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A BETTER TOMORROW: POLICY REFORM AND THE LIMITATIONS OF STATE-LED TARGETED ECONOMIC DEVELOPMENT

by Courtney Michaluk

MERCATUS CENTER
George Mason University

Abstract
This paper analyzes the economic literature on whether state-led targeted economic development creates jobs and boosts real economic growth within a region. Particular attention is paid to the political economy of state-led development and, because targeted development projects commonly offer tax incentives, the components of a good tax code. With this framework in mind, this paper then develops a qualitative case study on the economic development projects in Sevier County, Tennessee. This paper finds that the tools needed to accurately assess the value of state-led targeted economic development projects, which include transparency, retrospective analyses, and economic impact analyses, are lacking for Sevier County in particular and the state of Tennessee as a whole.

Author Bio
Courtney Michaluk is an alumna of the Mercatus Center MA Fellowship at George Mason University. She received a BS in accounting from the University of Tennessee, Knoxville where she conducted research on ethics education in undergraduate accounting programs while completing the Chancellor's Honors Program. She then spent a year in the Koch Associate Program before becoming an MA Fellow. Her research interests include tax policy, development economics, and public perception of economic ideas.

Committee Members
Jason Fichtner, senior research fellow, Mercatus Center at George Mason University
Paul Dragos Aligica, senior research fellow, Mercatus Center at George Mason University
Stefanie Haeffele-Balch, research fellow and deputy director, Academic and Student Programs, Mercatus Center at George Mason University

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Introduction

State and local governments form economic development boards with the goal of boosting local economies. These economic development boards use targeted economic development incentives like property tax breaks, public subsidization of private infrastructure costs, and special enterprise zones to attract businesses to a certain geographical area. These projects are often sold with the promise of bringing new jobs and economic activity to the area, which in turn will boost long-term tax revenue and thus provide a return on the government's investment in the various projects. But as the economic literature on targeted tax incentive programs develops, so does the evidence for whether such programs are effective in achieving their goals. The literature suggests that targeted economic development projects fall short of the promised economic gains for a community; they end up costing taxpayers, wasting economic resources, and distorting the economic incentives for long-term business development.

The goal of this paper is to apply an economic lens to the targeted economic development initiatives within a concentrated region. To do this, it will survey the current landscape of Tennessee's economic development incentive policies and analyze the targeted incentive programs ongoing in Sevier County, Tennessee, where the Sevier County Economic Development Board and the Sevier County Industrial Development Board have recently expanded operations. These operations provide a natural case study for the impact of targeted economic development incentives on a county's economic growth.

First, this paper will review current literature on targeted economic development incentives, including the political economy of targeted incentives and regional specialization. Second, since targeted incentives often come in the form of tax breaks, this paper will examine what makes for good state and local tax policy. Third, it will explore several pertinent state-based case studies on targeted economic development programs in Michigan and Tennessee. And finally, it will apply the insights from this literature to the initiatives taken on by the state of Tennessee and the Sevier County Economic Development Council and provide policy recommendations. The conclusion reached in this paper is that Tennessee and Sevier County fall short in providing transparent, high-quality analysis of economic development efforts. An examination of how economic development councils evaluate their initiatives is helpful in that, for future projects, economic development councils are better equipped to understand the benefits, costs, and dangers associated with targeted economic development incentives. Overall, this paper argues that targeted economic development incentives have no real, lasting effect on the prosperity of an area; create less economic diversity among firms; and drain more resources than they create.

A Review: The Political Economy of Targeted Incentives and Regional Specialization

Economic development boards promise that incentive programs bring prosperity, but the economic literature is less certain of the benefits.[1] Even if a targeted incentive's benefits appear to outweigh the conspicuous cost, there are other economic costs that are not as visible. A forthcoming paper in *Research in Applied Economics* by Christopher Coyne and Lotta Moberg finds that there are two major hidden costs associated with targeted economic development projects that may outweigh their benefits.[i] The first is that the implementation of targeted incentives distorts the allocation of resources, and the second is that they promote rent-seeking

[1] For example, the Sevier County Economic Development Council says that its mission "is to create, retain, and invest wealth for the creation of quality job opportunities for the residents." And the state of Tennessee's Department of Economic and Community Development's mission "is to develop strategies which help make Tennessee the No. 1 location in the Southeast for high quality jobs." For more, see http://www.scedc.com/mission-statement.php or http://www.tn.gov/ECD/

among firms looking to gain a state-provided reduction in the cost of doing business in a given geographical location.

