NATIONAL GOVERNORS' ASSOCIATION

Rethinking State Development Policies and Programs

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Economic Development and
Commerce Policy Studies

Center for
Policy Research

Rethinking State Development Policies and Programs

by Jay Kayne
and Molly Shonka

Since their initial meeting in 1908 to discuss interstate water problems, the Governors have worked through the National Governors' Association to deal collectively with issues of public policy and governance. The association's ongoing mission is to support the work of the Governors by providing a bipartisan forum to help shape and implement national policy and to solve state problems.

The members of the National Governors' Association are the Governors of the fifty states, the territories of American Samoa, Guam, and the Virgin Islands, and the commonwealths of the Northern Mariana Islands and Puerto Rico. The association has a nine-member Executive Committee, a Task Force on State Management, and three standing committees on Economic Development and Commerce, Human Resources, and Natural Resources. Through NGA's committees, the Governors examine and develop policy and address key state and national issues. Special task forces often are created to focus gubernatorial attention on federal legislation or on state-level issues.

The association works closely with the administration and Congress on state-federal policy issues through its offices in the Hall of the States in Washington, D.C. The association serves as a vehicle for sharing knowledge of innovative programs among the states and provides technical assistance and consultant services to Governors on a wide range of management and policy issues.

The Center for Policy Research is the research and development arm of NGA. The center is a vehicle for sharing knowledge about innovative state activities, exploring the impact of federal initiatives on state government, and providing technical assistance to states. The center works in a number of policy fields, including agriculture and rural development, economic development, education, energy and environment, health, information management, social services, trade, training and employment, and transportation. The priorities for the association's research are set by the Governors.

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Executive Summary

In August 1993, the National Governors' Association (NGA) adopted a policy on Economic Growth and Development Incentives that emphasizes state actions to enhance the general climate for new business investment and expansion of existing firms. To provide Governors with information about the impact of the policy in the "real world," the NGA Committee on Economic Development and Commerce asked staff to research two issues: recent state actions that exemplify the policy and the use of cost/benefit analysis when considering public subsidies for private investments.

In response to concerns in both the public and private sectors, the Governors adopted this policy. However, international trade agreements may impact the future use of development incentives. Specifically, the Uruguay Round of negotiations on the General Agreement on Tariffs and Trade (GATT) contains provisions about the types of public subsidies that states can offer to private businesses. These provisions could view commonly used state subsidies, such as grants, loans, and tax abatements to specific firms, as having potentially distorting effects on international trade.

The Governors' policy on development incentives provides guidelines for rethinking state development policies and programs. Some recent state initiatives suggest that states are already updating their development policies and programs in ways that are consistent with one or more of the provisions of the NGA policy.

- More states are employing strategic planning to obtain a comprehensive, long-term view of the state's economy and to identify steps to strengthen the state's economic outlook.
- States are basing public subsidies on more specific development objectives and are using objective criteria and cost/benefit analysis to justify subsidies.
- States are encouraging joint ventures between government and the private sector.
- States are supporting business investment through public investments in communities (e.g., infrastructure) and in people (e.g., workforce development programs).
- States are using subsidies to encourage business activities that otherwise might not occur.
- State use of clawbacks (i.e., provisions to recoup subsidies if a subsidized firm fails to deliver promised benefits) is increasing.

Examples of recent state development policies and programs demonstrate that there is considerable room for states to continue effective economic development efforts within the context of the NGA policy.

States and local governments often describe public subsidies in support of economic development as "investments" on the grounds that the government entity is seeking returns in the forms of new jobs, higher incomes, and additional revenues. The NGA policy recommends that states calculate the return on their investment (i.e., the public subsidies) by employing sound cost/benefit analysis on each proposed project.

Determining a methodology to assess whether a specific project is a "rational" investment should take the following principles into account.

- Sustained state support for economic development requires that public resources be reinvested again and again. Consequently, the rate of return on investment (i.e., the cash flow back to the state) is a more significant factor than is the ratio of dollars expended per job created.
- Policymakers should consider the "opportunity costs" of public funds used as subsidies. What would be the return from alternate investments?
- The integrity of the cost/benefit analysis deteriorates in direct proportion to the use of unsubstantiated assumptions such as multiplier effects. The analysis should only include these variables in the rate of return calculation when there is both a rigorous model and hard data to support assumptions about the secondary and tertiary impacts of the project.
- A positive return on investment need not be the sole factor in making an individual subsidy decision. State economic and social policy objectives may justify subsidies that are not fully recouped through new revenues. Public funds used in these situations are perhaps better categorized as "expenditures" than as "investments."

In response to limited state budgets, globalization of markets, and stiffened competition, states are rethinking their policies and programs in order to maximize their investments in economic development. Changing economic conditions, state development priorities, and externalities (e.g., GATT) ensure that the use of public subsidies in support of private investment is an issue that will continue to be debated both within and among states.

Introduction

At the National Governors' Association (NGA) 1991 Annual Meeting in Seattle, Washington, members of the Committee on Economic Development and Technological Innovation and the Committee on International Trade and Foreign Relations[1] raised concerns about the trend of businesses requesting higher levels of incentives for facility locations, expansions, and retentions. The Governors also acknowledged the increased propensity of states to respond to these requests.

Over the next two years, the Governors held three sessions on the issue of economic growth and development incentives. At the 1992 NGA Winter Meeting in Washington, D.C., the Committee on Economic Development and Technological Innovation addressed this issue with input from Don Haider, professor of economics at Northwestern University in Chicago, who had studied the use and effectiveness of business subsidies. This open discussion was followed by a Governors-only roundtable on existing state practices and issues.

Because the exchange of development incentives required both public and private sector participation, the Governors convened a second roundtable involving the presidents and chief executive officers of several major U.S. companies. The session was held prior to the 1993 NGA Winter Meeting in Washington, D.C. It resulted in a call from both the Governors and private industry leaders for a statement of principles on economic growth and development incentives.

The draft policy on Economic Growth and Development Incentives was debated by members of the Committee on Economic Development and Technological Innovation at the 1993 NGA Annual Meeting in Tulsa, Oklahoma, and the association adopted the proposed policy. Since that time, some critics have raised concerns that the policy did not immediately end state competition for high-impact development projects. Some have even called for federal intervention. However, the Governors believe that changes in state behavior related to state development incentives will occur not in response to a federal mandate, but because those changes represent good public policy. Decisions about the pace and direction of any changes rightfully remain within the individual states. A copy of the policy is provided in Appendix A.

Next Steps

Following the adoption of the NGA policy, the Governors charged NGA staff with providing two types of information. First, the Governors requested that staff identify state activities—recent policies and programs—that exemplify the new NGA policy. Second, the Governors requested further guidance on a specific principle in the policy—the use of cost/benefit analysis.

This state policy report responds to the Governors' charge. Chapter 2 focuses on recent state policies and programs that illustrate the various provisions contained in the policy. It includes brief descriptions of state activities to enhance the general business climate and to benefit all businesses through community investment (new infrastructure) and human resource investment (education and workforce development). Appendix B provides a list of contacts for many of the state programs highlighted in Chapter 2.

Chapter 3 outlines the essential elements of a cost/benefit analysis and discusses the subjective decisions that are part of this relatively objective, mathematical calculation. In particular, this chapter covers the issue of using the multiplier effect—the additional impact from secondary and tertiary economic activity associated with the initial investment—as part of the cost/benefit analysis.

In addition, the following section provides an update on the Uruguay Round of the General Agreement on Tariffs and Trade (GATT). GATT provisions on business assistance have implications for state development practices.

