

**Making the Grade:
A Response to the Assessment of Kansas in
*The 1996 Development Report Card for the States***

**Testimony of Bryan Riley
Kansas Public Policy Institute**

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My name is Bryan Riley, and I am Executive Director of the Kansas Public Policy Institute, a research organization dedicated to the principles of limited government, open markets, and individual freedom and responsibility. Thank you for the opportunity to testify on the 1996 Development Report Card for the States and its implications for economic development in Kansas.

In the past, this scorecard has been used to justify a growing role for the government in the economic planning process. Previous versions of this report actually graded states based on how much money they spent on economic development programs. The purpose of KPPI's testimony this morning is to shed some light on why traditional government-run economic development programs are unlikely to generate an improved report card for Kansas in the future, and to suggest an alternative approach that is more likely to put Kansas at the head of the class.

Introduction: Growing Criticism of Traditional Economic Development Programs

In recent years, government economic development programs such as selective tax abatements and credits, grants to businesses and industries, and subsidized loans have been subject to criticism from across the political spectrum. According to the state Republican party:

As a general principle, the Kansas Republican Party opposes government subsidies to business and supports the operation of the free market system without government interference.^[1]

And according to Labor Department Secretary Robert Reich:

These tax abatements, these subsidies, can be the most insidious forms of corporate welfare because they are difficult to see at the state and local level, unlike some big federal government giveaways, because they do put competitors at a competitive disadvantage if they do not get the same largess, because they rob local jurisdiction[s] and states of the resources that they otherwise might have to invest in people and in infrastructure, and because they are often, in the classic sense of the term, zero-sum games in which jobs are simply moved from one place to another, and there is not a net improvement in job growth or in the quality of jobs.^[2]

The available evidence suggests that there is good reason to view government economic development programs with suspicion. Indeed, at one point in our history such subsidies were viewed as damaging to overall economic growth.

Government Economic Development Programs in Kansas: A Historical Perspective

The use of government incentives to benefit industries used to be forbidden in Kansas. For example, in 1873, the Kansas Circuit Court ruled that the city of Iola was out-of-bounds in issuing bonds "to aid in the erection or completion of buildings at or near the city of Iola to be used for the purpose of

manufacturing Z. King's patent bridges." According to the Court:

And thus we have presented the inquiry. . . . Whether the legislature may thus compel or coerce the citizen to aid in the establishment of purely private enterprises or objects because these will or may incidentally promote the general good of the community or locality. I think it safe to affirm that no such principle has yet received judicial sanction. On the contrary, the principle has been declared unsound by courts of the highest respectability.^[3]

The Kansas Circuit Court referred to U.S. Supreme Court precedent:

In the words of [U.S. Supreme Court] Justice Black: "The legislature has no constitutional right to create a public debt or authorize any municipal corporation to do it in order to raise funds for a mere private purpose. . . . Taxation is a mode of raising revenue for public purposes. When it is prostituted to objects in no way connected with the public interests or welfare, it ceases to be taxation and becomes plunder."^[4]

The Court concluded:

[T]axation to aid ordinary manufactories or the establishment of private enterprises is a device, until recently, quite unheard of; and the power must be denied to exist unless all limits to the appropriation and the power to tax be disregarded. . . . I hold it to be sound doctrine that the mere incidental benefits to the public or the state which result from the pursuit by individuals of ordinary branches of business or industry do not constitute a public use in a sense which justifies the exercise of either the power of eminent domain or of taxation. If this salutary principle be abandoned, we unsettle the foundations of private property, and unwisely open the door for frauds and abuses of the most alarming character.^[5]

Things have changed dramatically since 1873. Economic development spending has been one of the fastest-growing segments of the state budget in the 1990s, and local governments in Kansas actively compete against each other to attract and retain businesses.^[6]

Figure 1: State Spending Increases in the 1990s:

Total state spending	+64%
Economic development spending	+177%

For fiscal year 1997, the state government will spend \$45.5 million on economic development programs, an amount equal to nearly \$13,000 for every manufacturer in Kansas.^[7]

The Economics of Government-Run Development Programs

Economists James Gwartney and Richard Stroup identified four reasons that government economic development programs tend to do more damage than good:

