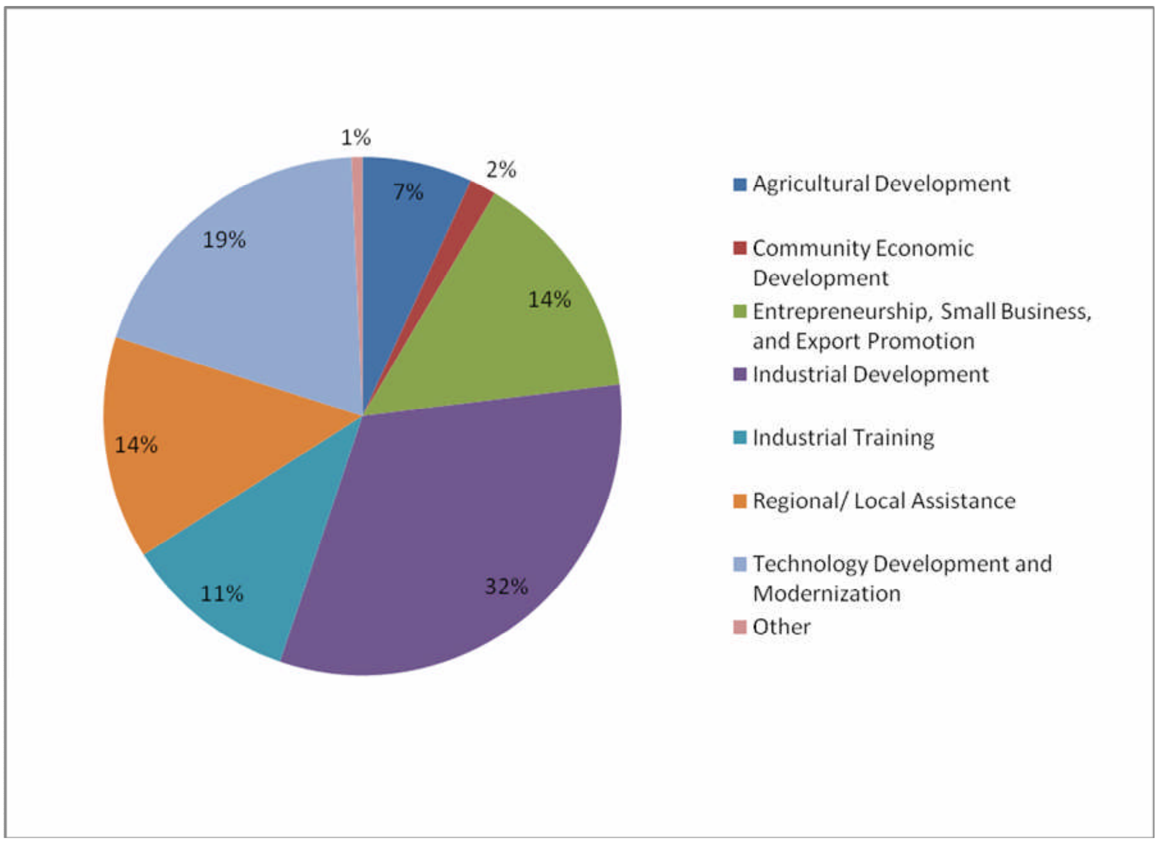
- Industrial Development (32% of on-budget spending) appears to be the top priority in terms of economic development spending.

- Technology Development & Modernization (19%), Entrepreneurship, Small Business and Export Promotion (14%), and Regional/Local assistance (14%) also appear to be *high priorities* for economic development spending.

- Agriculture (7%) and Community Development (2%) received relatively *low priority* in terms of economic development spending.

- It also appears that the total amount of on-budget development spending has gone from $149 million (FY 1995-1996) to $117 million (FY 2006-2007). Note that it is hard to be definitive here, because of the changing names of programs, the termination of others, relocations to other agencies, and the lack of a report or easy-to-use database, which would track such events.