GATT and State Development Incentives

Since the adoption of the NGA policy, the Uruguay Round of GATT was concluded. GATT is likely to impact the range of development incentives a state may provide. In a recent report to Congress, the U.S. Trade Representative's Intergovernmental Policy Advisory Committee noted, "The agreement substantially enlarges the existing international rules that seek to prevent the distorting effects that subsidies have on international trade."[2]

The definition of subsidies in the Uruguay Round, drawn from U.S. law and practice, includes "government-provided benefits to a specific industry or firm [and] may take the form of grants, loans, equity, loan guarantees, forgiveness of taxes otherwise due, the provision of goods and services other than infrastructure, or government purchase of goods at non-market prices or income or price supports to the benefit of a firm." The Uruguay Round of GATT identifies three categories of subsidies: prohibited, actionable, and nonactionable.

- Prohibited subsidies (i.e., red subsidies) are provided "explicitly or implicitly to encourage exports or that are contingent on the use of domestic goods over imports." These subsidies are viewed as "automatically trade distorting."
- Actionable subsidies (i.e., yellow subsidies) are said to distort trade if they meet one of the following three conditions:
  - they cause harm to a domestic industry;
  - they displace or impede exports from another country; or
  - they displace or impede the exports of another country from a third country market.
- Nonactionable subsidies (i.e., green subsidies), which generally are not subject to discipline, include the following three categories:
  - assistance for certain research and development costs;
  - regional development assistance; and
  - one-time payments not to exceed 20 percent of the costs of meeting new environmental regulations.

Alleged use of trade-distorting subsidies will be reviewed under procedures established for a new Dispute Settlement Body of the World Trade Organization. If the panel determines that the subsidy has caused injury, the provisions state that "the panel may direct removal of the subsidy or other trade retaliation by the injured party." Implementation of these provisions will force states to reassess their development incentives.

Summary

As a result of increased attention by both government and business to the effects of competition for private investment location and the newly adopted restrictions on subsidies contained in GATT, many states will have to rethink their development policies and programs. This report suggests that many states have begun to move in the direction of the provisions contained in the NGA policy on Economic Growth and Development Incentives, and it presents a framework that states can use for calculating a rate of return on public subsidies.

States Redefine Incentive Policies and Programs

The NGA time-limited policy on Economic Growth and Development Incentives provides an alternative to what are often called "incentive wars." This policy supports a number of principles for developing a pro-business climate that will foster economic growth and global competitiveness in all states. These principles emphasize cooperation between the public and private sectors to promote economic growth. Taking a broad view of development, the policy advocates development initiatives to improve education, transportation, telecommunications, tax policies, business regulation, and public services.

In certain circumstances, such as to overcome a real cost of doing business, incentives can be a useful tool. The Governors' policy contains the following provisions associated with public subsidies to businesses:

- using individual state development objectives, identified criteria, and a calculated rate of return to offer public subsidies that will be available to and benefit all businesses;
- assisting projects that otherwise would not occur, rather than just influencing site location;
- encouraging joint ventures between government and business;
- investing in people and in communities as foundations of a healthy economic environment, instead of concentrating resources in the fortunes of one company or project;
- providing special assistance to encourage investment in distressed areas or to bring jobs to populations experiencing high unemployment; and
- developing provisions to recoup subsidies if the business community fails to deliver promised benefits in return for state subsidies.

The provisions outlined in the NGA policy are principles, not mandates. As states rethink their policies and programs for encouraging economic development, the NGA principles on development incentives offer guidelines for states wanting to respond to an environment of stiff global competition and to provisions in international trade agreements such as the General Agreement on Tariffs and Trade.

An earlier NGA publication, *Investing in America's Economic Future: States and Industrial Incentives*, discussed the findings of a survey of state incentive practices. The survey found that the primary objectives of state incentive policies were to recruit new investment and to retain existing firms or encourage their expansion. A Council of State Governments' publication, *The States and Business Incentives: An Inventory of Tax and Financial Incentive Programs*, noted that in 1988, one-half to two-thirds of the states offered the following incentives: exemptions for research and development; property tax exemptions/moratoria on land and capital improvements; sales/use tax exemptions on new equipment; property tax exemptions/moratoria on machinery and equipment; corporate income tax exemptions; and accelerated depreciation on industrial equipment. Besides tax exemptions, many states also offer financing assistance, job training/recruitment services, infrastructure development, and tax credits to encourage new private sector investment by both existing firms and those considering relocating to the state. Provisions negotiated during the Uruguay Round of GATT may restrict some of these current practices.

Recognizing the changes in national and international economic forces, several states have revamped their state development policies and programs to use state resources more effectively to promote economic growth. Other states have initiated a strategic planning process to guide state development practices. The state practices described below highlight recent state development efforts that exemplify the principles and criteria embodied in the NGA policy. The descriptions neither represent the totality of any given state's development initiatives nor imply that other states have not undertaken similar efforts.

State Uses Cost/Benefit Analysis to Determine Incentives

Illustrating the use of cost/benefit analysis in determining incentive payments, Oklahoma recently enacted an initiative that is designed to meet the state's development objectives of creating quality jobs in its most important industries.

Oklahoma Quality Jobs Program
Because much employment growth in the state has been in part-time, low-wage, and low-skill jobs, Oklahoma chose to encourage new and existing firms to create "quality" jobs in Oklahoma. To participate in the Quality Jobs Program, a firm must offer its workers basic health benefits and fill 80 percent of the created jobs with full-time employees who work at least twenty-five hours per week. To receive quarterly incentive payments for creating jobs, a firm also must be a "basic industry" and have an annual gross payroll for new jobs of at least $2.5 million within three years of application. The Quality Jobs Program Act defines basic industries as manufacturers within standard industrial classification (SIC) codes 20 to 39; service industry firms with 75 percent of sales out of state; central administration offices; and companies engaging in research and development, including testing laboratories.

To determine the amount of the incentive payment, the Oklahoma Department of Commerce conducts a cost/benefit analysis. The payment equals the product of the estimated net direct benefit rate (total benefits less total costs) and the amount of payroll for new jobs, with a maximum incentive payment of 5 percent of the gross payroll for ten years. If the firm's payroll for four consecutive quarters falls below $2.5 million within three years of the first incentive payment, or if during the ten-year period its gross payroll falls below $2.5 million, incentive payments may stop. Fraud in connection with an incentive payment is a felony.

A firm participating in the Quality Jobs Program cannot qualify for some of the other sales and income tax incentives offered by Oklahoma. However, participating firms are eligible for five-year ad valorem tax exemption (manufacturing), free industry training programs, foreign trade and freeport benefits, and other technical and financial assistance programs.

Oklahoma Development Capital Corporation/Quality Jobs Investment Program
Supporting a pro-business climate and diversifying the state's economy are two other development objectives in Oklahoma. Accordingly, Governor David Walters signed legislation to create the Oklahoma Development Capital Corporation, which supplants the Quality Jobs Program. The Oklahoma Development Capital Corporation, or the Quality Jobs Investment Program, stresses goals such as increasing capital availability for businesses, enhancing export activity, and expanding private sector investment. The

corporation, which is administered by a nine-member board of directors that includes representatives from both state government and the private sector, offers assistance to firms needing investment capital.

The new corporation primarily will work to develop a more efficient and comprehensive financing infrastructure—in both the public and private sectors—for businesses that either relocate to or expand in Oklahoma. In addition, the corporation will:

- serve as an insurer or grantor of business capital and debt financing;
- help businesses identify and access various sources of capital assistance; and
- act as a wholesaler of business capital and credit, with private institutions acting as retailers.