The market process allows entrepreneurs and other private actors to interact and direct economic resources to their most highly valued uses. Because prices hold information about goods and services, prices facilitate efficient allocation of resources among market actors. The profit-and-loss mechanism in a market process then provides feedback on whether an actor's endeavors in the market are successful or not. As Coyne and Moberg point out, for targeted economic development incentives to work, policymakers would need to have better information on the allocation of resources than those interacting in a market.[ii] This, as Friedrich A. Hayek writes in "The Use of Knowledge in Society," is precisely what does not happen. Intelligent economic action depends on a highly particular knowledge of time and place. This knowledge does not exist in a concentrated form with any one person or institution, and so all of the relevant information to direct resources in an economy is never known to one mind.[iii]

However, the entrepreneurial discovery process systematically reduces the ignorance of relevant information. This discovery process allows actors with partial knowledge to interact and prices to coordinate their actions. It is through this process that actors are able to make decisions with as little information as possible. In Hayek's example, an increase in the price of tin concerns the manufacturer using it as an input only insofar as it affects his costs. He does not need to know precisely why the price of tin has increased, but only that it has. This is enough for him to make decisions going forward about how to use the metal.[iv]

The hidden costs and considerations for targeted economic development initiatives are vast. For public policy, this means that policymakers are already at a disadvantage in trying to determine where scarce resources should be allocated. But offering targeted incentives means that they must do so anyway. By holding out the offer of state-provided benefits, policymakers also promote rent-seeking by private actors. If the state can provide benefits to a business, it becomes in that business's best interest to devote resources to political strategies with the goal of obtaining those benefits. The presence of opportunities for rent-seeking also means that a business has the incentive to spend its resources in order to signal to policymakers that it will indeed respond to political incentives. This inefficient signaling is itself a hidden cost of rent-seeking. For example, in 2014, Tesla Motors announced it would consider five different states for its new battery plant. Tesla broke ground in more than one state to signal to policymakers that it was indifferent between each locality, and was primarily interested in securing the lowest-cost deal offered. In response, several of these states offered massive tax breaks to Tesla if it would locate the factory in their area.[v] Nevada eventually won the Tesla contract, and Nevada's Governor Brian Sandoval promised that for every dollar spent in "tax incentives and subsidies," Nevada would see $80 in economic activity.[2, vi]

While the benefits and costs of targeted development projects are often cited by policymakers in the news, it is difficult for taxpayers to keep track of the scale and scope of state-led economic activity for two reasons. The first is that often states do not keep track of each targeted economic development incentive and its progress, which leads the public to be ignorant by design. The second is that, even if states did keep better track, individuals would most likely not find it in their best interest to stay informed on economic development activity. Taxpayers thus have very little knowledge of where their tax dollars go, and because of this, it is more difficult to hold governments accountable.[vii]

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[2] The $1.3B incentive package ended up subsidizing Tesla Gigafactory jobs at $190,000 per job. http://www.washingtonpost.com/business/capitalbusiness/the-gamble-on-teslas-gigafactory-is-a-big-one--in-many-fashions/2015/04/10/50e9de40-d4c8-11e4-a62f-ee745911a4ff_story.html

This is another example of the role of individual actors' benefits and costs in relation to targeted incentives. Individuals are not likely to hold policymakers accountable because the costs of keeping abreast of the relevant information (let alone making their views known to policymakers) generally exceed the individual's actual benefits of doing so. The size of an individual's tax bill is small compared to the cost of staying informed on the programs they are funding. Additionally, the amount an individual pays in taxes is not tied directly to a specific program, so the taxpayer cannot see what their own taxes are being directly spent on.

Moreover, holding policymakers accountable for targeted incentive programs is difficult for an entirely different reason. There are political benefits to offering attractive economic development incentives, both to potential businesses looking to locate and to constituents who want economic growth and job security in their district. But once economic development incentives are taken, there is little incentive to measure the full impact that business initiative has had on a community. In fact, states often do not measure the effectiveness of the targeted incentives they have offered.[viii] A 2012 study by the Pew Center on the States notes that every state now has at least one incentive program in place, and that spending by policymakers on incentive programs is now in the billions, but "no state regularly and rigorously tests whether those investments are working."[ix]

The promised gains from economic development incentive programs are often overestimated due to the hidden costs pointed out above, but there are several other reasons why the net economic effect on an area may be unknowingly overestimated by economic development councils. William Fox and Matthew Murray point out that tax incentive programs mean a loss of tax revenue, and public expenditures on business development by a state or local government mean that a balanced budget can only be obtained through raising taxes elsewhere or providing fewer public goods.[x] Fox and Murray also note that economic development can have unintended consequences on existing industry through a crowding-out effect. A new establishment can shift sales away from existing businesses, especially if it is in the same industry. Fox and Murray find an “absence of significant growth” in regions with targeted incentives, suggesting that large companies who are offered incentive programs only “displace other sources of job and income growth in the regional economy.”[xi]