- Central planning merely substitutes politics for market verdicts. For example, Kansans pay twice the world price for sugar not because they want to, but because of the political clout of sugar lobbyists in Washington, D.C. Similar potential for abuse exists at the state level.
- Investors risking their own money will make better investment decisions than central planners spending other people's dollars. For example, in April of 1993, the government loaned a Kansas businessman \$485,000, with repayments to begin the following month. Six months later, despite not having received any payments on the loan, the government loaned another \$198,242. This year, the businessman filed for bankruptcy, a move that could prevent the government from recovering its investment.^[8] It's unlikely such a loan would have been made in the private sector -- and if it had, the

institution that made the loan would be responsible for the potential loss, not Kansas taxpayers.

- Government planners will be fed inaccurate information designed to attract taxpayer support. While anyone seeking support for their business has an incentive to hype the benefits and minimize the downside of their enterprise, the government often is ill-equipped to determine whether a particular company will live up to its promises. For example, in 1991, Wichita gave Pizza Hut about \$2 million in property tax breaks in return for a pledge to expand its headquarters and add new jobs. After taking advantage of about \$900,000 in property tax abatements, Pizza Hut announced that it was moving its headquarters from Wichita to Dallas.^[9]

- There is no way that central planners can acquire enough information to create an economic plan that makes sense.^[10] Friedrich Hayek won a Nobel prize in economics for highlighting this problem. Hayek explained: "The economic problem of society is . . . not merely a problem of how to allocate 'given' resources It is rather a problem of how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know. Or, to put it briefly, it is a problem of the utilization of knowledge which is not given to anyone in its totality."^[11]

Hayek's conclusion -- that government planners will do a *worse* job of planning than individuals acting in a free market -- is dismissed by many advocates of government incentives. According to one proponent of such programs, "[E]conomic development programs are helpful because they target aid. A business that receives a tax cut might just allow its managers to keep the profit, rather than investing it in research that could develop a lucrative new product."^[12] This sets up the question for state legislators: who best knows how to contribute to economic development -- entrepreneurs making decisions based on market forces, or officials in Topeka? Fortunately, there is a wide body of evidence available to help answer this question.

The Empirical Evidence on Government Economic Development Programs

There is little evidence that government economic development incentives do much good:

- Margery Marzahn Ambrosius of Kansas State University examined the impact of eight state economic development policies on total production and employment in state economies. She concluded: "None of these economic development policies can clearly demonstrate a positive effect on [any] measure of state economic health."^[13]

- In another study, Ambrosius concluded: "Does the state adoption of economic development policies, particularly upwardly redistributive ones, constitute a political mechanism by which occupational interests may, however inadvertently, act to slow economic growth? . . . This appears to be the case. Certainly business interests in states seek tax expenditures, training programs, industrial revenue bonds, and other types of programs which states adopt as economic development policies. . . . Most research raises doubt that these policies have beneficial effects on state economies."^[14]

- A review of the available research published by the Council of State Governments in 1989 concluded: "[A] comprehensive review of past studies reveals no statistical evidence that business incentives actually create jobs. . . . They are not the primary or sole influence on business location decision-making and . . . they do not have a primary effect on state employment growth."^[15]

- Andrew Cline of the John Locke Foundation concluded: "To date, not one incentives proponent has been able to demonstrate that government incentives create a net benefit for the general public. It's just robbing Peter to pay Paul."^[16]

While proponents of economic development programs can point to specific successes -- new jobs or business ventures resulting from government support, for example -- these measures of success often overlook the cost these government programs impose on the economy.

The Hidden Cost of State Economic Development Programs

Lawrence Reed sums up the hidden costs imposed by government economic development programs with the following analogy:

Imagine a thief who robs every house in a neighborhood and then heads for a nearby shopping mall to spend his loot. [Many development officials] would interview only the store clerks, note increased sales, and pronounce that a burst of economic development had taken place. The downside of state incentive packages -- from the anti-competitive effects on nonfavored firms to the opportunity cost of foregoing a more general tax reduction -- is rarely discussed.^[17]

One way to measure the opportunity cost of Kansas economic development programs is to look at potential reductions in state taxes that could be covered by the state development funds. The alternatives available include:

- Reducing corporate income taxes by 21 percent.
- Reducing inheritance taxes by 71 percent.
- Eliminating the corporate franchise tax and reducing financial institutions' income taxes by 90 percent.
- Reducing insurance premium taxes by 49 percent.

