

**An Evaluation of North Carolina's Economic Development Incentive Programs:
Summary of Analysis, Findings and Recommendations**

Prepared for

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

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The **UNC Center for Competitive Economies** (C³E) is part of the Frank Hawkins Kenan Institute of Private Enterprise and UNC's Kenan-Flagler Business School of the University of North Carolina at Chapel Hill. The Center brings the considerable resources of the University to help communities in North Carolina, the United States and beyond address critical challenges of competitiveness and economic development. In that role, C3E conducts economic policy studies for local, state and national governments across the spectrum of economic development issues.

Introduction

In March 2007, the President Pro Tempore of the North Carolina State Senate and the Speaker of the North Carolina House of Representatives established a Joint Select Committee on Economic Development Incentives to examine the state's economic incentive programs. In January 2008, the North Carolina General Assembly contracted with the University of North Carolina's Center for Competitive Economies (C³E) to assist the Joint Select Committee on Economic Development Incentives in evaluating the performance North Carolina's economic development incentive programs.

C³E undertook this 18 month research program with the goal of addressing a set of questions deemed key to the committee's efforts:

1. What is an economic incentive and which ones are most appropriate for the committee to assess?
2. How is the success of economic incentives to be judged and which outcomes are the highest economic development priorities for North Carolina?
3. What companies have received economic incentives, how much have they gotten, and how much more will be granted under current policies?
4. What have been the benefits from economic incentives and how do programs and types of recipients differ in their economic impact?
5. To what extent do North Carolina's economic incentives affect the state's economy?
6. How would the economic impact of reducing the state's corporate tax rate compare to that of current economic incentives?

This summary of findings discusses the importance of each critical research question under examination, reviews the research approaches utilized to examine these questions, and highlights key findings from the research. More detailed analysis and secondary research findings can be found in the complete report and appendices.

Research Methodology

Study Period: 1996-2006

At the time of the committee's formation North Carolina had recently completed its first decade of experience between 1996 and 2006 in the use of financial incentives in economic development. This span of time encompassed a dynamic period in the state's economic history. Much of the state's "traditional industries" economic foundation – textiles, furniture, agriculture – came under tremendous global competitive pressure, resulting in numerous plant closures and workforce reductions. Meanwhile, more technology intensive industries such as pharmaceuticals, telecommunications, and computer hardware and software, experienced both rapid growth and retrenchment in the "dot com" boom and bust of the late 1990s.

Data Sources

This economic dynamism, combined with the expansion of incentives use during the 1996-2006 study period provided an abundance of both quantitative and qualitative information. Much of the relevant information required resided at the North Carolina Departments of Commerce and Revenue:

- The North Carolina Department of Commerce provided information on Job Development Investment Grant (JDIG) and One North Carolina Fund (One NC) incentive recipients.
- The General Assembly passed legislation authorizing the Department of Revenue to release tax filings for William S. Lee tax credit recipients to C³E to complete the study. Electronic tax filings were available for companies receiving Lee tax credits from 1996-2006, and hard copies of tax returns, which included additional information on type of credit claimed, were released for 2002-2006 returns.
- The North Carolina Employment Security Commission provided quarterly employment history from 1990-2006 for incented firms based on information provided by the North Carolina Department of Revenue and Department of Commerce. In total, this database exceeds 250,000 observations used to track the pre and post employment performance of incented companies.

Case Studies and Surveys

Quantitative employment and incentive data was then augmented by qualitative data from company case studies and surveys. Executives from 36 companies receiving Lee Act incentives participated in confidential interviews to discuss the impact of the Lee Act on their company's business expansion and location decisions. Sixteen detailed case studies were conducted on JDIG/One NC Fund companies, including documentation of local and state incentives received. Another four case studies (two in South Carolina and two in Virginia) were performed to examine companies North Carolina had unsuccessfully competed to locate into the state.

Additionally, a survey was utilized to determine the perspective of incented and non-incented companies on the importance of economic development incentives to their business expansion and location decisions and importance to the state's business climate.

Research Analysis

The majority of the research was completed between February and December 2008, although additional analysis will be performed to assist the legislature in its deliberations. C³E researchers provided research results to the committee and its staff frequently in the course of the committee's meeting throughout 2008. Those findings addressed the initial key questions and are summarized below:

1) What Is An Economic Incentive And Which Ones Are Most Appropriate For The Committee To Assess?

C³E worked with the Joint Select Committee and the legislative staff to define the relevant population of economic development incentives to be addressed in the study. As anticipated this apparently simple question was complicated by differing understandings as to the definition of incentives and the state's history experience in their use.

North Carolina offers a wide range of economic development assistance that could be included in an expansive definition of economic incentives. Types of assistance range from highly specialized services such university-based technology transfer programs to broadly available small business training programs offered through the community college system. The state has also historically offered direct industrial development assistance such as industrial revenue bond financing, customized job training programs and industrial development.

Studied Incentives

However, in the early 1990s the state undertook a specific effort to develop a program of economic development incentives in response to a perceived weakening competitive position with its economic development rival states. This program of statutory tax credits, which came to be known as the William S. Lee Act incentives program, was later expanded through the addition of the discretionary incentive programs of the Job Development Investment Grant (JDIG) and One North Carolina Fund.

The implementation of these incentive programs marked a significant strategic shift in North Carolina's economic development efforts. Accordingly, the committee chose to limit the analysis to these programs and the state's Research and Development tax credits. The study did not measure or examine the effectiveness of local economic development incentive packages, although some data were collected on the types and amounts of local incentives in the JDIG/One NC Fund case studies and surveys of incented companies.

2) How Can The Success Of Economic Incentives Be Judged And Which Measures Are The Highest Priorities For North Carolina?

North Carolina was a late entrant in establishing an economic development incentive program relative to many other southern states. The William S. Lee Act was created in 1996 and has undergone multiple revisions to expand eligibility, refine criteria, and modify thresholds since the original legislation. The One North Carolina Fund and Job Development Investment Grants are also economic development incentive tools utilized

by the state for economic development purposes. As North Carolina's palette of economic incentives has expanded, often in response to unanticipated circumstances, the core goals of the adoption of economic incentives may have come to be perceived as muddled, inconsistent, or even contradictory. Therefore, to assess the performance of North Carolina's economic incentives it was first necessary to freshly define the standards by which such performance was to be measured.