If the goal is to create economic prosperity with targeted incentives, then a state or local government must also consider what types of industries it wants to attract. A common strategy is “regional specialization,” meaning that a local government focuses on a certain industry when planning for targeted incentives. The goal of such a strategy is for a city or county to become a hub for a certain industry, which might in turn attract more firms in that line of business. Proponents of regional specialization note that there are increasing returns to similar firms being geographically near each other. For instance, with a centralized location, firms can reduce the cost of related activities and increase their knowledge base through spillover within the industry. However, creating an economically homogeneous region has its downsides; a 2005 study by Keith Chapman explains that specialized regions are less stable during economic downturns, because they depend so heavily on one type of good or service.[xii] A phenomenon that Chapman calls “territorial lock-in” occurs when, over time, the advantages of developing a specific industry in one area become liabilities. Industries that decline and are geographically concentrated will feel a greater impact. More economically diverse areas, over time, are more resilient.[xiii]

The evidence also suggests that planned regional specialization may hinder entrepreneurial progress. In the Kirznerian sense, entrepreneurs must be alert to opportunities, and specialization may be a contributing factor in limiting the scope of opportunity for entrepreneurs within a region.[xiv] A diversity of economic activities allows entrepreneurs to identify more highly valued and innovative uses of capital, whereas in a specialized region, the targeted industry may experience a type of "stagnation" when the winds of innovation eventually blow a different way. Specialized regions are not inherently bad, but they do not need to be created through the use of public policy. As Frederic Sautet and Pierre Desrochers (2008) point out, regional specialization is capable of spontaneously emerging. In fact, if entrepreneurs recognize this as a profitable opportunity, then they will take actions that lead to that specialization without the involvement of government. As Hayek pointed out, policymakers are incapable of predicting the future or knowing which industry to choose, so incentivizing a specific type of industry to relocate with the goal of creating long-term economic prosperity for a region is unsound policymaking.

What Makes for Good State and Local Tax Policy?

There are certain principles that a good tax code must embody. Following the structure of Justin Ross's argument in "A Primer on State and Local Tax Policy: Trade-Offs among Tax Instruments," there are five evaluation categories for tax policy: economic efficiency, equity, transparency, collectability, and revenue production.[xv]

The first criterion, economic efficiency, is crucial to tax policy. It is important to define here what is meant by "efficiency." In this case, efficiency means creating a tax code that causes the least amount of distortions in an individual's preferences and choices. One way to analyze the efficiency of a tax is by examining the tax base. The broader the tax base, the less distortive the tax is. Ross gives the example of charging sales tax on Pepsi but not Coca-Cola. This could persuade consumers to switch to Coca-Cola, which is a distortion of the consumer's final decision. In this particular case, extending the tax to Coca-Cola would improve efficiency because consumers are no longer as inclined to make their decision based on tax differences.

Tax equity is the second criterion, and it is defined by both horizontal and vertical equity. Horizontal equity refers to the difference in tax burdens of taxpayers who are seemingly similar, and vertical equity refers to the progressivity (or regressivity) of a tax structure. To use the example of soda again, a tax on Pepsi and Coca-Cola is regressive since the relative cost of buying soda is higher for low-income individuals than it is for high-income individuals. The primary concern in terms of equity lies with who is faced with the tax burden.[xvi]

The third criterion is transparency. A tax code must be observable to outsiders, and taxpayers should be able to determine what their tax burden will be in a fairly consistent manner. Transparency usually decreases as a tax code grows in complexity, which results in less taxpayer compliance because the tax burden is less apparent. For example, a 2015 report by the Joint Committee on Taxation shows that individual income tax noncompliance for 2006 is estimated to be nearly $300 billion, and the Government Accountability Office attributes noncompliance in part to tax-code complexity.[xvii] For public policy, transparency is crucial, especially when discussing the creation of targeted tax incentives for businesses.

The fourth criterion, collectability, deals with the ability of a tax administration to enforce and collect a tax. Tax collection can be either taxpayer active or taxpayer passive, depending on whether compliance and collection lies more with the taxpayer or a tax agency. For example, income tax that is taken out of an employee's paycheck is largely taxpayer passive, because the collection does not rest with the taxpayer.[3] Property taxes are also a good example of

[3] It is important to stress that this only concerns the collection of taxes, not the incidence of taxes.

a tax that is taxpayer passive, because governments assess tax on property and send their assessments to property owners. The use tax is taxpayer active; some states impose a tax on purchases made out of state, but this relies on the taxpayer's reporting. Collectability and enforcement are fundamental and extremely important when creating tax policy; a tax agency will exhaust more resources on enforcing and collecting tax the more arbitrary the tax code becomes, and will thus erode its own intended revenue.