Figure 2: North Carolina's *On-Budget* Economic Development Spending by Category (2006-2007)



Data Source: *North Carolina Economic Development Inventory* (January 2008), Fiscal Research Division of the NC General Assembly.

The process of categorizing programs into categories is an imperfect science. However, we can still get a clearer picture of how the state is prioritizing its economic development spending by conducting such an exercise. [17]

If these types of measures were taken on a regular basis we might also learn how the state's priorities are shifting over time. Such information could be useful to track how a state is responding to meet the needs of changing industries. For example, a state that is experiencing industry shifts in the labor force (say from textiles to high-tech) would benefit from knowing how economic development funds are being used to support/ease that transition.

Because comprehensive economic development inventories have been relatively rare in North Carolina, we can only draw rough estimates for how development priorities are changing in the state. If we look at category spending from the 1997 inventory compared to the 2008 inventory, we can see how some of these priorities may be changing:

- There appears to be a shift away from technology development and industrial training. (See Appendix 6).
- On-budget spending has increased for industrial development and local assistance.
- Spending for agriculture and community economic development programs remain relatively small compared to other categories.

Another way to categorize the state's spending would be to look at business attraction efforts versus homegrown development/capacity building activities. While homegrown firms constitute the lion's share of the overall economy in terms of employment and number of firms, they typically receive fewer dollars and in-kind assistance from a state's economic development budget than recruitment programs.[18] Such a categorization is difficult to make without more detailed information on how expenditures from both tax incentives and on-budget programs are being targeted.

What do we need to do?

The importance of economic development in spending in North Carolina's overall list of priorities is only likely to grow in upcoming years. North Carolina has a unique

[17] Although some programs may overlap into more than one category (i.e. a rural business support program may fall under small business and local assistance categories), for this review a program was placed in one category that best represented its primary purpose. Note that Figure 2 represents percentages from "on-budget" spending, while Appendices 2 and 3 display on-budget categories weighed against tax preferences.

[18] We use the terms – "homegrown economy", and "indigenous economy" interchangeably. It basically refers to non-business attraction strategies or an economy whose growth was fueled primarily by entrepreneurs and existing firms, efforts to enhance the quality of human and social capital, et cetera.

opportunity to step to the forefront of this issue and become a national leader in best practices. In order to do so, the following actions are some manageable first steps:

- Make the EDI report a systematic, biennial procedure to keep legislatures and the general public informed about what the state is really spending on economic development. Future inventories should be presented to standing committees in the NC legislature such as the Commerce, Appropriations or Finance committees.

- Expand the scope of analysis in future inventories to look at spending by categories (i.e. agriculture, community development, technology/modernization, etc.) as well as recent trend lines to see how spending is changing year to year.

- Form a task group that would develop an appropriate set of performance measures for evaluating incentives.[19] This task force should include independent economists and economic development experts and should attempt to establish a system that provides some measure of return on investment the state is receiving from these incentives. Without such performance measures, the state cannot say which types of development programs/incentives are working better than others.

- Management Information Systems (MIS) Requirements. Before a tax preference or incentive deal is given to a company, the state should ensure a system is in place to collect the detailed information needed to understand the return on investment of the given incentive. For example, if a company receives a tax preference based on promises of new jobs or investments in R&D these indicators should be closely monitored. This is especially important in those situations where the state has created a new statutory incentive. No fiscal or other aid should be transferred to the project and firm until an approved MIS has been designed. Hence, benchmarks must be in place before the state's new subsidy program is "open for business." Similarly, company specific legislation, such as the Dell project required must operate with performance "triggers" and other accountability and transparency mechanisms.