Performance Criteria

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

Working with the Joint Select Committee and supported by legislative staff, C³E defined four parameters to utilize in measuring the effectiveness of the state's economic development incentive programs:

Quality Job Creation

- Job creation measures included the number of new jobs created and/or existing jobs maintained after receiving an incentive, the wage level of created jobs, whether or not the job was in a targeted industry sector/cluster, and the location of the job and whether incented companies were hiring existing residents for new jobs and creating upward employment opportunities.

Distressed Areas Benefit

- Distressed area benefit measures included examining the share of new job creation in distressed areas (classified as Tier One counties) and the wage levels associated with those jobs. Additional prospective measures included reemployment of displaced workers and replacement of declining industries.

North Carolina's Economic Competitiveness

- Economic competitiveness was examined through the lens of economic diversification and insulation from any negative effects of globalization. Focusing on the location of headquarters, entrepreneurship, and high value industry clusters were also prospective measures. These key measures were examined through a portfolio approach designed to determine which economic incentive programs were offering the best return on investment.

3) What Companies Have Received Economic Incentives, How Much Have They Gotten, And How Much More Will Be Granted Under Current Policies?

The examination of the statutory and discretionary incentive programs activity between 1996 and 2006 revealed that in many ways North Carolina's economic incentives were being used differently than the popular public perception. It found that the focus by the media – and therefore the public – on a few "high profile" examples (such as Dell, Google, Goodyear, etc.) tended to distort understanding of both the participation and costs of the state's incentives.

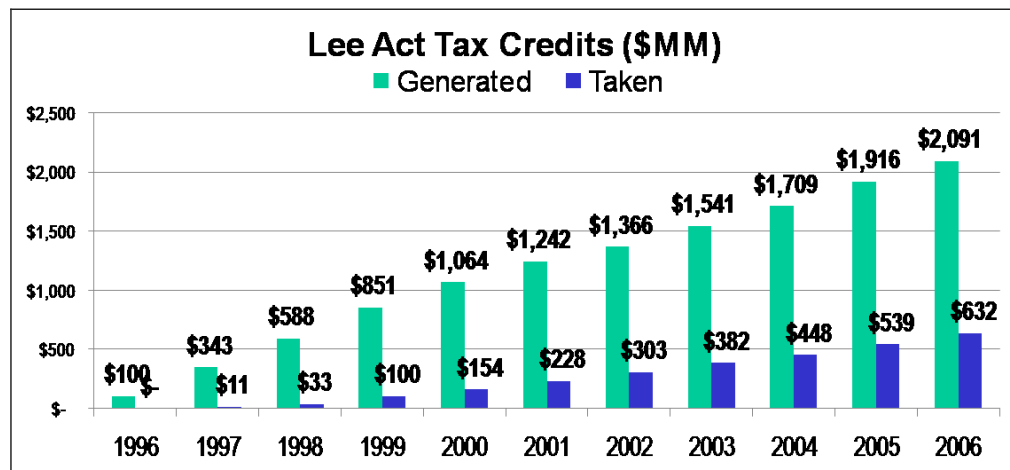
Incentive Use Differs from Assumptions

Between 1996 and 2006 approximately 5,000 companies participated in one or more of the North Carolina economic incentive programs covered in this research. Analysis of this population found a disparity between public and legislative expectations and actual participation:

Costs are High but Typically Overstated

- By 2006 the total **maximum** amount of incentives “generated” or awarded by the state since 1996 exceeded \$2 billion but the eventual actual cost will be less
- Media accounts typically cite maximum possible incentive amounts whereas the eventual actual cost will be significantly less as most incentives are in the form of tax credits that are historically not fully utilized
- The amount of tax credits used or “taken” in the period totaled \$632 million, as compared to the \$2.1 billion “generated” (Figure 1); an estimated 35% of generated credits will never be used

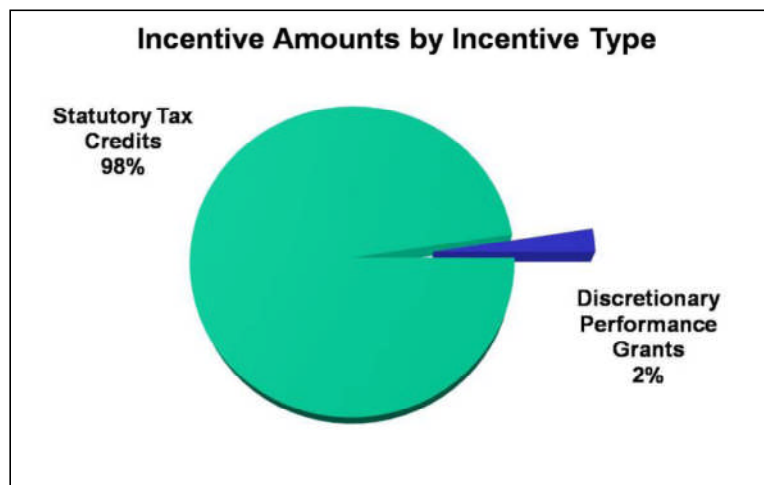
Figure 1



High Profile Discretionary Incentives are Atypical

- Media studies found that discretionary incentive (JDIG, OneNC) deals receive a disproportionate level of coverage compared to Lee Act tax credit recipients, thus creating a distorted perception of incentive use
- Lee Act tax credits consume the majority of North Carolina’s incentive “portfolio” allocation (Figure 2), representing 98% of the allocation, while discretionary incentives only comprise 2%.

Figure 2



Most Firms get Small Incentives, only a Few get Large Amounts

- Media attention on the large incentive deals also distorts perceptions of the typical incentive amount received by a company
- Between 2002 to 2006, 1,967 companies received \$875 million in Lee Act tax credit incentives
- But of these, 860 companies (44%) received less than \$25,000 each, with the effectiveness of such small amounts be logically suspect
- By contrast, for the same period just 46 companies (2%) received an average of more than \$11 million each, for total of \$523 million or nearly 40% of the total tax credits generated

4) What Have Been The Benefits From Economic Incentives And How Do Programs And Types Of Recipients Differ In Their Economic Impact?