To participate, a company must be a basic industry, as defined by the Quality Jobs Program, and assign, if applicable, its Quality Jobs Program incentive payments to the Credit Enhancement Reserve Fund. The state and the private sector equally fund the corporation, with the equity of the private sector receiving priority over the equity of the state in the case of a loss. The reserve fund can offer credit enhancements to high and moderate credit quality revenue bonds.

States Use Strategic Planning to Take a Broad View of Development

Several other states are using state development objectives and criteria to guide development initiatives. Kansas and Arizona recently finished a strategic planning process in which they conducted analyses and gathered diverse perspectives in order to identify development objectives and recommend actions to implement their goals. Kansas encourages high-performance firms by establishing criteria for incentive eligibility. Arizona adopted an industry-cluster strategy and plans to make investments in infrastructure and in community skills.

A Kansas Vision

In 1986 Kansas began a strategic planning approach to economic development. The current 1993 strategic plan, *A Kansas Vision*, is a forward-looking document that shifts the focus of state development efforts from creating the largest number of jobs possible to supporting "high-performance" firms that produce value-added goods and services, employ highly skilled workers, and pay high wages. This plan, a product of grassroots participation and economic analyses, identifies ways to avoid a downward spiral in the quality of life and to strategically use state resources to invest in economic development.

Recognizing the components that can lead to a strong, healthy economy, *A Kansas Vision* sets forth four major goals:

- to enable Kansas businesses to be internationally competitive through high-quality, high value-added goods and services;
- to develop a highly skilled workforce that is competitive in the global market;
- to support a pro-business climate that enables businesses to access resources they need to increase investment and production; and
- to continue to facilitate effective public-private partnerships for economic development, with support from an efficient public sector.

High Performance Incentive Program. In *A Kansas Vision*, the state envisions itself as home to high-performance companies that apply advanced technology, use quality management practices, involve employees in decisionmaking, focus on satisfying customers, and train their workers. An outgrowth of this vision is the High Performance Incentive Program. This program encourages small and medium-sized firms, defined as those with fewer than 500 employees, to invest in new technology and upgrade their workforce. To qualify as a high-performance firm, a company must either pay higher-than-average wages for its industry in the county or be the only two-digit SIC code industry in the county; and must spend a minimum of 2 percent of its total payroll on workforce training or participate in the state's workforce training programs (e.g., the Kansas Industrial Training/Retraining program or the State of Kansas Investment in Lifelong Learning program).

Once a company qualifies as a "high-performance firm," it is eligible to receive higher levels of tax credits and other state-financed business incentives. These benefits may include a tax credit for workforce training expenditures that exceed $50,000 and 2 percent of total payroll; a sales tax exemption on purchases related to new investment in facilities, with no requirement for new job creation; a 10-percent investment tax credit against corporate income tax on any amount above $50,000; and priority consideration for state business assistance programs. Although the incentives are not determined through a cost/benefit analysis, only firms with a commitment to quality jobs and worker training are eligible for these higher levels of incentives.

Public-Private Partnerships. The first Kansas strategic plan in 1986 emphasized building public-private partnerships. The state chartered several new organizations, including Kansas, Inc., Kansas Technology Enterprise Corporation, and Kansas Venture Capital, Inc. Respectively, these organizations are responsible for state strategic planning, promoting the innovation and commercialization of new technologies, and providing equity and debt financing to Kansas businesses. Complementing these statewide partnerships are substate alliances among local governments, regional planning commissions, utilities, financial institutions, and business groups.

Kansas, Inc., the organization responsible for strategic planning, represents a partnership between the private sector and state government, including both the Governor and the legislature. Since its creation in 1986, Kansas, Inc., has guided the implementation and evaluation of the state's economic development strategy. These functions include recommending not only policy and program enhancements and initiatives, but also updates to the development strategy in response to changing economic conditions.

Kansas Comprehensive Highway Program. The NGA policy recognizes that investments in infrastructure can benefit all businesses and development efforts instead of a select few. The 1989 Kansas Comprehensive Highway Program implements one objective of *A Kansas Vision*—investing in infrastructure to enhance the expansion and competitiveness of all Kansas businesses. Over the eight-year program period, Kansas will invest $2.65 billion to maintain and upgrade the state's highway system. Although most of the money will be spent on substantial maintenance of, major modifications to, and new construction of highways and bridges, approximately one-third of total expenditures will support economic development projects.

Arizona Strategic Plan for Economic Development

The recently completed *Arizona Strategic Plan for Economic Development* (ASPED) is now being implemented through a public-private partnership to achieve the state's development objectives of creating quality jobs, strengthening ten industry clusters, and improving Arizona's economic foundations of business capital, technology, infrastructure, business taxation and regulations, and quality of life. The ASPED document also offers guidelines for an industry cluster-based incentive policy that would require a cost/benefit analysis of return to the state from a given project. Other Arizonan plans include investing in community skills and in "economic-strengthening projects" that will improve transportation, telecommunications, and infrastructure along the Arizona-Mexico border.

States Launch Initiatives to Benefit All Businesses

Many states are working to make the business climate in their state more attractive to investors. For example, South Dakota and West Virginia offer an approach to increasing the availability of capital that differs from the approach used in Oklahoma. In Pennsylvania the legislature reformed workers' compensation provisions.

South Dakota Creates Revolving Loan Economic Development and Initiative Fund

Like Oklahoma, South Dakota considers business financing to be important for creating a pro-business climate. A few years ago, the state collected an additional 1-percent sales tax to capitalize its Revolving Loan Economic Development and Initiative Fund (REDI). REDI provides low-interest loans to qualifying businesses, regardless of whether they are existing, relocating, or startup enterprises, as a means of achieving the state's development objectives. Those objectives include increasing capital investment, diversifying the state's economy, and encouraging businesses to create "primary jobs" defined as jobs within businesses that bring in outside income, stimulate other business growth, or assist the state in diversifying or stabilizing the economy.

West Virginia Establishes Revolving Loan Fund

West Virginia also initiated a revolving loan fund in 1993 for industrial development, with limits of no more than $2 million for a single project. In addition, West Virginia is implementing a comprehensive education improvement and school construction effort and a seven-year road building program. State officials are exploring how to develop state-of-the-art communications and transportation infrastructures as well as community facilities.

Pennsylvania Reforms Workers' Compensation

Pennsylvania reformed its workers' compensation law for the first time in twenty years. The reform contained a number of cost-cutting provisions to try to offset the 24-percent average rate increase that took effect in January 1993. The legislation limits the fastest-rising cost factor, medical payments, and attempts to introduce competition into a traditionally noncompetitive system.

States Use Incentives to Encourage New Business Behaviors

Oregon, Massachusetts, Minnesota, and New Jersey are using incentives to encourage firm behaviors that otherwise might not occur. Specifically, all four states want to help businesses form flexible industry networks to strengthen their competitiveness. These networks enable small and medium-sized businesses to pool resources for investing in worker training, quality management practices, new technologies, and new markets.

Oregon Key Industries Development Program

To help Oregon's thirteen key industries grow and become internationally competitive, Oregon launched the Key Industries Development Program. Oregon defines its key industries as those most important to the economic future of the state.

Under the Key Industries Development Program, the state acts as a catalyst by encouraging firms within a key industry to cooperate to improve domestic and global competitiveness. The Oregon Economic Development Department (EDD) first convened monthly CEO roundtables, organized by key industry, where the leaders identified their mutual problems and opportunities. The participating CEOs found that the roundtables helped them not only to understand how industry partnerships could benefit their firm and their industry, but also to begin to overcome traditional rivalry among firms in the same industrial sector.

Together with state and local government officials, private sector leaders developed industrywide strategic plans and established benchmarks as measurable goals of the strategic plan for each key industry.