- Regular sunset reviews. All government programs (including "off-budget" programs) need to be evaluated periodically to determine how we can deliver them better. Thorough sunset evaluations can help policymakers identify

[19] The Commerce Department does collect and use some indicators, but, as reflected in a State Auditor report in 2007, the system could be improved. The report stated that its vision and objectives are not clear and that it has not implemented a number of recommendations by outside consultants that would strengthen its role as lead agency and clarify its goals and priorities. For a quick summary, see: "Audit Critical of Easley, Commerce Department," *Triangle Business Journal* (May 2, 2007); and Jonathan Cox, "Easley urged to Help Lure Businesses", *Raleigh News and Observer* (May 2, 2007).

ineffective efforts and terminate them, as well as discover what is working well and build on these efforts. Given the amount of funds spent on development incentives, even expensive sunset reviews would be worth the costs to gain relevant information that could guide future budgets/decisions.[20] A more extensive review process – Outcome Budgeting is described in Appendix 7.

- Lastly, given all the complexities, unfairness, and "gaming" that occur under a myriad of specialized tax subsidies, we urge policymakers and the citizenry to explore eliminating almost all of these loopholes in exchange for an across the board cut in the business tax rates that would equal roughly the same amount of revenues lost. Or, policy makers might decide some of the foregone revenue should be used for other state priorities. Either way, this would create a much more level playing field for all types of business enterprises. This process would also bring long-forgotten tax "entitlements" into the sunshine of good government.

[20] NC does better than some states in this arena. Recently, a special legislative committee commissioned an incentives evaluation by the University of North Carolina.

CONCLUSION

Are incentives good or bad? Neither. The problem is they have been used to such an extent to win a competition rather than to accomplish clearly defined goals…[this practice] can end up being like winning a javelin catching competition. The thrill of victory is soon replaced by economic agony.

- Andrew Grose, Former Director of Nevada's Economic Development Programs

Large amounts of money are being spent on economic development in North Carolina. This spending raises questions about how priorities are being set and whether sufficiently rigorous planning, budgeting, and evaluation functions are in place. [21]

This paper only attempts to move us another step towards the direction of good governance. NC legislative staff and CFED have catalogued the main programs, identified the state's fiscal commitments, and created a case for in-depth evaluations and discussions.

Moreover, it is due to the controversial nature of incentives that greater transparency of the kind provided by the new legislative report (especially if it is improved) is so needed. There are many promising tactics for improving our business incentive efforts (local hiring preferences, better investments in worker skills, for instance), but before the state can improve the system it needs a much clearer idea of what is happening now.

[21] We must celebrate some promising transparency and accountability in NC, such as requirements for an assessment report on its Job Development Investment Grants to be issued to policymakers, performance-based contracting, and a decent open records law. However, a report by Good Jobs First on "The State of State Disclosure: An Evaluation of Online Public Information about Economic Development Subsidies, Procurement Contracts, and Lobbying Activities" released in November 2007, gave the state only a grade of "C". The state appears to need to work on its subsidies disclosure (D+) and lobbying disclosure (C+) in particular.

APPENDICES

- Appendix 1: What should be included as "Economic Development Spending"
- Appendix 2: NC Economic Development Spending by Category (2006-2007)
- Appendix 3: NC Economic Development Spending by Category (1995-1996)
- Appendix 4: On-Budget Economic Development Programs by Category
- Appendix 5: Summary Table- Economic Development Spending (1995-1996 vs. 2006-2007)
- Appendix 6: NC On-Budget Economic Development Spending By Category (95-96 and 06-07)
- Appendix 7: Outcome Budgeting

APPENDIX 1

WHAT SHOULD BE INCLUDED AS "ECONOMIC DEVELOPMENT" SPENDING?