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

Incentives Usage Inconsistent with Performance Criteria

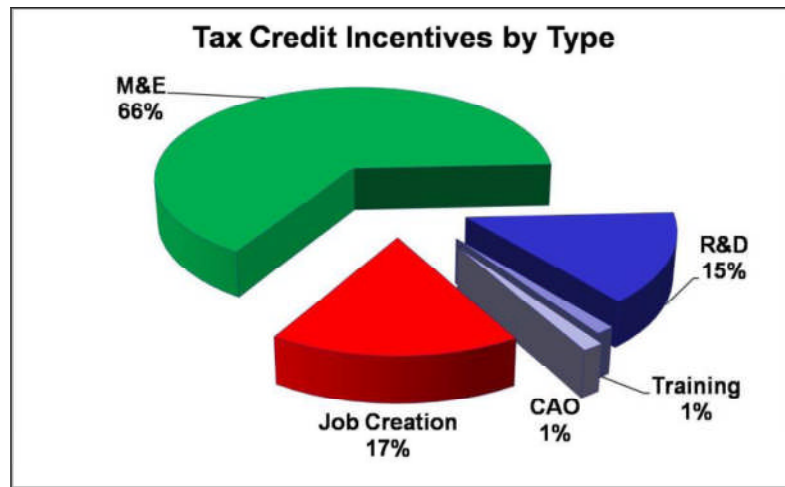
While there may be many objectives for the use of incentives in economic development, the criteria established by the Select Committee for evaluating the performance of North

Carolina economic incentives specifically emphasized their contribution to job creation in the state's distressed counties. By those measures the distribution of economic incentives usage between 1996 and 2006 failed to achieve those goals.

Most Incentives went to Investments, Not Job Creation

- The popular perception is that job creation is the major focus on economic development incentives, yet only a small amount of Lee Act tax credits are directly attributed to job creation activities
- Only 18% of Lee Act tax credits generated in 1996-2006 are specifically for job creation or employee training, whereas two-thirds (66%) are used for machinery and equipment (M&E) investment (Figure 3)

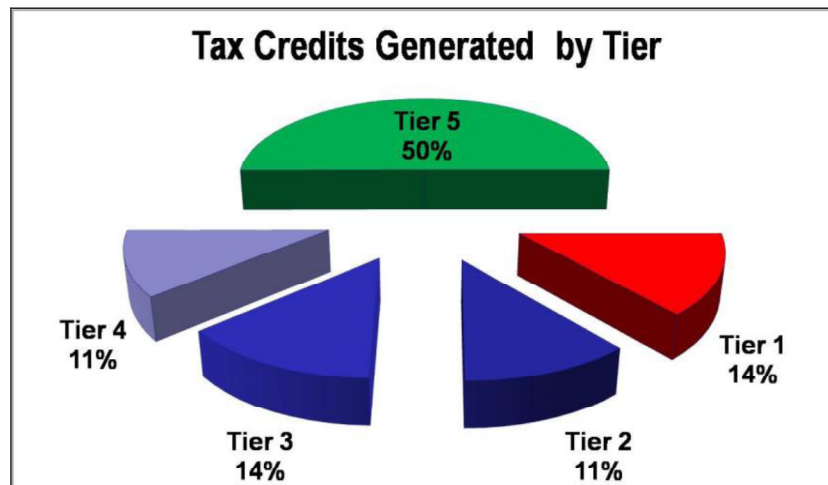
Figure 3



Few Incentives Benefitted Distressed Areas

- While the Lee Act provided favorable incentives in the state's poorest counties (Tier 1), most tax credits went to the least distressed (Tier 5) counties

Figure 4



- During the most recent period of 2002 to 2006, companies receiving Lee Act incentives generated \$875 million in tax credits. Of that amount, half of the incentives went to companies in the least distressed (Tier 5) counties while only 14% went to companies in the most distressed (Tier 1) counties (Figure 4)

Job Creation by Incented Firms is Generally Lacking

This study was enhanced when the General Assembly legislatively empowered C³E to obtain and analysis confidential data unavailable to previous analysts. C³E obtained quarterly employment history for all firms receiving a Lee Act tax credit that report employment levels to the NC Employment Security Commission. These data were analyzed to examine the pre and post employment trends of incented companies. Data analysis required that C³E hold the tier status of counties constant across the analysis using 2006 tier designations and limit some of the analysis to companies with single locations and/or companies existing throughout the study period. Additionally, data on the type of credit claimed by companies under the Lee Act was only available from 2002-2006. These methodological procedures are not expected to significantly alter the findings or trends.

First, single location companies in the study period were examined to determine the growth rate and levels of employment change of companies receiving one or more Lee Act tax credit from 1996-2006. Surprisingly, the examination revealed that only 57.46% of companies receiving a Lee Act tax credit had a positive growth rate (i.e. more employees) in 2006 than they did in 1996 (Figures 5 and 6). Over 41% of the companies had a declining growth rate leading to fewer employees in 2006 than the business had in 1996. These trends were also analyzed for each tier (see the full report for charts/tables).