The Flexible Networks Initiative is the centerpiece of the Key Industries Development Program. This initiative offers firms in key industries incentives to form flexible networks. Networks—or groups of at least three companies—enable members to collaborate in efforts such as expanding their markets and developing new products. Once the companies agree to form a network, they can receive a matching grant of $10,000 from the state and access trained "network brokers" to help them take advantage of networking opportunities. EDD also offers consulting and mentoring services to businesses that are considering setting up networks.

Massachusetts Manufacturing Networks

In 1993 Massachusetts charged the Bay State Skills Corporation with creating and developing manufacturing networks to enhance the quality of manufactured products and improve the national and international competitiveness of Massachusetts manufacturers. In addition to grants and services commonly provided to networks, the corporation also will help the networks reduce employee health care costs, access new export markets, and comply with environmental regulations.

Minnesota Manufacturing Collaborative Network

The Minnesota Manufacturing Collaborative Network Grant assists small manufacturers with fewer than 300 employees in forming networks to jointly purchase products and services, develop new products and projects that are beyond the capacity of a single firm, and access quality management and quality assurance programs.

Network New Jersey

New Jersey is working to create flexible manufacturing networks and provide them with technology extension services through the Network New Jersey/Manufacturing Extension Partnerships Initiative. This effort, headed by the New Jersey Institute of Technology, focuses on bringing together academic and corporate experts to help five key industries form networks for modernization. Through their networks, firms in the key industries will be able to access technologies, workforce training, and assistance in improving management and quality control practices.

States Initiate Public-Private Partnerships for Innovation

Many state universities are involved in the research and development of new technologies, but public sector efforts do not always correspond to private sector needs. Florida recently launched a major initiative to build public-private partnerships that will help diversify the state's economy and create high-wage, high-skilled jobs. California and Michigan also have initiated public-private partnerships to help the private sector develop, access, and use new technologies.

Enterprise Florida

Enterprise Florida is a nonprofit, public-private partnership that is leading the state's development efforts. The partnership directs overall economic development policy, assesses progress toward measurable state development goals, and offers support to performance-based local, regional, and state economic development organizations. In the near future, Enterprise Florida will work to increase businesses' access to capital and develop market-driven workforce training programs.

Another objective of Enterprise Florida is creating a favorable environment for technology- and innovation-driven firms through its subsidiary, the Technology and Innovation Partnership. This partnership will provide leadership in enacting a comprehensive technology policy for the state and in facilitating technology extension efforts. Specifically, the partnership will bring together universities, research laboratories and facilities, and firms to help existing and startup manufacturers and support businesses' access to and use of technologies. These efforts will seek to create jobs by enhancing productivity and efficiency through technology commercialization, modernization, and defense conversion.

The Technology and Innovation Partnership's main activities will include technology development and commercialization, technical assistance, and technology transfer and extension services. The Innovation Alliance and the Technology Investment Fund are two efforts within this partnership. The Innovation Alliance, a technology extension program, will help entrepreneurs and small and medium-sized manufacturers build managerial, technological, financial, and scientific capacity. Instead of creating a new structure and new programs, the Innovation Alliance will work with existing private and public businesses and technological service providers.

The Technology Investment Fund is a complementary effort to partially finance public-private research and development projects through the Florida University System. Using monies from both the public and private sectors, the Technology Investment Fund will invest in projects that demonstrate commercial viability. By facilitating a flow of investment-grade technologies to businesses, Enterprise Florida hopes to create jobs through new or enhanced goods and services.

California Economic Development Network

Recognizing that companies may need assistance preparing for the future, California established the Economic Development Network (EDNet). Community colleges in the state work with industry on a number of initiatives, including workplace learning, contract education, applied competitive technologies, small business programs, and international trade.

Michigan State Research Fund

In Michigan small technology-based firms or business-university collaborations can receive partial funding for research and development through the Michigan State Research Fund (SRF). SRF assists with short-term, applied research projects that have high commercial potential, will benefit the state's economy, and are in one of five technology areas: biotechnology or in the manufacturing, environmental, information, or materials sciences. Efforts that will take longer than a year or that do not meet SRF criteria may apply for federal Small Business Innovation Research grants.

States Invest in People and Communities

Recognizing the importance of a skilled workforce and an adequate infrastructure to a healthy economic environment, especially in a global economy, Illinois, Iowa, South Carolina, Texas, and Virginia have updated existing or introduced new workforce development programs. Transportation and telecommunications investments in Mississippi and North Carolina are two ways that states are strengthening their communities.

Illinois Industrial Training Program

Illinois recently announced changes to the state's Industrial Training Program. Of particular note, the state has increased the effectiveness of its training program by using producers as intermediaries to design and conduct training for their respective suppliers. Rather than dealing with individual firms, the program now reaches groups of businesses with common training needs.

The Illinois Industrial Training Program's new efforts focus on the needs of small and medium-sized firms that often do not have sufficient resources for the ongoing workforce training needed to keep up with today's technologies and markets. Prior to the changes, many small firms did not benefit from state training resources because they either could not meet state documentation requirements or lacked the capacity to administer grants. Consequently, DCCA decided to work with intermediary organizations to identify membership needs, market the concept of multicompany training, establish training programs, administer grants, and/or coordinate membership needs with the trainer. These organizations could include manufacturer supplier networks, business and industry associations, community colleges and universities, local economic development commissions, chambers of commerce, and employer associations.

While the Industrial Training Program can still service single firms, it emphasizes working with groups of small and medium-sized enterprises that are trying to become more competitive. Through the program firms may receive training for new technologies or processes, quality management systems, new export markets, and new machinery or equipment. Single companies that either expand or relocate to Illinois also can apply for matching grants if they are adding product lines or training employees.

Iowa Human Investment Strategy

When Iowa developed its 1992 strategic plan it included a human investment strategy. If it is implemented, the strategy will restructure and integrate state programs in education, human services, and workforce development to improve the effectiveness of the state's investment in its human infrastructure.

South Carolina Statewide Technical College System

South Carolina also is investing in its workforce and communities. The state transformed its community college program into a technical college system based on the premise that firms will not relocate out of state if a trained workforce is available. The technical college system provides traditional community college services such as adult basic education and two-year technical degrees. Moreover, community colleges are a primary player in implementing South Carolina's training and retraining programs. To attract new firms and retain existing businesses, the system enables the state to offer a uniformly trained workforce. When appropriate, companies relocating to South Carolina can access a customized training program for their workers. The retraining program is part of the state's efforts to help communities facing plant closures or layoffs rebuild their economic base.

Texas Smart Jobs Fund Program

In response to changing economic conditions, Texas initiated the Texas Smart Jobs Fund Program to train new workers and retrain current employees in the private sector. To receive state matching grants for training, a firm must certify that an actual job exists for the trainee. For retraining, the firm must be trying to retain jobs during a period of industry downsizing or modernization to remain competitive. The fund gives preference to projects that support "family-wage jobs" defined as those that pay at least two-thirds of the state average weekly wage. In addition to assisting minority businesses, the program will focus on employers involved in defense conversion and those offering full-time employment and high-wage, high-technology jobs.

Workforce Virginia 2000

The Virginia Legislature established a new public-private council to lead efforts in implementing the recommendations of the Governor's Advisory Committee on Workforce Virginia 2000. This forward-looking initiative seeks to build the state's human resource base to meet the demands of industry into the next century. The secondary, technical, and higher education systems will implement the initiative, and all state employment and training agencies also will participate.