The final criterion, which relates well to collectability, is revenue production. Ross says that "it is worth considering whether the revenue potential offered by a tax justifies its undertaking." This final criterion, while distinct, does interact with the other four; when considering a tax's revenue potential, policymakers must examine its collectability as well as its efficiency. This matters for state and local budgets too. When considering long-term fiscal balance, a proposed tax must be capable of achieving the revenue it sets out to collect. With these criteria, policymakers are able to assess the quality of a tax code. Of course, implementing a tax involves tradeoffs between these five broad criteria. But for the purposes of this paper, Ross's primer allows a solid starting point for assessing how state and local governments should develop their tax codes. These criteria will be used later in the paper to assess how targeted tax incentives fit within state and local tax codes. There are a variety of tax incentives a local government can use to attract businesses, and it is important to extend the principles of a good tax code to evaluate the use of these incentives.

Retrospective Impact Analysis of Targeted Economic Development Projects

State and local governments use a variety of targeted economic development strategies to attract businesses and boost economic growth in a community. These can include Payment in Lieu of

Tax (PILOT) programs, property tax breaks, and public subsidization of private infrastructure. The use of targeted economic development incentives has been on the rise since the 1980s.[4] As the strategy grew in popularity, so did competition between states in trying to attract businesses.[xviii] Keon Chi and Daniel Hoffman (2000) report that over 40 states offered low-interest loans for business infrastructure by 1998 and that from 1995 to 2000, 32 states increased the use of targeted incentive programs. In their study, the authors report that many states do not have written guidelines that determine the specific types of business incentives that will be offered and that 13 states reported they would likely increase the use of targeted incentives in the future.[xix] Moreover, the Pew Center on the States found in 2012 that many states do not enforce strict retrospective evaluation of targeted incentive strategies.[xx]

The PILOT Program in Memphis, Tennessee

PILOT programs are a type of property tax break that state and local governments use with the goal of creating new jobs. PILOT programs typically offer property tax abatements for select businesses that meet criteria set forth by the county or city government.[5] In a case study on the PILOT program in Memphis, Tennessee, Frederic Sautet and John Shoaf explain that the program offered property tax breaks for 3 to 15 years for select businesses. Businesses that met the criteria set forth by the PILOT program would pay only $100 in city personal property taxes per year.[6] Additionally, PILOT companies annually paid city property tax only on the

[4] The competition initiated between states also presents the opportunity for firms to request bids from state or local governments, and this aspect of cronyism is developed later in the paper.
[5] The term "PILOT" can also be associated with the taxation of nonprofits to collect some revenue to offset the cost of community-provided services.
[6] For comparison, Sautet and Shoaf note that Memphis and Shelby County have the highest combined property tax in the state of Tennessee.

unimproved value of the property. Any real improvements made to the property would not increase the businesses' property tax bill during the PILOT incentive time period.[xxi]

The Industrial Development Board (IDB) in Memphis uses a matrix for determining the eligibility of a firm for PILOT benefits. The Memphis IDB uses four criteria: projected number of net new jobs created, median wage of new jobs, capital investment, and location of new business. Sautet and Shoaf explain that the matrix awards points for each category, but that the value of each point diminishes once they reach certain thresholds. The resulting score is then translated into years of PILOT incentives the business will be allowed; in 2003, the authors report, the average PILOT contract was seven years. The minimum threshold for obtaining a three-year contract is quite minimal indeed: a business need only hire 15 workers not previously employed by that business in Shelby County and pay them the average median wage for that county. Importantly, the IDB is allowed to use discretion in assigning special bonus points for other considerations.

The incentive for lowering property tax burdens becomes stronger as the level of government becomes more local. Variations in tax levels between local communities can affect both where businesses decide to locate and where individuals find employment. For example, individuals can more easily cross county lines than state lines for employment.[xxii] Sautet and Shoaf call this intraregional competition. With this in mind, it becomes clear why Memphis might implement a property tax reduction program in order to become more competitive with surrounding counties. The success of the PILOT program can be analyzed in two ways: by extending the principles of good state and local tax policy to targeted property tax breaks, and by retrospectively examining the PILOT program's success in increasing employment and boosting real economic growth since its implementation.

PILOT programs such as the one in Memphis violate several of the five principles of good state and local tax policy. First, PILOT programs fundamentally violate tax equity and efficiency. Notably, tax codes have been used to distort behaviors on purpose; high taxes on cigarettes and other “sin taxes” are based on the idea that an increase in price will deter certain behaviors. When a business decides to locate somewhere based on a temporary tax incentive, it then could have the incentive to relocate once the PILOT benefits expire. PILOT programs also violate the tax equity principle, since businesses with similar operations can be treated differently if one applies for PILOT benefits and one does not. Instead of offering temporary property tax breaks, Shelby County and Memphis could have permanently reduced property tax rates to resemble those of their neighbors. This would create an indiscriminate and thus more equitable way of attracting businesses. Also, the IDB’s ability to award points based on special considerations could cause inequity; without having a defined set of criteria, the IDB is not required to treat firms equally.