Figure 5

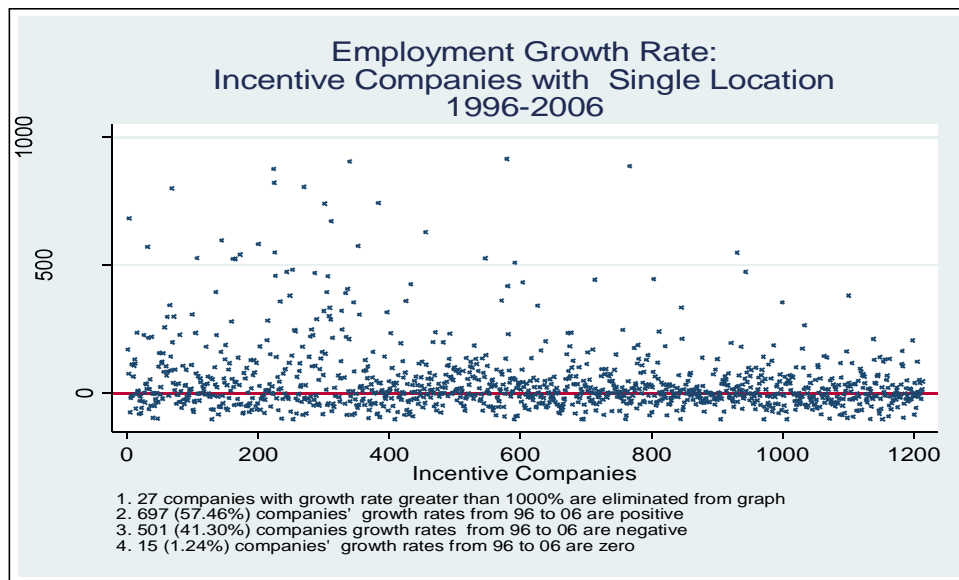
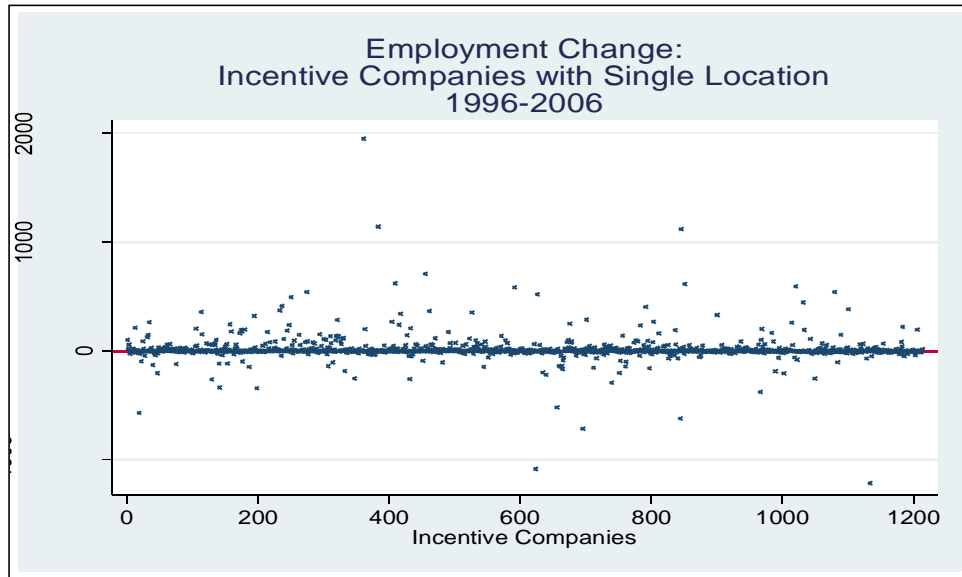


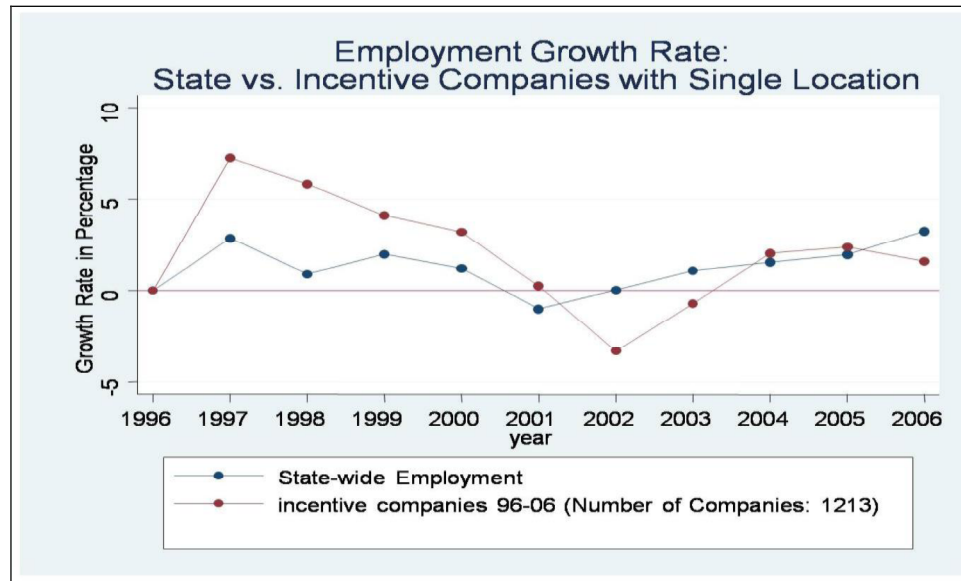
Figure 6



Job Creation by Incented Firms Lagging State Economy in Recent Years

Next, the employment growth rates of incented firms existing from 1996-2006 and existing from 2002-2006 were examined against the overall employment growth for the state. Data on the growth rate comparison for each tier is available in the full report. Incented companies did demonstrate a slightly higher employment growth rate in the 1990s, yet the gap between incented companies and the state average closed over time and is nearly negligible now (Figure 7).

Figure 7



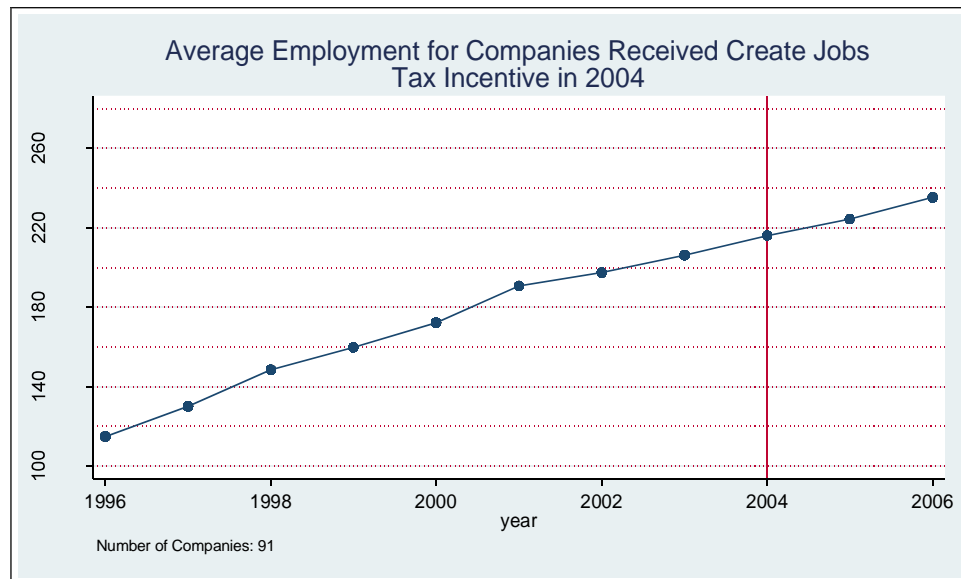
Pre- and Post-Tax Credit Incentive Analysis Shows Lack of Job Creation

To fully assess the Lee Act's impact on employment levels, it was important to contrast the pre- and post-incentive employment levels of incented firms. An analysis was conducted to examine the difference in pre and post incentive employment by both tier and credit type.