Mississippi 4-Lane Highway Program

The Mississippi 4-Lane Highway Program is a fourteen-year effort to enhance the state's competitiveness in attracting investment and retaining industry. When the system is completed, any site in the state will be within thirty miles or thirty minutes of a four-lane highway, thus giving all communities a transportation infrastructure for development efforts. The program is unique because it is based on a "pay-as-you-go" philosophy and is funded by highway user revenues and some federal monies. Highway segments that were least effective in carrying traffic volume, as determined by sufficiency ratings, receive priority attention.

North Carolina Information Highway
Scheduled to be operational by June 1994, the North Carolina Information Highway (NCIH) will be a state-of-the-art, multimedia, statewide communications network that will link residents, businesses, schools and universities, and governments. Developed through a public-private partnership, NCIH could improve government operations, health care practice, crime control, education, and economic development efforts. North Carolina officials view the NCIH initiative as key to expanding opportunities for all residents and businesses.

States Tailor Incentives for Special Needs

Consistent with NGA policy that provides for circumstances or development objectives that warrant special incentives, Ohio is offering businesses a special incentive to encourage more export activity. In another example, Vermont recently introduced a program to support microentrepreneurs.

Ohio Export Tax Credit
The Ohio Department of Development estimates that every $1 billion in export sales creates 25,000 new jobs and that exporting firms have a higher survival history than do businesses that rely solely on the domestic market. Consequently, the year-old Ohio Job Creation Act created the Ohio Export Tax Credit as part of the state's global strategy for private industry. The credit is a time-limited incentive for all businesses, regardless of size, to export.

Corporate or individual taxpayers with export sales can receive a nonrefundable franchise tax credit through this initiative. Qualifying businesses can receive a credit for the average increase in export sales during the two years prior to the year in which they claim the credit, up to a limit of 10 percent of pretax profits from an increase in export sales. To be eligible for the maximum 10-percent credit, businesses must qualify for special Foreign Sales Corporation federal tax treatment and have increased either their Ohio payroll or their capital expenditures in the state by 10 percent. The credit claimed by an individual or a business cannot exceed $250,000 in a year or $3.25 million over the life of the credit. As an incentive for small and medium-sized enterprises to export, even modest increases in export sales will qualify a firm for the tax credit. The Export Tax Credit is legislated to sunset in 2001, making it a targeted effort to encourage Ohio firms to enter and expand export markets.

Businesses that currently export or are considering exporting can receive trade assistance from the international trade division in the Ohio Department of Development. This assistance includes tax and financing incentives, matching Ohio companies with potential foreign buyers, representing firms at international trade shows, conducting trade missions, and sponsoring export seminars. In addition, the department plans to pioneer the Electronic Data Interchange or "info-port," enabling firms to make export sales electronically.

Vermont Job Start Program
A microenterprise program in Vermont also illustrates the use of incentives to encourage investment in special cases. Recognizing that more than 90 percent of all Vermont businesses are small businesses, the state developed the Job Start Program. The new program is a revolving loan fund for low-income applicants wanting to develop microenterprises. (Microentrepreneurs

traditionally lack the assets to secure startup financing, even though the amount of capital needed often is small.)

The Economic Progress Act that created the microenterprise program also contained a number of development provisions, including tax reductions, tax incentives, and a Vermont business registry. The registry is a comprehensive database on Vermont businesses.

States Strengthen Clawback Provisions

The NGA policy recognizes that if businesses receive public subsidies, including tax abatements, they have an obligation to deliver the promised benefits (e.g., creating a specified number of jobs). Connecticut and Indiana are two states that have strengthened their "clawback" provisions. (A clawback is a mechanism for recovering all or part of past subsidy expenditures.)

Connecticut Revises Clawbacks

Connecticut Governor Lowell P. Weicker Jr. recently signed revisions to the state's clawback legislation. The revised statute lengthens the period in which a company is held accountable to its commitment; applies to all firms receiving assistance, not just to those with more than twenty-five employees; increases the financial penalty; and requires firms relocating within the state to offer employment at the new location to employees from the original site.

Indiana Terminates Abatements for Noncompliance

In 1991 the Indiana Legislature approved a bill that affects firms benefiting from tax abatements. Under the new statute, local governments must require recipients of tax abatements to hire locally and to purchase goods and services from Indiana suppliers to the greatest extent possible. Firms also must submit sufficient information so that local governments can determine whether the recipients are complying with the statement of benefits. If the local government determines that the firm is not in compliance, abatements must be terminated. Termination is waived if the firm could not comply due to circumstances beyond its control (e.g., a natural disaster). Firms that install new manufacturing equipment or develop or rehabilitate property at a cost of at least $10 million within a specified period also are exempt.

Summary

States are rethinking their development incentives and structuring new initiatives in ways that are consistent with the NGA policy on Economic Growth and Development Incentives. At least four states—Arizona, Iowa, Kansas, and Oregon—have taken a long-term, comprehensive look at their economic future in their strategic plans. As a result, these states are making infrastructure improvements and changing industry policy. Workforce development programs, community investment strategies, and tax and financing interventions are other ways states are creating a climate in which all businesses can prosper. At the same time, public-private partnerships are increasingly prevalent in state development activities. These partnerships help foster innovation, develop strategic plans, and guide policy development.

Recently, several states have established criteria on the level and type of investment, job quality, and industry classification that a project must have in order to qualify for incentives. Protecting their development investments, states have toughened provisions to recover subsidies if a business fails to meet its commitments. Some states base incentives on firm performance, while other states have implemented or are considering provisions for determining the level of incentives by using cost/benefit analysis.

The development policies and programs highlighted in this chapter demonstrate that states have taken a number of actions consistent with the NGA policy. These practices illustrate positive steps toward developing an environment in which all states and businesses can enjoy economic growth and achieve global competitiveness.

Calculation of the Costs and Benefits of Economic Development Subsidies

One provision of the policy on Principles of Economic Growth and Development Incentives, adopted by the Governors at the 1993 Annual Meeting in Tulsa, Oklahoma, states that in those instances when state government elects to provide incentives, public subsidies for private investment "... should be based on individual state development objectives, identified criteria, and a calculated rate of return." In a 1991 survey of state economic development agencies, NGA found a difference among states relative to the methodology used to conduct cost/benefit analyses and the attention paid to them. "The survey findings appear to confirm the opinion of outside observers that states need to pay more attention to the costs/benefits associated with incentives, and to the capacity to accurately evaluate individual incentive programs and practices."[3]

This chapter outlines several issues for consideration as states devise methodologies for conducting cost/benefit analyses of economic development subsidies.[4] It intentionally does not recommend a specific methodology for states to adopt. A uniform cost/benefit analysis methodology is limited principally by the range of development incentives and sources of revenue available within individual states. For example, the methodology to accurately calculate the revenue stream from a project is significantly different for a state that has corporate or personal income taxes than for a state that must rely on sales taxes as a source of revenue. However, some elements of the methodology are common to all situations. For example, to what extent does the methodology take into account the multiplier effect (i.e., the job, income, and revenue growth from secondary and tertiary impacts of the original investment)?

Finally, the calculation remains a combination of art and science. Each state will make numerous subjective decisions about factors such as "multipliers" and "opportunity costs." Once these choices are made, relatively standard algorithms can be used to calculate the associated dollar amounts.

Why Conduct a Cost/Benefit Analysis?

Proponents of development incentives liken subsidies to "investments." Opponents of incentives view them as a gift of public resources to a private interest. The final determination of whether a development incentive to a firm is an investment or a gift is no different than the case of an investment or gift to an individual. An individual offers a gift to another person with no expectation of reward or income as a result of the transaction. In contrast, an investment is made for the purpose of increasing wealth.