The Memphis PILOT program is certainly popular among businesses; in 2003 alone, there were “557 active PILOT parcels” in Shelby County.[xxiii] For 2002, a report from the Tennessee Advisory Commission on Intergovernmental Relations found that PILOT programs in Shelby County amounted to a $57.5 million tax revenue loss.[xxiv] This represents over half of the tax revenue loss from targeted tax incentives across the entire state of Tennessee for that year.[xxv] In annual reports from 1996 to 2003, the IDB reported that PILOT businesses projected a total of 38,764 jobs and $5.42 billion in investment in Shelby County.[xxvi] In 1998, the unemployment rate for Memphis was 4.9 percent, and it increased to 7.1 percent by 2005. This was in part due to a 3.9 percent decrease in the size of the labor force during that time. While the increase in PILOT programs coincides with the decline of employment in Memphis, it is important to note that these are aggregate statistics and reflect more than simply the PILOT programs.[7] Measuring PILOT programs' impact on a community is difficult. Indeed, as Sautet and Shoaf note, measuring the number of jobs created by PILOT programs is problematic, because it is impossible to tell whether these jobs were filled by employees who would have sought employment elsewhere in that city. If this were the case, then there would be no actual increase in employment. The main difference is that tax revenue is forgone under the PILOT program, so an employee who chooses to work for a PILOT business costs more economic resources than if they had chosen a non-PILOT business employment opportunity. It is even more difficult to directly measure PILOT programs' effect on economic growth, since job creation is only one aspect of growth in a community.[8]

MEGA Michigan Tax Credits: Did They Work?

In 1995, then governor of Michigan John Engler announced the Michigan Economic Growth Authority (MEGA), which was to be a new government agency in charge of providing tax credits to select firms. MEGA was proposed with the goal of diversifying the economy of Michigan, because the state relied so heavily on the automobile industry.[xxvii] MEGA set forth a list of requirements for businesses to gain tax credits, including the creation of a minimum of 75 "qualified" new jobs, an increase in or maintenance of the number of new jobs after the first year in business, a greater average wage than that of private sector firms in the same county, and evidence that the firm would have located elsewhere if the tax credit had not been offered.[xxviii]

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[7] Other factors, like macroeconomic conditions and fiscal, monetary, and regulatory policy, also help to determine unemployment rates.

[8] It is also important to point out that net jobs can be created and still be considered economically inefficient. If taxpayers end up losing more economic surplus than they gained with the new jobs created, the program is still economically inefficient.

MEGA then added several provisions, including that the applying firm must have a solid financial record and provide proof that the tax incentive is needed in order to keep the firm from locating in a different state. Relative to those of other state economic development committees, MEGA's requirements were originally stringent. However, as Michael Hicks and Michael LaFaive point out, since 1995, MEGA laws have been amended five times, and they are now much more flexible with the size and scope of tax incentive offerings. In analyzing the aggregate effect of MEGA tax credits up to 2002, Hicks and LaFaive found that the MEGA credit program had no detectable impact on county-level employment, wages, unemployment rates, or income. They did find that construction employment increased, but at the cost of $123,000 per job.[9] Only 25 percent of new construction jobs lasted into the second year.

Again, the MEGA tax credits violate the equity principle of good tax policy. Similar firms in an industry are treated differently by the tax code; once a firm in Michigan became an "authorized business," it was then allowed access to the tax credits. Firms outside of this category would receive no such treatment. It could even be argued that providing tax credits for an authorized business, as well as requiring that business to pay an above-average wage, would hurt other firms in that area. Not only does an "unauthorized" business have a higher cost of doing business because of a larger tax burden, an individual seeking a job would, on the margin, go with the firm that offered a higher wage. Michigan is unsustainably distorting market signals.

[9] There is a growing literature pointing out that studies on targeted economic development often conclude that firms taking advantage of state-offered incentives usually do fare better than firms that are not offered incentives. This is a relevant point because firms with lower costs are naturally going to fare better; so this is not an appropriate measure of targeted growth strategies. Instead, the crucial variable is whether the area itself experiences economic growth.

Additional Analysis of Michigan's Tax Incentives

The Anderson Economic Group also evaluated Michigan's use of business tax incentives.[xxix] The authors are optimistic that business tax incentive programs can be useful when a tax climate is considered uncompetitive for businesses, when state budgets are "strained," or when a state is experiencing economic decline. However, there was no in-depth assessment of the at least 36 different business tax incentives that Michigan offers. Because of the lack of comprehensive analysis, the Anderson Economic Group conducted its own analysis on the effectiveness of Michigan's business tax incentive initiatives. Additionally, the authors point out that tax incentives could be more efficient and more equitable if they were used in a broader manner:[xxx]

> Thus, both the recipient company and the state government often have an incentive to allow inflated reports of job creation to stand unchallenged. . . . [S]ome incentives are so widely used that their "success" reveals a systematic weakness in Michigan's business tax system, rather than specific opportunities to attract jobs with the judicious use of an incentive.