As an illustration, data on companies receiving a Lee Tax credit in 2004 are provided as an example (Figure 8). Yearly performance by credit and tier are available in the full report.

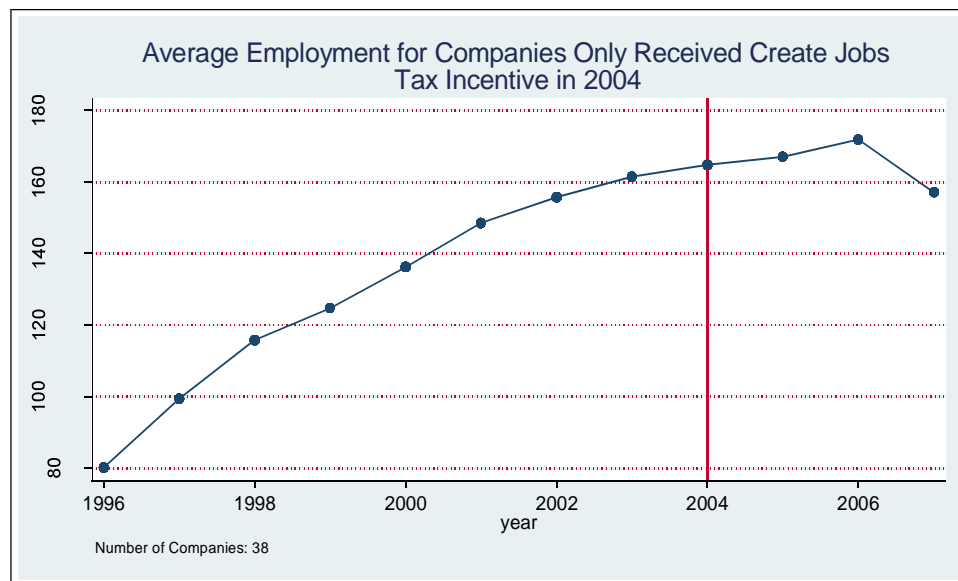
This graph illustrates the average employment for companies receiving a jobs creation tax credit in 2004 for the William S. Lee Act. Companies are not excluded if they also received another type of tax credit. On average, job creation after the tax credit is positive, yet the tax credit does not appear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

Figure 8



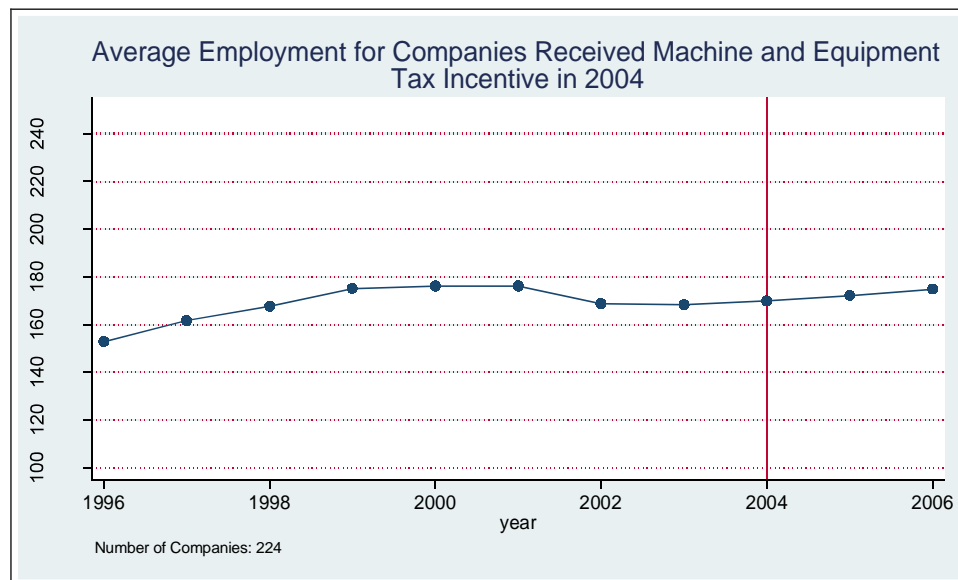
In an effort to isolate the impact of just the job creation tax credit, firms *only* receiving a jobs creation tax credit and no other tax credits in 2004 were also examined (Figure 9). Again, the slope of average employment after the tax credit was generally positive, but the credit does not appear to impact the rate of job creation.

Figure 9



A similar analysis is presented for machinery and equipment and research and development tax credits for 2004. The first graph demonstrates the average pre and post employment levels for businesses receiving a machinery and equipment tax credit in 2004, but does not exclude the company if it received other tax credits (Figure 10).