Because the objective of state economic development efforts is to increase jobs, income, and revenues through the location or expansion of businesses, the state clearly is seeking some reward for its efforts. Consequently, the injection of public funds into any economic development project falls within the category of an investment. The important question then becomes, "Is the investment a rational one?" The purely mathematical answer is that any rational investment is one from which the return on that investment is greater than it would have been from alternative investments.

Unfortunately, the answer to this question goes beyond simple mathematics. Sometimes the benefit from one project exceeds the internal parameters of that activity. The situation is somewhat analogous to a new commercial mall where the developer may make certain concessions to the anchor stores (e.g., Bloomingdale's or Macy's). The presence of the anchor stores makes the location more attractive to smaller vendors.

Such considerations must continually be weighed. For this reason, the use of development subsidies to foster and sustain economic growth remains much more an "art" than a science. However, the use of a sound cost/benefit methodology improves the ability of decisionmakers to make and justify the use of subsidies.

This does not suggest that a state will never invest in a project if it is not justified on the basis of a rigorous cost/benefit analysis. There are legitimate development policy objectives that supersede fiscal constraints. However, when a project does not generate a positive rate of return, the unrecovered costs should perhaps be viewed as an expenditure in support of the policy objective rather than as an investment.

Traditionally, public officials have focused on the human element (i.e., job creation) of economic development as the justification for public intervention in private investment decisions. Not surprisingly, much of the criticism of public subsidies relates to the ratio of dollars expended to jobs created vis-à-vis the investment. As the ratio increases, so does the criticism of the public subsidy. The result is an unending argument about what constitutes a "reasonable" ratio.

However, sustained economic growth does not come from one-time investments, but from the ability to reinvest resources again and again. Consequently, if the focus turns to the rate of return on the public investment, the question of what is a reasonable dollar outlay per job created becomes moot. For example, a public subsidy of $5,000 per job created that does not result in a positive rate of return (i.e., new revenues) can only create that job once. In contrast, a subsidy of $50,000 per job created that has a 15 percent rate of return will quickly replenish the economic development pool and can be used to support additional job creation.

How Can the Rate of Return on Development Subsidies Be Calculated?

Calculating the rate of return on public development incentives requires an examination of three elements.

- Revenues—Dollars returned to the treasury as a result of taxes, fees, and other payments that result from the private investment.
- Expenditures—The cost of improvements to the physical and human infrastructure (e.g., sewer collection and job training) that directly support the private investment.
- Revenues Foregone—Adjustments to the private investor's tax burden that result from credits and abatements or to the investor's development costs because of waived and reduced fees.

The reason for distinguishing between expenditures and revenues foregone is one of timing. Expenditures generally represent out-of-pocket outlays by the public sector prior to the commencement of private economic activity (e.g., construction of a new interchange to provide access to an industrial site). Conversely, foregone revenues are assessed at the time the tax or fee would have been due.

In general terms, the equation for determining the rate of return on a public investment is as follows.

$$ARI = (AR - AE)/I$$

where:

ARI = annualized return on investment
AR = annual revenues
AE = annual expenditures (both direct expenditures and revenues foregone)
I = value of the original investment

Using the sum of each ARI over the period of analysis, the present value of the return on investment can be calculated to determine an average annual rate of return.

Several subjective decisions can influence the accuracy of the rate of return model. Primary among these is a desire by most development specialists to take into account the multiplier effect (i.e., the secondary and tertiary economic activity that occurs as a result of the initial private investment). For purposes of this discussion, "secondary" effects refer to the activity of other businesses that provide raw materials to or intermediate processing for the subsidized business. "Tertiary" economic activity refers to the economic activity (i.e., personal consumption) that results from circulation of the income to employees of the firms.

As a rule, the integrity of the rate of return calculation deteriorates in direct proportion to the extent to which the multiplier effect is included in the calculation. Dependence on the multiplier effect requires the investigator to make numerous subjective decisions about the project. For example, a major manufacturer in central Texas may rely heavily on in-state suppliers. The same type of company in Rhode Island may look out of state for the same inputs.

This also holds true for tertiary multiplier impacts. Residents living in the central region of a large state will most likely expend their disposable income in the same state. Residents in smaller states or those living near the state's boundaries will operate in a consumer market area that encompasses two or more states. As a result, projections of revenue impacts would be erroneous if they were based on the assumption that all income associated with a new facility location or expansion will be expended in the same jurisdiction providing the incentives. (Note: The accuracy of the multiplier effect becomes more tenuous if the calculation attempts to capture the revenue impacts on a citywide or regional basis.)

There are complex models that will calculate numerous consumption impacts. For example, with sufficient information about the number of jobs created, the number of jobs in various income categories, the percent of these jobs that will go to existing rather than new residents of the community, and current housing vacancy rates, there are models for estimating the amount of new housing construction that will result from an private industrial or commercial development. Unfortunately, the analyst seldom has sufficient or accurate figures for each input variable. Consequently, the accuracy of cost/benefit estimates for these projects deteriorates rapidly.

The situation is analogous to the return on a private investment. The rate of return from the purchase of stock is normally limited to the dividends from that investment. Potential reinvestment of the dividends, whether in stocks, mutual funds, or the state lottery, would not be included in the calculation. From a cost/benefit approach, the integrity of the calculations improves the more the investigator sticks to known information about the investment itself. Secondary and tertiary benefits from a new project can be assumed, but the decision to inject public funds in a private activity should not be based on unsubstantiated assumptions about suppliers and consumer behavior.

The "bottom line" is that the analysis should be intellectually honest. Where the analyst has access to both good models and good inputs, this information should be included in the calculation of the costs and benefits associated with a project.

The second subjective decision revolves around the inclusion of local as well as state incentives in the equation. The primary sources of state and local revenues differ. In most states, the primary revenue stream comes from income taxes—personal and corporate—and sales and use taxes. In contrast, the primary source of local revenues is real and personal property taxes. On the expenditure side, the locality may be faced with major costs (e.g., new schools to accommodate population growth and additional fire and police facilities). A cost/benefit analysis that excludes local revenues and expenditures may distort the true cost to the state, particularly if the locality then looks to the state for aid to meet the increased public service requirements.

The third subjective decision is the length of time covered by the cost/benefit analysis. Clearly, an analysis that concludes at the first year of the company's operations would produce a negative outcome, especially if the state (and locality) make major capital investments in support of the project. However, the longer the period of analysis is extended, the more the investigator must speculate about the recipient company's long-term operations. At the extreme, there is the question of whether the firm will still be in business.

The final subjective decision focuses on the opportunity costs of funds used for development subsidies. To what other purposes would the state put these dollars? If they simply would remain in the state's general investment pool, it is relatively easy to calculate an opportunity cost based on the historical rate of return the state treasury receives from invested state funds. However, if the funds would be used for alternative economic development subsidies, a comparable cost/benefit analysis for each alternative project must be undertaken.

What Are the Elements of the Rate of Return on Investment Equation?

The equation by which state decisionmakers can assess the rate of return on economic development incentives consists of three factors: annual revenues, annual expenditures, and original investment. This section defines the range of elements that should be included as part of each factor. The information assumes that the state is only looking at the primary costs and benefits of the project. Therefore, the calculation would not include additional costs or potential revenues that result from suppliers or from personal consumption associated with the company's payroll. It also assumes that the state is interested in the total public costs, whether they are incurred by the state or the locality in which the company locates or expands.

Original Investment

The original investment is defined as the total cost of all incentives or subsidies provided in support of the project that are incurred only as a result of the project. Examples include the costs associated with the following.