Any of these actions would bring improvement in areas where Kansas received a grade of "C" or "D" from the [1996 Development Report Card for the States](#). The potential for broad-based cuts in state taxes could be raised even higher by ending any loopholes, abatements, and other measures that shift tax liability from particular constituencies onto the remaining population.

Bidding for Business

In addition to state-level economic development programs, many cities in Kansas provide tax breaks for selected businesses in the name of economic development. These tax breaks impose several hidden costs on the economy:

- They raise the tax burden for the rest of the population. If a city grants tax relief to one business instead of providing a level playing field for all businesses, the remaining companies and individuals are left to pick up the tab.
- They reduce the level of economic activity in Kansas:

Tax breaks discourage firms from locating where they could be the most productive. For example, suppose Kansas decided to subsidize orange growers and Florida decided to subsidize wheat production. Resources would be diverted from more productive uses as Kansas farmers switched from growing wheat to oranges and their counterparts in Florida entered the wheat business.^[18]

The possibility of winning government support encourages firms to divert resources from hiring new workers and producing better products to lobbying for tax breaks and other subsidies.

- They represent a zero-sum game. As the President of the Association of Federal, State, County and Municipal Employees put it, "The jobs that incentives 'create' would have been created anyway. Jobs are simply being 'stolen' from other states. Governors have implicitly acknowledged this by saying

states should focus on [the] general economic climate rather than subsidies.”^[19]

- They tend to benefit large firms with the resources to lobby for special treatment. For example, suppose you went to any town in Kansas and offered to create five jobs in return for \$364,000 in financial bonuses and a ten-year exemption from property taxes. You’d probably have a difficult time getting anyone to deal with you. But when the city of Independence was competing with other Kansas cities to lure Cessna, this is essentially what it offered -- the key difference being that the Cessna deal was a hundred times bigger.^[20] Because small companies that don’t receive subsidies often must compete with subsidized firms for labor and customers, they’re left at a competitive disadvantage.

Since the U.S. Constitution gives the federal government the power to regulate interstate commerce -- and since these types of subsidies affect interstate commerce -- some experts have called on the federal government to restrict their use. One analyst suggested: “A literal reading of the Court’s opinions might well suggest that all state tax incentives are unconstitutional.”^[21] Others have called on Congress to pass legislation restricting such subsidies. Along the same lines, efforts to promote economic development in Kansas should include consideration of ways to limit incentives that make Swiss cheese of state and local tax roles.

Kansas Economists’ View of Business Incentive Programs

More than 130 Midwest economists, including 30 economists at colleges and universities throughout Kansas, have endorsed the following language on economic development:

[G]overnments should terminate targeted business assistance such as direct grants, selective tax incentives, and abatement programs and adopt a comprehensive economic development strategy based on statewide tax relief for all businesses and citizens, a “fair field with no favors” approach, budgetary restraint, high-quality physical infrastructure, access to transportation, a superior education system, and market-based competition and deregulation.

The full text of the economists’ resolution on development programs is attached to this testimony.

The Importance of the Overall Economic Climate

While there’s little evidence that targeted government financial incentives generate economic growth, research indicates that the overall fiscal climate in Kansas plays an important role in economic development.

For example, a recent Joint Economic Committee review of state tax trends from 1960 to 1993 concluded:

- The economic performance of states is negatively related to the overall amount of taxation; higher taxes mean lower growth, lower taxes mean higher growth. Relatively low-tax states grew nearly one-third faster than high-tax states.
- On average, an increase in state and local tax burdens equal to one percent of personal income lowered income growth by more than three and a half percent.
- High state taxes reduce population growth.
- Income taxes have a particularly adverse impact on income growth.^[22]