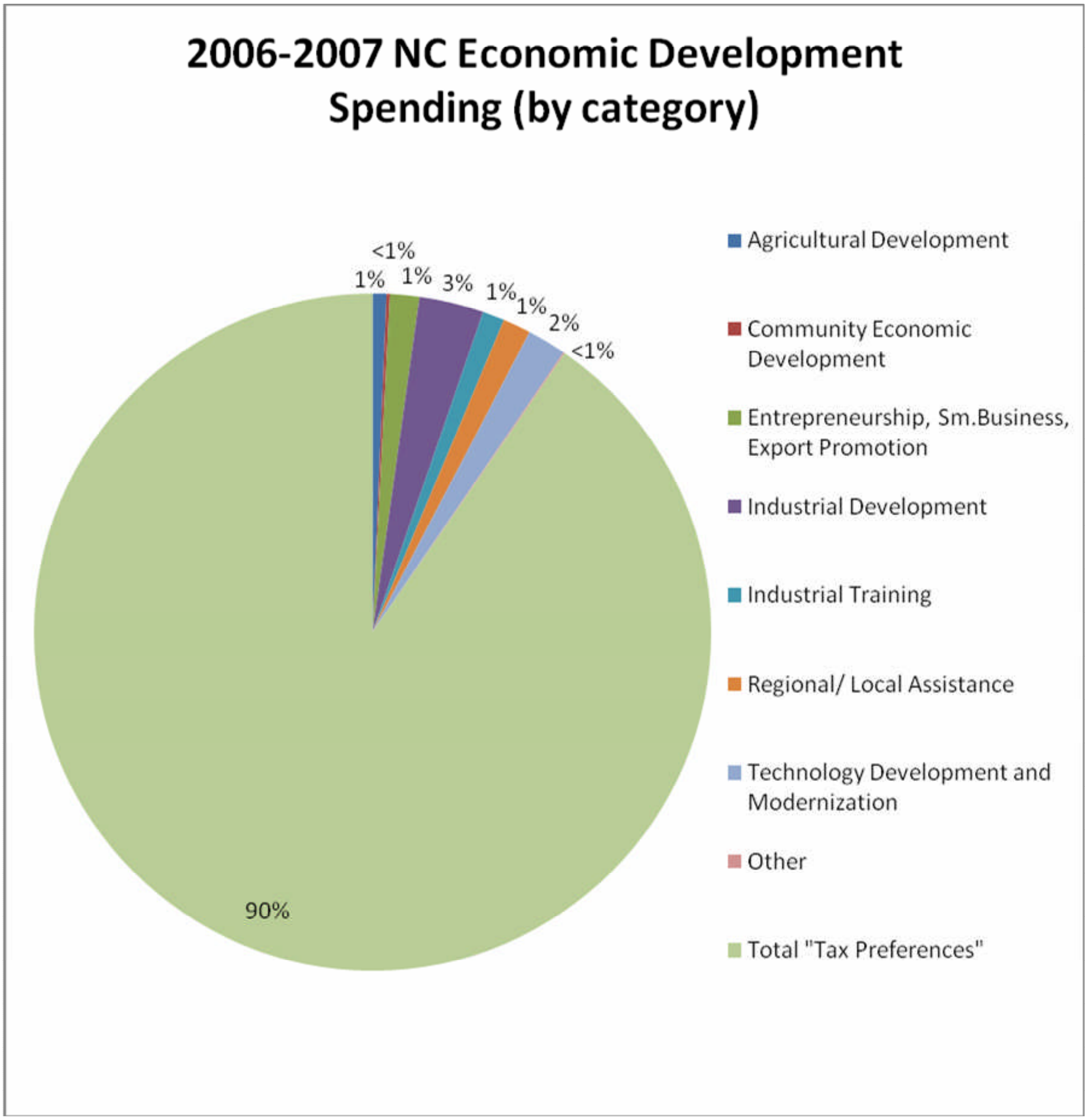
Critics have attacked the Economic Development Inventory as being over-inclusive. They claim the report counts a number of long-ago adopted tax exemptions and other well-accepted measures (i.e. exemptions for farmers and manufacturers) and lumps them in with more controversial recent programs such as the William S. Lee Act and tailored subsidies to individual companies (i.e. Dell and Goodyear). While critics have a point (there are important differences between these programs), we would contend that cash grants, tax expenditures, free land, low-interest loans, etc. still constitute subsidies. In return for governmental assistance, the private sector is supposed to provide a good, service, or investment as either a *quid pro quo* or part of a commercial transaction and exchange relationship. Even in cases where tax preferences are meant to adjust for double-taxation or "pyramiding", such preferences could be considered incentives toward a particular group in order to encourage some type of behavior or economic development. An EDI is meant to address *all* development spending, not just location incentives. Also, identifying and counting these expenditures is merely an accounting exercise. Including such expenditures does not in any way label them as "bad" or ineffective.