- Infrastructure improvements (e.g., roads, water, and sewer) that are constructed in direct support of the project. The improvements eventually may serve additional development, but the cost should be allocated to the project that initially generated the demand.
- Purchase of additional industrial/commercial property. Did the state assemble a parcel of land to accommodate the location/expansion?
- Construction or reconstruction of real property improvements (e.g., the expense associated with construction of a "clean room" to attract a computer chip manufacturer).
- Job training or retraining.
- Grants, loans, and/or loan guarantees.

Even when some or all of these costs are recovered (e.g., through loan repayments), these revenues show up as part of the annual return on investment equation.

Annual Revenues

The revenue side of the equation is the easiest to calculate. It is based on state laws related to taxation and regulatory fees. However, over time assumptions must be made about changes in the tax rates and the growth of business activity.

For example, in year one a firm knows that its pretax income is expected to total $5 million. The revenues from the state corporate income tax are easy to calculate for that first year. They are equal to the product of the estimated pretax income and the current corporate tax rate. However, in year ten the original equation must be adjusted based on assumptions about the growth in sales and changes in the state corporate tax rate. If the project is an expansion of an existing firm, an assumption on growth in sales can be based on historical data. Likewise, fluctuations in tax rates over time can be estimated from historical data. However, these estimates may be skewed by unanticipated economic conditions (i.e., a recession that affects the overall growth of consumption), increased competition, or significant changes in public policy (e.g., a major reduction in tax rates to spur new private investment).

In all cases, revenues generated through the provision of public services (e.g., utilities or permitting) is adjusted on the expenditure side by the marginal cost of providing that service to the firm. Revenue elements included in this portion of the cost/benefit equation include the following.

- State and local taxes including, but not limited to, corporate profits taxes, personal income taxes, real and personal property taxes, franchise taxes, and sales and use taxes. The base for calculating the tax revenue should be limited to the direct activities of the assisted firm(s). For example, the personal income tax rate would be applied to the company's payroll.
- Repayment of loans. This revenue stream is adjusted by the opportunity cost of the loan. For example, if the state has an average interest payment rate of 7.0 percent on its general investment pool, loan repayments at an interest rate of less than 7.0 percent would technically be an expenditure (i.e., negative revenue).
- License and permit fees, including development fees, impact fees, inspection charges, and connection fees.
- Utility charges in cases where the utilities are provided through a public entity (e.g., a municipal utility company).

Some revenues, especially permit fees, are one-time revenues; they typically are generated during the first year of the project. In contrast, taxes and loan repayments are spread out over several years.

Annual Expenditures

Annual expenditures fall into two categories: cash outlays and foregone revenues. Specific items considered under these categories include the following.

- Payment for capital improvements. Major improvements will be financed through public borrowing. Consequently, the expenditure calculation should include the debt service for public improvements.
- Incremental cost of service delivery. Expenditures in this category can vary greatly based on the firm's demand for services and current access capacity. For example, a small commercial enterprise will not tax existing water and wastewater treatment capacity. However, a food processing plant that requires massive amounts of water for its production process may require the expansion of water and wastewater treatment facilities. In this case, the marginal cost for servicing the new facility may require a major capital outlay as well as an increase in annual operating expenses.
- Job training costs, whether they are provided in the form of a subsidy to the company's own training program, through a public or quasi-public entity, or through a contract with a private sector provider.
- Opportunity cost of money dedicated to the project. Again, the most consistent method of calculating the opportunity cost is an assumption that dollars used in support of the project would have, at a minimum, remained in the state's general investment pool and would have generated interest at a determined interest rate.

The concept of including the opportunity cost of money as an expenditure in the cost/benefit equation is often overlooked, but it represents an important factor in the decision process. This is best illustrated through a private sector analogy. In the late 1970s, many policymakers argued that double-digit interest rates on borrowed funds were discouraging new investment in equipment with the attendant expansion of industry. Although this was a factor, the more important issue was the availability of double-digit interest payments on guaranteed investments (e.g., certificates of deposits). Companies faced the following decision. Should the company invest millions of dollars in expansion with an unguaranteed return of investment of less than 10 percent? Or were the owners or stockholders better served by cash investments that paid a guaranteed rate of more than 10 percent?

What Is the Bottom Line?

The table on page 19 presents a sample cost/benefit analysis for a hypothetical firm. Of particular interest is the fact that during the first year, the expenditures far exceed the revenues and that the break-even point does not occur until year five.

This example represents a positive return on investment over the period of the analysis if, and only if, the company operates at or above its level of commitment to the state. This feature of the analysis emphasizes the importance of the provision in the NGA policy on development incentives related to a firm's obligation "... to deliver the promised benefits in return for state subsidies." The development agreement between the state and the private investor should cover the minimum amount of time to ensure that the long-term revenue stream from the company's operations generates the projected rate of return.

Admittedly, this discussion of cost/benefit analysis adopts the most conservative view of economic benefits from a particular project. There will be secondary and tertiary benefits from all private investments. The issue is whether such variable and indeterminable factors should be used to justify policy decisions on the investment of public funds.

Sample Cost/Benefit Analysis

Project Assumptions			
Investment in Real Property Improvements ($)	1,000,000	Personal Income Tax Rate	5.00%
Investment in Machinery and Equipment ($)	750,000	Sales Tax Rate	6.00%
Number of New Employees	50	Property Tax Rate	2.25%
Average Salary ($)	30,000	Abatement of Property Taxes (10 Years)	50.00%
Annual Sales ($)	1,000,000	Sales/Use Tax on Machinery and Equipment	Exempt
Percent Profit to Sales	15.00%	Donation of Land ($)	100,000
Anticipated Annual Growth in Sales	10.00%	Job Training Subsidy Per Job ($)	2,000
Public Investment Pool Interest Rate	8.00%	Sewer and Water Extension ($)	250,000
Municipal Bond Rate	4.50%	Development Fees	Waived
Corporate Income Tax Rate	6.50%		

Cost/Benefit Calculation	*Year One*	*Year Two*	...	*Year Ten*
Revenues ($)				
Corporate Income Tax	10,725	11,798	...	25,289
Personal Income Tax	68,750	75,625	...	162,109
Property Tax	43,313	43,313	...	43,313
Sales/Use Tax on Machinery/ Equipment	45,000		...	
Development Fees	20,000		...	
Total Revenues	187,788	130,735		230,710
Expenditures ($)				
Purchase of Land	100,000		...	
Water/Sewer Improvements (Amortized over 10 Years)	31,595	31,595	...	31,595
Job Training	100,000		...	
Total Expenditures	231,595	31,595	...	31,595
Revenues Foregone ($)				
Abated Property Taxes	21,656	21,656	...	21,656
Waived Development Fees	20,000		...	
Sales/Use Tax on Exempt Property	45,000		...	
Interest from General Investment Pool	36,000	36,000	...	36,000
Total Revenues Foregone	122,656	57,656	...	57,656
Net Revenues ($)	-166,463	41,484	...	141,459
Annual Return on Investment	-36.99%	9.22%	...	31.44%

Conclusion

The NGA policy on Economic Growth and Development Incentives was crafted to provide guidance to Governors about long-range economic development policy and the decisions they make related to specific investments of public dollars. It was not intended to thwart state economic development efforts. This report adds to the debate that resulted in the policy in two ways.

First, the discussion of emerging state development policies and programs demonstrates that states have considerable latitude to operate within the context of the NGA policy. Rather than arbitrarily using development incentives, states are building public-private partnerships, investing in people and communities, supporting specific development objectives, and ensuring that firms meet the commitments for which private subsidies were provided. These policy and program choices respond to individual state development needs and are a positive step away from high-stakes incentive wars.