Another study found that from 1980-1993, job creation rates in states with no income tax were

more than twice as high as in states with income taxes.^[23] This finding was bolstered earlier this year when meat packer IBP announced that it was moving its headquarters from Nebraska to South Dakota, which has no income tax. According to IBP Chairman Robert Peterson, "It'll be like getting a 7 percent raise" for employees.^[24]

The available evidence suggests that to promote economic development in Kansas, it makes much more sense to look at the overall tax climate than to develop and maintain government-run incentive programs. Lowering the overall tax burden would have the added benefit of reducing the value of specific tax breaks. The Wichita Eagle editorialized in 1995 that "IRBs and tax abatements are especially important to communities such as Wichita because the Kansas tax structure is out of whack compared to competitors such as Oklahoma and Missouri."^[25] Lowering taxes would eliminate this justification for such breaks.

Improving Access to Financial Resources

The low grade received by Kansas for "development capacity," in particular the area of "financial resources," highlights the importance of adopting policies that maximize freedom and competition in the financial services industry.

Conclusion

Many businesses in Kansas are more concerned about what the government may do *to* them than what it does *for* them. Along these lines, instead of looking at subsidies as a key to development, the government should concentrate on removing barriers to economic growth. Provide a level playing field for Kansas businesses, expand the share of the economy that remains in the private sector, and work to remove unreasonable regulations, and Kansas will be on its way to creating an "A +" economy.

Resolution on Economic Development

Whereas, targeted business incentive programs such as direct grants, selective tax incentives, and abatement programs have proliferated into a counterproductive war between the states in our region, and now form the cornerstone of state-sponsored "economic development" policies in many states; and

Whereas, these programs fail to promote healthy and even-handed statewide economic growth because they:

1. Unfairly penalize existing businesses and labor through higher taxes to subsidize large, relocating firms;
2. Target relocating firms that, according to empirical academic research, add little if anything to net job creation;
3. Serve only a small proportion of the firms that need tax and regulatory relief;
4. Are minor factors in the plant location decisions of most firms;
5. Give unfair advantages to large firms with the administrative capability to negotiate the "best" deal with state government; and
6. Represent state-level industrial policies that attempt to pick winners and losers through the political rather than the economic process, with all the potential for political abuse that this implies; and

Whereas, spread of these policies to every state in our region effectively cancels the advantages their advocates initially promised;

Therefore, be it resolved, that state governments should terminate targeted business assistance such as direct grants, selective tax incentives, and abatement programs and adopt a comprehensive economic development strategy based on statewide tax relief for all businesses and citizens, a "fair field with no favors" approach, budgetary restraint, high-quality physical infrastructure, access to transportation, a superior education system, and market-based competition and deregulation. We also urge the Governors and Legislators in our states to call upon their counterparts in all the other states in the union to do the same.

[undersigned economists]

William L. Beedles
School of Business
University of Kansas

Melissa H. Birch
School of Business
University of Kansas

James E. Clark
Department of Economics
Wichita State University

Don Erickson
Department of Agricultural Economics
Kansas State University

R. C. Gamble
Department of Economics/Finance
Fort Hays State University

John S. Garland
School of Business
University of Kansas

Nancy Groneman
Division of Business Education and General Business
Emporia State University

Mark Hirschey
School of Business
University of Kansas

Vern Hoglund
Department of Economics
Hutchinson Community College

Doug Houston
School of Business
University of Kansas

James Hughes
Department of Business
Highland Community College

Rodney Jones
Department of Agricultural Economics
Kansas State University

Maurice Joy
School of Business
University of Kansas

Kathryn M. Kelm
Division of Management, Finance & Economics
Emporia State University

Mehrene Larudee
Department of Economics
University of Kansas

Jim Lee
Department of Economics/Finance
Fort Hays State University

Murray Levin
School of Business
University of Kansas

Kenneth D. Mackenzie
School of Business
University of Kansas

Larry Manes
Department of Economics
Allen County Community College

Jack McCullick
Department of Economics/Finance
Fort Hays State University

Roger A. McEowen
Department of Agricultural Economics
Kansas State University

Dale R. McKemey
School of Business
Fort Hays State University

Edwin G. Olson
Department of Economics
Kansas State University

Glenn N. Pettengill
Division of Management, Finance & Economics
Emporia State University

H. Joseph Reitz
School of Business
University of Kansas

Catherine Schwoerer
School of Business
University of Kansas

Prakash P. Shenoy
School of Business
University of Kansas

Roger Trenary
Department of Economics
Kansas State University

Samuel C. Webb
Department of Economics
Wichita State University

Gene C. Wunder
School of Business
Washburn University

^[1]The Kansas Republican Party 1996 Handbook, p. 61.