IMPORTANT TERMS RELATED TO THIS DISCUSSION

In a nutshell, here is our terminology. *Tax incentives, tax preference*, or *tax-based measures* are all the same thing. They are spending programs "in disguise," channeled through the tax system. Within these categories (e.g., tax preferences) one can find the typical *tax expenditures*[22]. But also included are the varied apportionment formulas, which involve the division of a firm's multi-jurisdictional income. Some corporate tax experts also regard these (double-weighted sales formulas), as tax expenditures, since they deviate from an earlier well-established precedent. The goals of the latter are to attract export-based business (in part, by helping the firm create "nowhere income" and in theory, improve the overall business climate). Tax preferences of these types end up benefiting some businesses and households and not others. If enacted, due to states' balanced budget requirements, they imply a tax increase on some other household or firm or cut programs to avoid a deficit. Moreover, they are not neutral or equitable in their effects, as an across-the-board corporate rate cut would be for all firms.

[22] Tax expenditures, as defined in *The Encyclopedia of Taxation and Tax Policy*, are "revenue losses resulting from . . . tax provisions that grant special tax relief designed to encourage certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances. Tax expenditures may, in effect, be viewed as spending programs channeled through the tax system . . . tax expenditures may take any of the following forms: 1) exclusion, exemptions, and deductions that reduce taxable income, 2) preferential tax rates, 3) credits, 4) deferrals."