This has implications for what successful tax policy should look like. If tax incentives are needed in a given place to attract business, local officials should consider lowering the tax burden on all businesses by systematically reducing tax rates rather than using special programs that try to target specific industries. The success attributed to some economic development incentives may not be a sign that targeting specific companies is a sustainable strategy; rather, it may be a symptom of an otherwise-burdensome tax code that stifles innovation and entrepreneurial activity.

Economic Development in Tennessee

The state of Tennessee does not tax most forms of income, but it does have the highest combined state and local average sales tax rate in the country.[xxxi] In "Evidence Counts: Evaluating State

Tax Incentives for Jobs and Growth," the Pew Center on the States examined how well states keep track of and are held accountable for the use of tax incentives. The effectiveness of each state's evaluation was based on four criteria. State evaluations must

1. Inform policy choices
2. Include all major tax incentives
3. Measure economic impact
4. Draw clear conclusions

Tennessee is one of the 26 states found to be "trailing behind" in meeting "any of the criteria for scope or quality of evaluation" and one of 35 states either not reviewing all tax incentives or not using the resulting data for policy decisions.[xxxii] Out of 293 tax incentive documents collected for all 50 states, Tennessee had 1. Out of the 82 evaluation documents collected, Tennessee had 0. The Pew Center named Tennessee as one of 16 states that have "not evaluated the effectiveness of any incentive in recent years."[xxxiii]

The Tennessee Department of Economic and Community Development (TNECD) offers several business grants, tax credits, and exemptions. There are three major development programs.[xxxiv] The first is the FastTrack Economic Development Fund, which is a grant to subsidize infrastructure, job training, relocation, capital improvements, or temporary office space. Eligibility is restricted for "exceptional cases" in which a company provides "significant" net full-time jobs or capital investment. Second, the TNECD offers a grant to new or expanding businesses for training "net new full-time employees." Capital investment, net full-time jobs, wages, and skill level of employees are taken into consideration for eligibility. The final fund is the FastTrack Infrastructure Development Program, which provides grants to local governments for "public infrastructure needs for new and expanding companies." Projects can include water, rail, sewer, and other utilities and improvements. The local government is required to match the funds, and improvements require a PILOT program for five years or more.

The TNECD offers several other tax credits and exemptions. The Job Tax Credit is available for companies creating 25 net new full-time positions within 36 months (as well as at least $500,000 in a "qualified business enterprise") and offers up to $4,500 per new job to offset franchise and excise taxes up to 50 percent. The Enhanced Job Tax Credit is similar, but offers additional credits and "can offset up to 100 percent of the franchise and excise tax liability" for a company. The eligibility requirements are the same. The TNECD also provides an Industrial Machinery Tax Credit, which is a credit for 1–10 percent of a purchase, installation, and repair of industrial equipment. The eligibility requirements vary based on the type of machinery being purchased. Industrial machinery, repair parts, and supplies for manufacturing are also potentially eligible for sales and use tax exemptions up to 1.5 percent of tax on water, electricity, gas, and other energy sources. The benefit is offered to "qualified manufacturing facilities." Certain headquarter facilities, warehouses, and call or data centers can also be offered sales and use tax exemptions. The eligibility requirements vary, with warehouses having to invest $10 million or more during three years and call centers having to provide at least 250 jobs. Full-time jobs must be at least 37.5 hours per week, and 12 months of health coverage must be offered.

I found no comprehensive assessment of Tennessee's use of tax incentive programs. The TNECD offers OpenECD.TN.gov with the goal of offering "public information and documents pertaining to TNECD grants and incentives," but the documents available pertain solely to the amount and numerical value of grants and incentives given by the state per year. Retrospective analyses, as well as initial economic impact analyses, are not available. But the state has been informed of both the need for retrospective impact analyses and the potential dangers from a lack of quality analysis. In 2009, Stan Chervin and Reuben Kyle issued a primer on economic and fiscal impact analyses to the Tennessee Advisory Commission on Intergovernmental Relations.[xxxv] The report notes that two types of economic impact analyses are conducted by those states that do evaluate targeted economic development projects. The first type measures the economic impact of an existing business on the local economy. The second measures the potential impact of a proposed policy reform or new business in a given area. The authors warn that elected officials and the public at large must be "more educated, alert, and skeptical of the second type of impact study than the first." This stems from the potential "danger" that manifests itself when public investments are made in projects that should not have been taken on—bad public investments are not difficult to come by. Importantly, every model used for economic impact analyses is based on assumptions, and the results are largely a function of what these assumptions are.