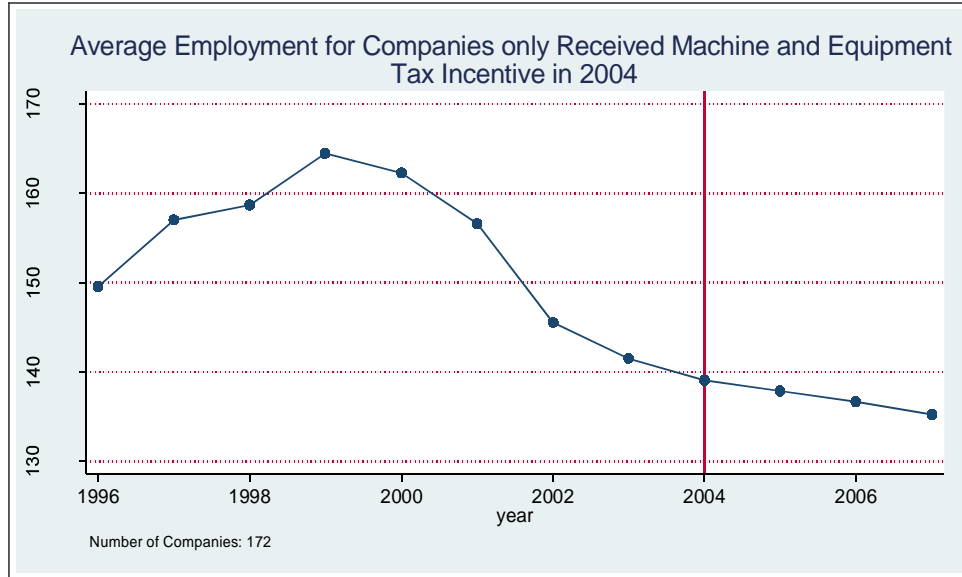
Figure 10



The second graph focuses on companies only receiving a machinery and equipment tax credit in 2004 (Figure 11). Taken in conjunction with other tax credits, the M&E credit does not appear to increase average employment levels at all. Companies only taking the M&E tax credit in 2004 demonstrate a employment loss in subsequent years, which may

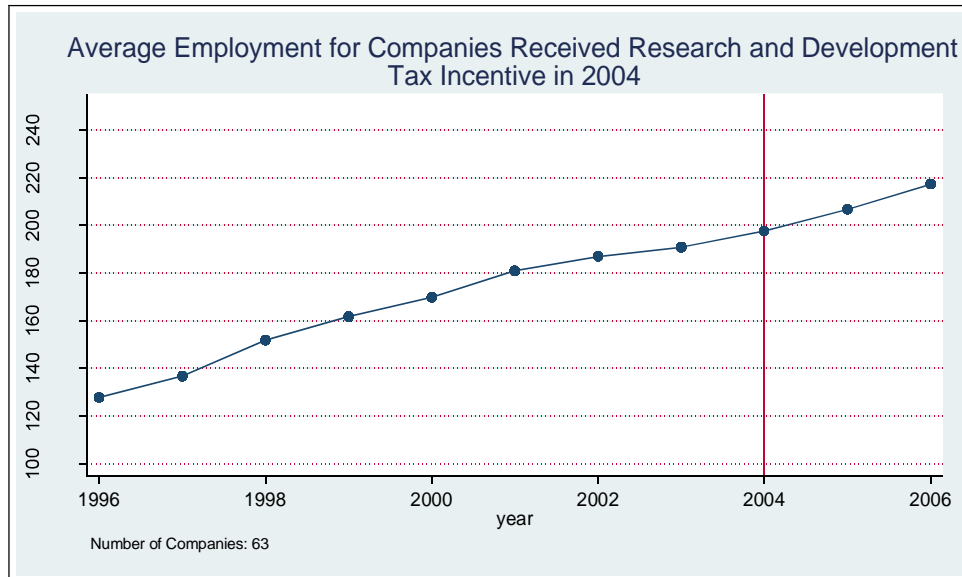
illustrate that companies taking the M&E credit are more susceptible to economic downturns or that these companies are engaging in capitalization—the substitution of labor with capital (i.e. machinery and equipment).

Figure 11



An examination of research and development tax credits for 2004 reveals positive employment growth for companies taking an R&D tax credit with other credits (Figure 12graph).

Figure 12



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

Discretionary Incentives Offer Advantages over Tax Credits

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

A panel of economic development scholars assembled by the C³E for a Symposium on Economic Development Incentives also acknowledged that discretionary programs are more likely to allow for economic development targeting to key industry clusters and are more likely to assist in economic transformation of distressed regions. Like the statutory tax credits, the majority of discretionary economic development incentives are utilized in the state's less distressed counties.

Scholars also acknowledge that incented job creation in growing metropolitan areas must generate a sufficiently large wages and investment levels to offset the fiscal costs incurred by local and state governments by the influx of new residents. Discretionary incentives leading to investment and job creation have a much large economic impact when existing residents are employed, especially in distressed areas.

5) To What Extent Do North Carolina's Economic Incentives Affect the State's Economy?

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

Economic Incentives have Limited Potential

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

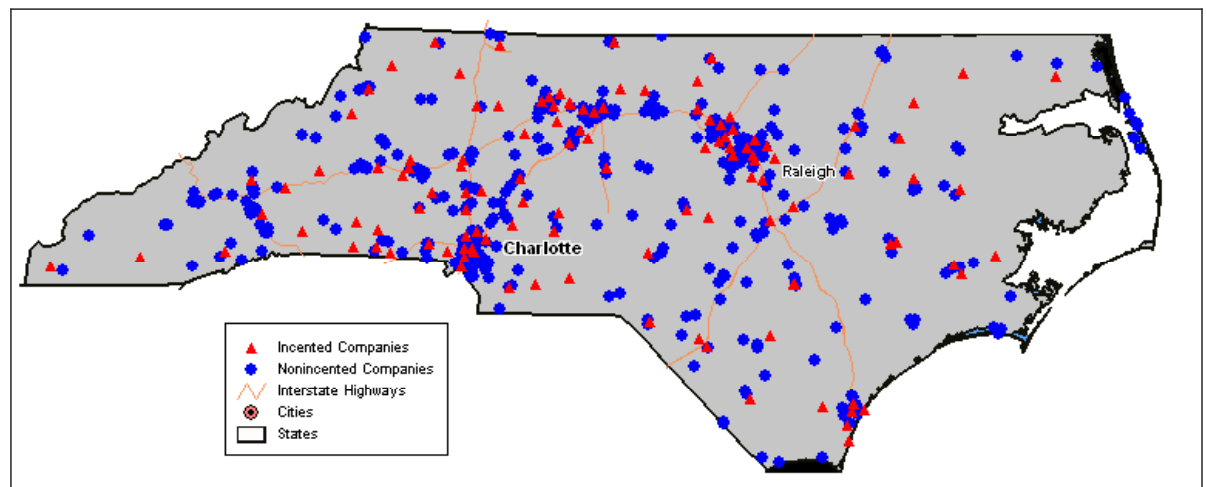
The large number of businesses claiming and generating small amounts of Lee Act tax credits suggests that the states statutory tax credit programs are having a limited effect on the state's economy. The size of the state's economy makes it challenging for an incentive program to greatly stimulate statewide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

State Survey and Case Studies Indicate Incentives are Low Priority

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

C³E surveyed North Carolina companies to determine their perception of the effectiveness and importance of economic development incentives. The survey included 150 Lee Act recipients and 465 non-incented companies (Figure 13).