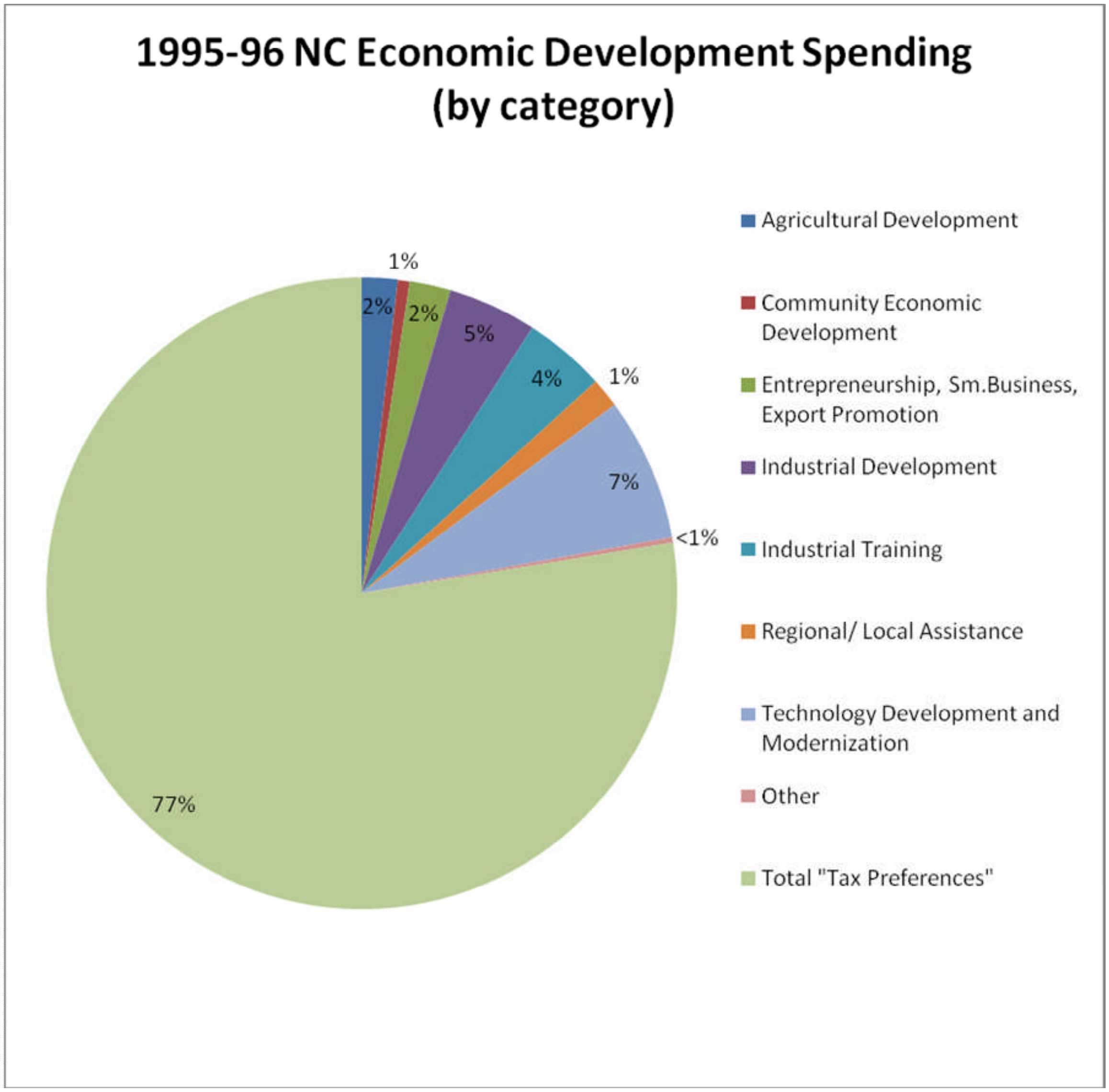
APPENDIX 2



Data Source: *North Carolina Economic Development Inventory* (January 2008), Fiscal Research Division of the NC General Assembly.

*These percentages represent the relative economic development spending for tax preferences and on-budget programs. Transportation is not included.

APPENDIX 3



Sources:

1) *1997 Review of North Carolina's Economic Development Budget,* NC Economic Development Board
2) *Managing for Higher Returns: What does North Carolina actually spend on economic development and how can these investments be better managed?* (March 1997), CFED

*These percentages represent the relative economic development spending for tax preferences and on-budget programs. Transportation is not included.

APPENDIX 4

On-Budget Economic Development Programs by Category (2006-2007)

AGRICULTURAL DEVELOPMENT	Appropriation
NC Cooperative Extension Service	$8,069,399
Section Total	$8,069,399
COMMUNITY ECONOMIC DEVELOPMENT	
ECU Community Engagement	$114,466
NC Institute of Minority Economic Development	$1,847,602
Section Total	$1,962,068
ENTREPRENEURSHIP, SMALL BUSINESS, & EXPORT PROMOTION	
Office of International Trade	$2,503,188
Small Business Technology Dev. Center (SBTDC)	$2,132,772
Business ServiCenter	$525,000
FSU Business Center	$86,705
UNC-C Ben Craig Center	$116,058
NCCS- Small Business Center Network	$5,689,882
One NC Small Business Fund	$5,000,000
NCCS- Military Business Center	$1,000,000
Section Total	$17,053,605
INDUSTRIAL DEVELOPMENT	
Industrial Development Fund	$320,107
Executive Aircraft	$2,725,563
Regional Econ Dev Commissions	$6,775,000
Commerce Finance Center	$532,664
One NC Fund	$15,000,000
JDIG- Job Development Investment Grant	$12,400,000
Section Total	$37,753,334
INDUSTRIAL TRAINING	
NCCS- Focused Industrial Training (FIT)	$3,964,471
NCCS- Customized Industry Training (CIT)	$2,750,000
NCCS- New and Expanding Industry (NEIT)	$6,028,541
Section Total	$12,743,012
REGIONAL / LOCAL ASSISTANCE	
Regional DOC offices	$1,646,509
REDC- Institute for Rural Entrepreneurship	$144,000
REDC- Microenterprise Loan Program	$195,000
REDC- Research & Demonstration Grants	$2,500,000
High Point Furniture Market	$1,750,000
UNC-CH Office of Economic & Business Dev.	$129,307
Economic Development Reserve	$10,000,000
Section Total	$16,364,816