^[2]Robert B. Reich, U.S. Secretary of Labor, "Bidding Against the Future?" The Region, June 1996.

^[6]State of Kansas Comparison Report: The Governor's Budget Report with Legislative Authorization, Fiscal Years 1990 and 1997, and The Governor's Budget Report, Fiscal Year 1992.

^[7]Based on Comparison Report: The Governor's Budget Report with Legislative Authorizations, Fiscal Year 1997, p. 22, and Kansas Statistical Abstract 1993-94, p. 218.

^[8]Bob Cox, "Company Goes Under, With State Cash. Newton Business Files for Bankruptcy; It Can't Pay More Than \$800,000 it Owes in State Loans," The Wichita Eagle, June 17, 1996, p. 11A.

^[9]"Better Better: Pizza Hut's Decision Eases a Bitter Move," The Wichita Eagle, June 8, 1995, p. 8A.

^[10]James D. Gwartney and Richard L. Stroup, What Everyone Should Know About Economics and Prosperity, Kansas Public Policy Institute, 1996, pp. 98-100.

^[11]Friedrich Hayek, "The Use of Knowledge in Society," American Economic Review XXXV, No.4, September 1995, pp. 519-530.

^[12]"KTEC's Business is Nurturing Business," The Wichita Eagle, January 2, 1996, p. 6B.

^[13]Cited in John Hood, "Ante Freeze: Stop the State Bidding War for Big Business," Policy Review, Spring 1994, p. 65.

^[14]Margery Marzahn Ambrosius, "The Role of Occupational Interests in State Economic Development Policy-Making," Western Political Quarterly, Vol. 42 No. 1, 1989, p. 64.

^[15]Council of State Governments, State Business Incentives and Economic Growth: Are They Effective? A Review of the Literature, cited in Lawrence W. Reed, "End the War Between the States," Mackinac Center for Public Policy Viewpoint No. 96-16, June 3, 1996.

^[16]John A. Barnes, "The New 'War Between the States,'" Investor's Business Daily, December 22, 1995.

^[17]^[17]Lawrence W. Reed, "Time to End the Economic War between the States," Regulation, Number 2, 1996, p. 37.

^[18]See Melvin L. Burstein and Arthur J. Rolnick, "Congress Should End the Economic War Among the States," The Region, March 1995, and Thomas J. Holmes, "Analyzing a Proposal to Ban State Tax Breaks to Businesses," Federal Reserve Bank of Minneapolis Quarterly Review, Spring 1995, pp. 29-39..

^[19]Gerald W. McEntee, President, American Federation of State, County and Municipal Employees, "The Problem with State Bidding Wars and Some Possible Remedies," The Region, June 1996.

^[20]Molly McMillin, "Taxpayer Investment in Plant Adds up to \$36 Million; Residents Hope Their Investments in Cessna will be Paid Back with a Better Economy," The Wichita Eagle, June 30, 1996, p. 12A.

^[21]Walter Hellerstein, Professor of Law, University of Georgia, "Commerce clause restraints on state tax incentives," Federal Reserve Bank of Minneapolis, The Region, June 1996. Hellerstein concluded, however, that the Supreme Court is unlikely to strike down such subsidies.

^[22]Richard K. Vedder, Distinguished Professor of Economics, Ohio University, "State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform," Joint Economic Committee, December 1995. The study includes a review of other research reaching a similar conclusion.

^[23]Raymond J. Keating, "The State Tax-Cut Revolt," Investor's Business Daily, October 21, 1994.

^[24]"Tax-Free South Dakota Gets IBP Headquarters," The Wichita Eagle, June 13, 1996, p. 18A.

^[25]"Tax Break: Wichita City Council Right About Tank Wars," September 25, 1995, p. 10A.