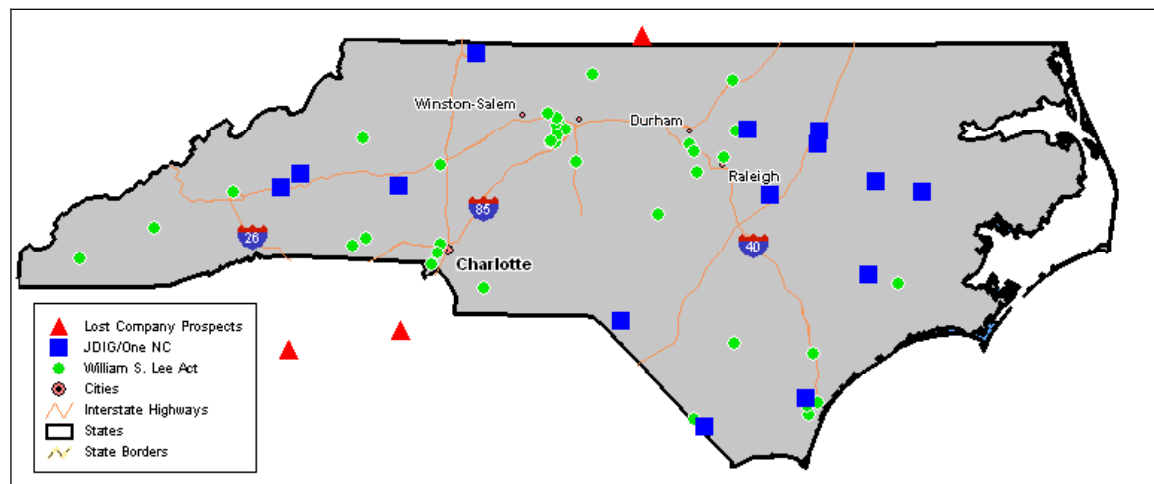
Figure 13



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

Case studies were also conducted with 36 companies receiving a Lee Act tax credit, 16 companies receiving a JDIG or One NC Fund grant, and four companies North Carolina tried to recruit but lost to other states (Virginia and South Carolina). The map (Figure 14) below identifies the general location of case study companies.

Figure 14



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

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

When Incentives are Most Effective

To the extent incentives have been found to substantially influence company location decisions, they are most effective when:

- the targeted prospects are highly mobile and less resource constrained
- when the incentives are tailored to the company’s specific priorities
- when used proactively to target growth companies with substantial job creation “upside” rather than reacting to individual company “auction” opportunities
- when used to strengthen existing industrial clusters through buyer-supplier chain enhancements
- when used to target firms with best match for existing labor market availability, thus maximizing the net economic benefit of a location success

6) How would the economic impact of reducing the state’s corporate tax rate compare to that of current economic incentives?

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

Currently, North Carolina has one of the highest corporate tax rates in the southeast (Figure 15) which is perceived to be a significant disadvantage in North Carolina attracting companies.

Figure 15

<i>State</i>	<i>Corporate Tax Rate</i>
North Carolina	6.90%
Alabama	6.50%
Tennessee	6.50%
Georgia	6.00%
Virginia	6.00%
Florida	5.50%
South Carolina	5.00%

NC Company Surveys Reveal Preference for Tax Reduction

The study’s survey of incented and non-incented firms asked “Some people believe that it is better for North Carolina’s economy to offer select incentives to certain businesses, while other people believe it is better to reduce taxes impacting business taxpayers and their owners. Which strategy do you think is better for NC’s economy?”

Approximately 14.5% of non-incented companies and 21.7% of incented companies stated it was better to offer select incentives to certain businesses, while 85.5% of non-incented companies and 78.3% of incented companies stated it was better to reduce taxes impacting businesses taxpayers and their owners. **A majority of companies in both groups favored reduced taxes to incentives.**

Research Findings Summary

NC incentives are most effective in influencing business decisions when:

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

NC incentives have the greatest economic benefit when:

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

NC Statutory Tax Credits Findings:

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

Discretionary Incentive Programs Findings:

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

Corporate Tax Rate Findings:

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

Economic Incentives Utilization Findings

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

Recommendations

1. Retain North Carolina's Research and Development Tax Credit

North Carolina offers a Research and Development (“R&D”) tax credit based on the percentage of qualified research expenses that a business pays or incurs during the year. This credit has been modified by the legislature several times. Recently the General Assembly extended the tax credit, which had been scheduled to expire on January 1, 2009, for five years.

The R&D tax credit was the only investment-based tax credit incentive examined that was correlated with companies adding new jobs both before and after receiving the incentive. Moreover, job quality goals are admirably intrinsic as the credit is premised on companies satisfying several “employment quality” eligibility criteria including wage standards, health insurance, and occupational safety regulatory compliance.

The R&D credit is also distinct from other investment-based tax credits in that it is available to companies regardless of their industry, business type or size. Therefore, corporations, partnerships, and limited liability companies are eligible. This flexibility enhances the prospect of its use by firms in distressed areas and incents (or rewards) innovative corporate strategies that undergird “growth companies” regardless of industry.

North Carolina firms generated \$221 million in state R&D tax credits between 2003 and 2008. Retaining the R&D tax credit will cost an estimated \$250 million in credits generated and \$124 million taken during 2010-2015.

2. Eliminate North Carolina's Statutory Tax Credits (i.e. Article 3J Program)

North Carolina's current economic incentive portfolio is heavily allocated toward the statutory tax credits constituting the William S. Lee Act and the Article 3J program. Of the more than \$2 billion in economic incentives committed between 1996 and 2006, 98% of the incentives were in the form of statutory tax credits.

Such tax credits were the basis of North Carolina's original foray into economic incentives. The process which devised what became the William S. Lee Act was a thorough and thoughtful one that drew on the best available information to devise appropriate incentives for the economy of the mid-1990s. In fact the incentives appeared to have succeeded for several years as the companies receiving them outperformed the North Carolina economy throughout the 1990s.