Categories Continued:	
TECHNOLOGY DEV & MODERNIZATION	
NC Biotechnology Center	$13,083,395
NCSU Industrial Extension Service	$3,220,252
NCSU Economic Development Partnership	$333,065
WCU Institute for Economy & the Future	$830,820
NCCS- Textile Center	$963,401
NCCS- Hosiery Tech Center	$600,000
NC Center for Automotive Research (NCCAR)	$3,750,000
Section Total	$22,780,933
OTHER	
Econ Development Board	$1,374
Economic Development Information System (EDIS)	$797,898
Section Total	$799,272
TOTAL	**$117,526,439**

Data Source: *North Carolina Economic Development Inventory* (January 2008), Fiscal Research Division of the NC General Assembly

APPENDIX 5

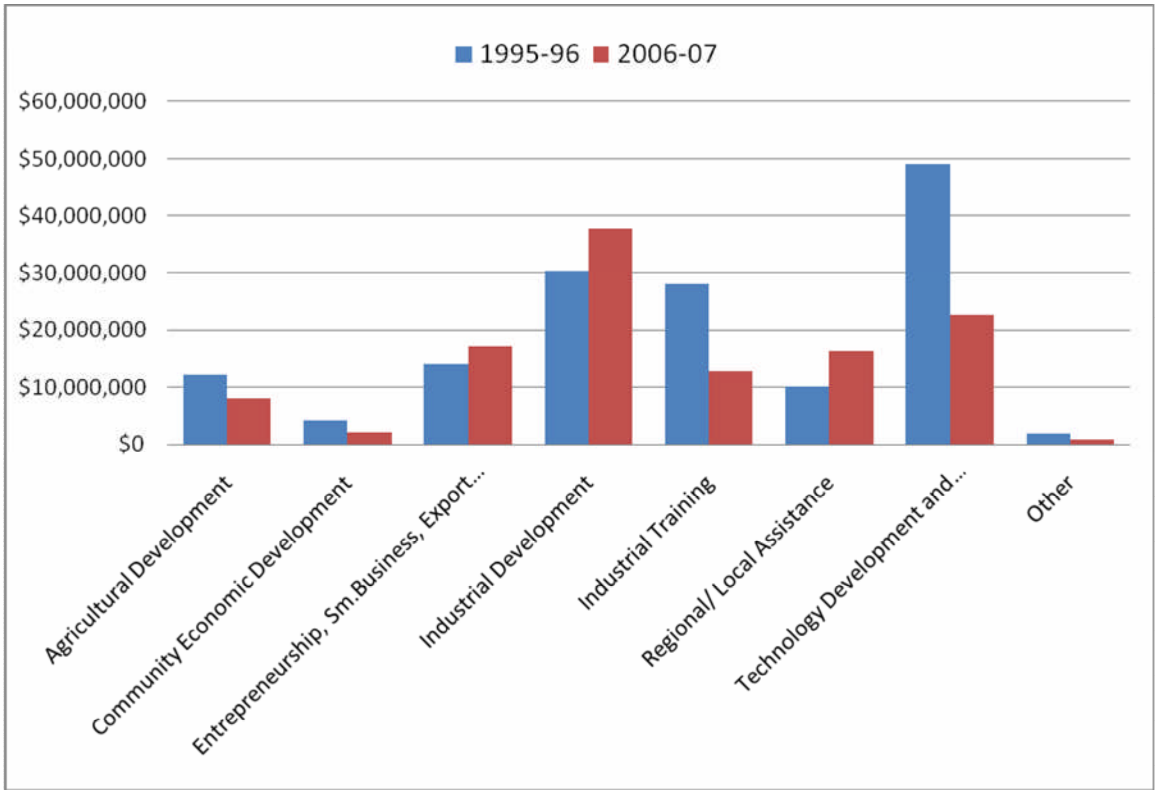
Summary Table- Economic Development Spending (95-96 vs. 06-07)