Second, the chapter on cost/benefit analysis introduces some new concepts and challenges some old assumptions about factors that have traditionally been used to justify the benefits of economic development projects. Although there still is wide latitude for determining what factors should be included in a cost/benefit analysis, there is one underlying principle that should govern the use of this tool. Projections of benefits from public investment in a particular project should be based on hard data. Development subsidies should not be justified on the basis of unsubstantiated assumptions.

As states continue to rethink their development priorities to meet the ever-changing needs of businesses, their efforts to promote economic growth and global competitiveness will remain an issue for debate. In addition, external forces such as GATT also will impact the climate for state policymaking.

Endnotes

1 In 1993 these two standing committees were incorporated into a new standing committee, the Committee on Economic Development and Commerce.

2 This section is based largely on material contained in the *Report of the United States Trade Representative's Intergovernmental Policy Advisory Committee (IGPAC) to the Congress of the United States on the Agreements Reached in the Uruguay Round of Multilateral Trade Negotiations*, submitted to Congress on January 14, 1994. Charles Colgan of the University of Southern Maine, who served as Uruguay Round Task Force Chair for the IGPAC Staff Working Group, prepared the section on development subsidies in the IGPAC report.

3 Jay Kayne, *Investing in America's Economic Future: States and Development Incentives* (Washington, D.C.: National Governors' Association, 1992), p. 27.

4 The information in this chapter is based largely on work conducted during the late 1980s by Jay Kayne, then-owner of Kayne and Associates in Austin, Texas, and Paul Williams, president of Southwest Consulting Services of Georgetown, Texas. Their efforts were in response to the passage in 1987 of major amendments to the Texas statutes concerning tax abatement by local communities. The 1987 amendments required that all jurisdictions develop a tax abatement policy prior to offering such abatements to potential private investors.

Appendixes

Appendix A:
National Governors' Association Policy on Economic Growth and Development Incentives

Preamble

The accelerated use of direct development incentives by states to attract economic investment is symptomatic of the continuing slow rate of growth of the nation's economy. State government finds itself pressured to take whatever steps are necessary to support job creation that otherwise might occur unaided under more healthy economic conditions.

The current economic climate also affects the way the business community behaves when making investment decisions. To minimize new investment in plant and equipment, businesses readily take advantage of available subsidies in the form of development incentives.

Both the public and private sectors are responding to legitimate objectives. The issue is whether current practices by states that utilize development incentives and by businesses that take advantage of these incentives provide a rational, long-term strategy for either party.

The Governors believe that the public and private sectors should undertake cooperative efforts that result in improvements to the general economic climate rather than focus on subsidies for individual projects or companies. We acknowledge that this will not be easy. It will require a behavioral change by both government and business, balancing short-term self-interest with the long-term common good.

Finally, we do not believe this change should result from the threat of punitive measures or federal intervention. Governors and business leaders should operate in accordance with the following principles because they represent good public policy; in the long run, adherence to these principles will achieve the desired outcomes in terms of new jobs and higher income in all states and sustained profitability for businesses that invest and operate in these jurisdictions.

Principles of Mutual Cooperation

The Governors offer the following principles for cooperation between state government and the business community. These principles support our mutual development objectives through the creation of a business climate in all states that will result in economic growth and the ability to compete in international markets.

Partnership Between State Government and Business

The relationship between state government and business should be a true partnership. Both state government and business have certain responsibilities and anticipated benefits. States and the business community within states should maintain an ongoing dialogue for the purpose of developing sound public policy and programs. States should implement policy processes that are nonthreatening to the business community and the public.

State Competition

States will always be in competition with one another for business investments. However, this competition should not be characterized by how much direct assistance a state can provide to individual companies. It should focus on how each state attempts to provide a business climate in which existing businesses can operate profitably and expand and new businesses can be established and survive. The competition should be judged on factors such as improvements in education, transportation, and telecommunications; stable fiscal conditions; tax policies; business regulation; and the provision of quality public services.

Subsidies

States will continue to provide subsidies to businesses. However, they should adhere to the following criteria.

- Public resources should be used to encourage and foster development that otherwise would not occur, not merely to influence the location of private investment.
- Public subsidies should benefit and be available to all businesses—large and small, new and existing, of domestic or foreign ownership—based on individual state development objectives, identified criteria, and a calculated rate of return.
- Public subsidies should be in the form of investments in people, resulting in a better educated and skilled workforce, and in communities, by developing the physical and social infrastructures that are prerequisites of healthy economic development. Although such investments may be tied to the location or expansion of an individual company, the improvements in the workforce and community should not be wholly dependent on the fortunes of one business and should be viewed as assets for other businesses that locate in the community.
- States and the business community need to identify and address specific tax and regulatory barriers that slow the rate of new investment in economic activity. When appropriate, the parties should jointly petition the federal government for regulatory relief.
- To the extent possible, programs (e.g., workforce training and research and technology transfer) that support mutual development objectives should be joint ventures between government and business.
- The business community has an obligation to deliver the promised benefits (e.g., investment, jobs, and payroll) in return for state development subsidies. The state owes it to its citizens to ensure that all development agreements include provisions for recouping subsidies when businesses fail to meet this obligation.
- When two or more Governors believe that a company is engaged in counterproductive interstate competition in order to increase the value of a subsidy package, those Governors should feel free to exchange information related to the types of assistance being offered. In cases where a company informs one state of the specifics of another state's incentive package, Governors should have the right to verify the accuracy of this information.
- Using subsidies to encourage investment in distressed areas of the state or to increase employment opportunities that bring the underclass into the economic mainstream are viewed as legitimate development objectives.

Governors and representatives of the business community must support each other's efforts to adhere to these principles. State governments, businesses, and citizens need to understand the relationship among tax bases, tax rates, and quality public services. Both government and business should engage in a continuing process to educate each other and the public on this issue. Business leaders should be prepared to stand by state officials when it is clear that one company is seeking unreasonable incentives at the expense of other businesses or the state in general. Business leaders also must be prepared to publicly voice their disapproval when corporations engage in counterproductive interstate competition. Conversely, Governors must be prepared to withstand the political pressure that may result when they announce that their state will not engage in a bidding war for a high-visibility, high-impact project.

Time limited (effective August 1993-August 1995).
Adopted August 1993.

Appendix B: State Program Contacts

Arizona
Frank Plencner
Governor's Strategic Partnership for Economic Development
602/280-1499

California
Employment Development Department
California Trade and Commerce Agency
916/653-0707

Florida
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Enterprise Florida
407/425-5313

Illinois
Peter Ramirez
Business Development
Illinois Department of Commerce and Community Affairs
312/814-2335

Kansas
David Bybee
High Performance Incentives Program
Kansas Department of Commerce and Housing
913/296-7174

Charles Warren
Kansas, Inc.
913/296-1460

Michigan
State Research Fund
Michigan Department of Commerce
517/335-2139

Mississippi
F. J. Newell
Mississippi Department of Transportation
601/359-1213

New Jersey
Arthur Gold
Center for Modernization Systems
New Jersey Institute of Technology
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Ohio
James Sisto
International Trade Division
Ohio Department of Development
614/644-6476

Oklahoma
Oklahoma Department of Commerce
800/588-5959

Oregon
Kathy Powell
Key Industry Development Program
Oregon Department of Economic Development
503/373-1200

Janet Jones
Flexible Manufacturing Network Program
Oregon Department of Economic Development
503/378-2286

Pennsylvania
Scott Bair
Economic Development Policy Office
Pennsylvania Department of Commerce
717/787-4088

South Dakota
Ken Shock
Enterprise Initiation
Governor's Office of Economic Development
605/773-5032

Texas
Smart Jobs Fund Program
Texas Department of Commerce
512/320-9672