Unfortunately, by the end of that decade companies receiving statutory tax credits no longer outperformed – or even matched - the state's economy. The explanation for this performance decline may be attributable to several factors, including legislative amendments that expanded the number of eligible firms and possibly diluted the net

employment effect. But the economic circumstances and growth industries of the early 1990s had clearly changed by 2001 and have changed even more dramatically in 2009. Thus it is reasonable that an incentive portfolio highly reliant on tax credits should be reconsidered based on updated information.

Research has shown that the most effective incentives are those that can be tailored to address company specific location decision matrices. Statutory tax credits, while they have the advantage of certainty based on stated eligibility criteria, lack the flexibility needed to develop customized incentive packages. Moreover, despite significant modifications over the years, statutory tax credits have consistently failed to significantly benefit distressed counties.

Tax credits can have a positive marketing effect as a program to benefit existing businesses and have been commonly utilized as a marketing tool by economic developers. While employment outcome research and even the company executives themselves have minimized the effectiveness of tax credits, undoubtedly among the more than 3,000 firms receiving such tax credits in North Carolina between 1996 and 2006 there were numerous instances where such credits were essential. Unfortunately, the rigidity of the credits' statutory nature makes North Carolina's current tax credits expensively inefficient for targeting such opportunities selectively.

We recommend eliminating the Article 3J program in advance of its scheduled "sunset" date. North Carolina's statutory tax credits accounted for an estimated \$783 million in credits generated between 2003 and 2008. Forecasting tax credit generation and usage is complicated by the transition from the Lee Act to Article 3J credit programs, as well as the dampening effect of the current economic downturn. Nonetheless, eliminating the Article 3J program is predicted to result in total savings of \$574 million in retained tax revenues during 2010-2015, with the great majority of savings being realized in the later years due to the lag effect of the carry-forward nature of current credits.

3. Expand JDIG and OneNC programs in number of annual projects and annual threshold with increased amounts targeted to distressed counties.

Many of the deficiencies of North Carolina's statutory tax credit incentives have been addressed in the development and implementation of the state's discretionary incentive programs, the Jobs Development Investment Grants and the One North Carolina Fund. While to date the discretionary incentives have shown limited success in targeting distressed counties, a strong potential for enhancing such outcomes nonetheless exists within the program.

Administration of the program through the Department of Commerce provides for the deliberate evaluation of potential net economic benefits. Such analysis provides a basis for calculating the appropriate scale of offered incentives and the capability to incorporate economic incentives within a broader package of assistance resources. The inclusion of specific performance outcomes as the prerequisite for incentive payments provides a powerful enforcement mechanism absent from the statutory tax credits.

We recommend that the JDIG and OneNC programs be expanded with the additional funding being committed to serving distressed counties. To maximize the net economic benefit of discretionary incentive projects, the Department of Commerce's cost-benefit model should be modified to emphasize a stronger preference for incumbent workforce utilization, location of corporate headquarters, and consistency with Commerce's targeted industry clusters.

Achieving these objectives will require a more proactive effort to use incentives in targeting firms whose workforce and other location criteria provide better matches for the characteristics of North Carolina's distressed counties. We therefore also recommend increasing state and regional economic development research and marketing budgets for proactive targeting of growth stage companies in targeted industry clusters.

Doubling JDIG program with increased amounts targeted to distressed counties will require an estimated additional cost of \$74 Million total from 2010 to 2015. Enhancing economic development research and marketing will require an additional \$1.5 million per year.

4. Utilize savings from elimination of statutory tax credits to support phased reduction of corporate tax rate to competitive neutral rate of 6.5%.

North Carolina's corporate tax rate is conspicuously higher than the next highest rates of its primary rival states. We recommend that a portion of the future saving achieved by the elimination of the Article 3J statutory tax credits be used in a multiyear reduction of the current rate of 6.9% to a competitive neutral rate of 6.5%.

Reducing North Carolina's corporate tax rate was found to be a viable alternative to existing statutory tax credits. Corporate tax rate reduction is economically preferable in that it has lower transaction costs for tax filings and reporting than statutory tax credits. Our surveys also found that reducing business taxes was preferred by both incented and non-incented companies as an alternative to selected tax credits.

Such corporate tax rate reduction would bring North Carolina "in-line" with our competitor states. At 6.9% North Carolina's corporate tax rate is 0.4% higher than Alabama and Tennessee (6.5%). A reduction to 6.5% would still leave the North Carolina rate substantially higher than South Carolina's rate of 5.0%, but would at least neutralize the corporate tax rate as regional competitive disadvantage.

Based on the latest available data from the North Carolina Department of Revenue (2005 tax year) reducing the corporate tax rate to 6.5% would cost \$56 million annually. This should be achieved by phasing in the reduction over several years to match the gradual achievement of saving realized from the elimination of the Article 3J program.

5. Institute a legislative oversight function specifically to establish priorities and assess performance of state and regional economic development agencies

Over the past decade economic development in North Carolina has become a complex landscape of numerous public and private organizations operating from the county to the international level. In particular the number of agencies and organizations funded by the legislature to perform economic development functions on behalf of the state has grown and the definition of economic development itself has expanded to near ubiquity. Each of these organizations has its own agenda and in this mixture the broader interest of the state itself is often unaccounted for.

While the General Assembly is often the primary funder of these activities it does not have an established oversight function. Instead it relies upon periodic reports from the Department of Commerce supplemented by information from various groups or Fiscal Research as part of the appropriation process. This situation may have been adequate in the less complicated time of the early 1990s, before economic incentives, regional partnerships, and site location consultants became everyday concerns. But today the General Assembly needs to play a stronger role in establishing economic development priorities and assessing performance among the many activities and actors it funds.

An unexpected revelation of this economic incentives assessment is that there is abundant information upon which the success of North Carolina's economic development efforts can be judged. While the initial research design and data collection process is daunting, once achieved this capability is readily maintainable. What is necessary is the designation of an appropriate legislative entity or vehicle for the continued performance assessment role played by the Select Committee in this research.

We strongly recommend the institution of such a legislative oversight function as well as support for ongoing collection and analysis of strategic economic status data at the state and regional levels as basis for economic development performance assessment.

END