Budgeted Expenditures	1995-1996*	2006-07
Agricultural Development	$12,186,153	$8,069,399
Community Economic Development	$4,056,318	$1,962,068
Entrepreneurship, Small Business, and Export Promotion	$14,025,123	$17,053,605
Industrial Development	$30,309,930	$37,753,334
Industrial Training	$28,021,140	$12,743,012
Regional / Local Assistance	$10,025,694	$16,364,816
Technology Development and Modernization	$49,031,703	$22,780,933
Other	$1,844,262	$799,272
Sum	$149,500,323	$117,526,439
Tax Incentives	**1995-1996**	**2006-07**
Bill Lee		$93,763,666
Tax Incentives	$517,197,176	$1,012,600,000
Total Economic Development Expenditures	$666,697,499	$1,223,890,105

*95-96 spending adjusted for inflation using CPI, Bureau of Labor Statistics

APPENDIX 6

NC On-Budget Economic Development Spending By Category (95-96 and 06-07)



*95-96 spending adjusted for inflation using CPI, Bureau of Labor Statistics

APPENDIX 7

OUTCOME BUDGETING

Economic development budgets include more than budget appropriations; they also include tax exemptions, credits and deductions as well as preferential rates for some corporate taxpayers. To assess the effectiveness of any economic development program, one must first determine the amount of resources being devoted to it and then, with that information, decide which programs and policies to keep and which to change or eliminate. Public funds are too valuable to be squandered on low return uses.

David Osborne, author of *Reinventing Government*,[23] and his colleagues propose "outcomes budgeting," an approach to re-engineer agencies, policies and programs within tight fiscal constraints. The 12-step process produces a cost-sensitive, results-based budget.[24] Applying outcomes budgeting to economic development is the next logical step to aggregating direct and tax expenditures (also known as a unified development budget). The 12 steps are listed below.

1. Determine a unified development budget that includes all agency resources as well as all tax expenditure resources devoted to economic development.
2. Use surveys to solicit priorities for development from community members.
3. Determine the price of each priority outcome.
4. Develop strategy maps to identify the most promising ways to achieve the priority outcomes.
5. Determine benchmarks for each priority. Set goals and make sure data are collected.
6. Solicit requests for results (bids) for achieving the priority outcomes (bidders can be any reputable public, private or nonprofit entity).
7. Negotiate terms (especially outcomes expected) with winners.
8. Eliminate items from the budget that go beyond lump sum allocation of spending and incentives.
9. Devise full-cost accounting which allows tracking of all expenses for specific programs/strategies.
10. Review progress against targets.
11. Share and use data to reform or terminate efforts.
12. Reorganize/relocate strategy/program "home" if required.

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[23] Osborne, D. and T. Gaebler. (1992). *Reinventing Government: How the Entrepreneurial Spirit is Transforming the Public Sector*. (New York: PLUME).

[24] Osborne, D. and P. Hutchinson. (2004). *The Price of Government.* (New York: Basic Books), p. 23-93.

Based on the outcomes budgeting process, the state will be able to bolster the most effective programs of its development portfolio. (For more background, see: Peter Hutchinson and David Osborne, *The Price of Government*.)

With information, existing industry and community development as its principal targets for action, new directions that a Department of Commerce *migh*t take include reducing attention on incentives and attraction and leveraging other institutions, like community colleges and Small Business Technology Development Centers, which have significant economic development impacts. A Department might also:

- Expand existing industry staffing, whose job it is to build capacities of local existing industry professionals in priority counties.
- Provide community capacity-building services and training to civic leaders and nonprofits.
- Create a partnership with the state's public universities, an "Economy Research Center," that would scan industrial trends and global conditions.
- Create the databases and web sites that allow in-state entrepreneurs and business persons to access needed public and proprietary data on financing and marketing among other topics. These would be designed by public/private partnerships.