The report highlights several dangers when a government is dealing with an impact analysis, and many of them fit into the economic literature discussed in previous sections. For example, Chervin and Kyle warn against assuming that economic development will not occur "in the absence of the new investment or project." There are alternative uses for both public funding and potential business sites. As I discussed in the first section of this paper, policymakers must have better knowledge than entrepreneurs of the alternative uses for a resource in order to justify the use of targeted economic development incentives. However, this is not the case. Chervin and Kyle also note the potential for "unsubstantiated" or "exaggerated" estimates, especially those like estimated expenditures per visitor per day. Additionally, the authors advise caution when dealing with the assumption inherent in large projects like stadiums that most visitors and dollars spent come from outside the local region.

The dangers laid out in Chervin and Kyle's report are especially important once the incentives in economic development councils are taken into consideration. For example, many impact analyses are done by for-profit firms; and, as the authors note, it is difficult to stay in business if most analyses show a negative impact. As a solution, many states offer their own locality-specific analysis model for local governments. The authors find that "neither the State of Tennessee nor any Tennessee state-wide local government organization currently offers such a service to local governments." Impact analyses in Tennessee are done by for-profit firms or university research centers. Tennessee has millions in state and local tax incentives, and "a small budget devoted to an impartial and alternative economic and fiscal impact analysis service would be well spent."

Economic Development in Sevier County

Sevier County, located in East Tennessee, houses four cities: Sevierville, Pigeon Forge, Gatlinburg, and Seymour. Located at the foothills of the Smoky Mountains, Sevier County is a tourist-heavy area, and the tax code reflects this. Under the Open Records Act, Tennessee is required to provide quarterly statements on FastTrack Economic Development and Job Training Assistance funding. TNECD offers statements from 2012 to 2014, and Sevier County received funding for several projects within that period.[xxxvi]

From the recession in 2007 to fiscal year 2010, state and local sales tax collections for Sevier County fell from $250.5 million to $233 million.[xxxvii] In Gatlinburg, gross receipts of retail establishments fell by nearly 11 percent between 2008 and 2010.[xxxviii] As a means to attract businesses and revive a slumping tourism economy, Sevier County began a whirlwind of economic development projects. As noted previously, a slumping economy can be a valid reason for economic development efforts, depending on the type of efforts undertaken. Some of the major ongoing projects are the around $300 million Bridgemont Events and Entertainment Destination; a five-year PILOT contract with KaTom, a restaurant-supply service, that reduces the company's property tax burden; and the $22.5 million Cal Ripken Experience, a baseball complex, in Pigeon Forge.

According to Sevier County's 2013 financial report, the purpose of the Sevier County Economic Development Council is "to coordinate the governmental and private sector activities in attracting businesses and industries to the Sevier County area."[xxxix] For the 2012–2013 year, Sevier County gave the Sevier County Economic Development Council $158,500 for operations.

Bridgemont Events and Entertainment Destination

Bridgemont Events and Entertainment Destination was designed to become a large entertainment complex on the highway leading into Sevier County. Highway 66 is the primary route for tourists arriving in Sevier County, and therefore the complex would be highly visible. The project failed after banks foreclosed on the property, and Sevier County lost at least $9 million after the private developer failed to pay infrastructure costs, even after it had partnered with the county. Currently, the Bridgemont Complex sits on 545 acres and has been bank owned since 2011.[xl]

KaTom Restaurant Supply, Inc.

Tennessee has a relatively competitive tax climate for businesses seeking locations. The state itself does not impose a property tax, but localities do. In trying to attract KaTom, a restaurant-supply company seeking a new headquarters and distribution center, both Sevier County and the neighboring Knox County offered PILOT programs that would eliminate property tax temporarily. Knox County offered a four-year PILOT program worth $198,000 in lost tax revenue.[xli] However, KaTom eventually decided to go with Sevier County, which, according to an attorney for the Sevier County Industrial Development Board, offered a five-year PILOT property tax incentive. The value of the property tax incentive was not quantified, and depends on "certain performance factors."[xlii] As the table below shows, KaTom also received funding through the state. The executive director of the Sevier County Economic Development Council, Allen Newton, said the following on the use of incentives for manufacturing businesses like KaTom in Sevier County:[xliii]

Normally, the majority of the incentives are provided from a state perspective. However, these incentives are normally only for manufacturing type projects. . . . [W]e normally, as it relates to manufacturing, just use the PILOT program, assist with infrastructure and if we own the property, provide low cost property for qualified projects. We are currently working 3 major manufacturing projects.

State-Granted Funding for Sevier County[xliv]

Grantee/ Location	County/ Location	Scope	Industry	Award Amount	Jobs	Date Contract Approved	Program Funding
Sevier County	Sevier	Infrastructure	KaTom Restaurant Supply, Inc. and B & B Equipment	$146,059	75	3/7/2013	FIDP
Kodak	Sevier	Training	B & B Equipment & Supply, Inc.	$67,500	25	3/4/2013	FJTAP
Kodak	Sevier	Training	KaTom Restaurant Supply, Inc.	$67,500	25	3/4/2013	FJTAP
Sevierville	Sevier	Training	Quality Solutions Group, LLC	$11,500	23	3/4/2013	FJTAP

The table above shows the grants received in Sevier County from the state of Tennessee through its various incentive programs. B & B Equipment & Supply is a partner of KaTom and the two businesses are in the same physical location. In 2013, KaTom and B & B received a combined $281,059 from the state of Tennessee.

The Cal Ripken Experience Sports Complex

The Cal Ripken Experience is a six-field facility designed to host youth sports events in Pigeon Forge. The complex is estimated to cost $22.5 million, and it is funded through city-issued bonds.[xlv] Pigeon Forge requested additional funding from the county itself, but as of this time, the county has not responded to the request. According to a report by CDM Smith Engineers, the Ripken Experience will have an economic impact of $46.7 million in the first year of operations, and will reach as high as $65.5 million annually in its tenth year.[xlvi] The impact analysis was based on several factors: total number of baseball fields available, total number of teams attracted to the complex, associated spectators traveling to the complex to watch tournaments and teams play, and visitor spending and length of stay for visitors. The partnership with the city of Pigeon Forge will also include a 10-year management agreement with Ripken Baseball, and Ripken is also required to make appearances in the city. Proponents of the project have suggested that it will bring millions of new visitors to the area.[xlvii]

Sevier County Summary

It is clear why local governments often want to take action after an economic slump, but the risks and costs associated with state-led targeted economic development are increasingly apparent to those familiar with the economic literature. The ongoing projects in Sevier County lack the economic impact analyses suggested by Chervin and Kyle. Also following the result of the Pew Center on the States study, transparency in development projects in both Sevier County and the state of Tennessee itself is lacking.

Policy Takeaways and Guidance

The literature suggests that both Sevier County and the state of Tennessee should proceed cautiously when developing their incentive programs. Most notably, both the county and the state should adopt more stringent measures to evaluate economic development projects. As the Pew Center on the States study suggests, Tennessee has a long way to go in developing and maintaining effective and transparent measurement of the economic development incentives offered. To change this, the state should offer a neutral impact analysis model for local governments to use in evaluating potential economic development packages. The county and state should be aware of the issues with measuring economic growth: jobs created by firms do not accurately represent net aggregate job growth. Models are based on assumptions, and those assumptions determine the outcome of an analysis. The broader economic literature suggests that, in retrospect, economic development incentives have a negligible impact on economic growth and sustainable job creation.

The county should also be cautious in developing more tourism-based businesses. During the recession, the tourist industry took a big hit, and this negatively impacted Sevier County due to its lack of diversity. If Sevier County wants to attract business by lowering property tax burdens, such as with KaTom, it should lower its property tax rates in a nondiscriminatory way. Broad tax bases and low tax rates let businesses decide where to locate without state and local governments distorting economic incentives. KaTom is not a tourism-based company, so the diversity in industry may be a good step for the county, but it is impossible to say whether another business would have used the same location without development incentives.

In general, targeted economic development incentives are beneficial to short-term political strategies, but the literature suggests they do not have a detectable positive impact on the economic growth of a region. Perhaps even more concerning are the large hidden economic costs associated with targeted incentives. Regions taking on multiple development projects at a time must be more aware of the limitations of targeted incentives for growth and more open to the idea of creating tax policy that fosters economic prosperity and innovation.

Notes

[i] Christopher Coyne and Lotta Moberg, “The Political Economy of State-Provided Targeted Benefits,” Mercatus Center at George Mason University, 2014.
[ii] Ibid., p. 6.
[iii] F. A. Hayek, “The Use of Knowledge in Society.” *American Economic Review*, 35(4). 1945. http://www.econlib.org/library/Essays/hykKnw1.html
[iv] Israel Kirzner, “Entrepreneurial Discovery and the Competitive Market Process.” *Journal of Economic Literature*, 35(1). March 1997.
[v] David Brunori, “Tesla, Taxes, and Free-Market Hypocrisy.” *Forbes*, April 7, 2014. http://www.forbes.com/sites/taxanalysts/2014/04/07/tesla-taxes-and-free-market-hypocrisy/
[vi] http://www.nytimes.com/2014/09/13/business/nevada-woos-tesla-plant-in-tax-deal-but-economic-benefits-prompt-debate.html
[vii] For more on the economic illiteracy of individuals, see Bryan Caplan’s “Straight Talk about Economic Literacy.” Mercatus Center at George Mason University, 2004.
[viii] Pew Center on the States. “Evidence Counts: Evaluating State Tax Incentives for Jobs and Growth,” 2012.
[ix] Ibid., p. 1.
[x] William F. Fox and Matthew N. Murray, “Do Economic Effects Justify the Use of Fiscal Incentives?” *Southern Economic Journal*, 71(1). 2004.
[xi] Ibid., p. 91.
[xii] Keith Chapman, “From ‘Growth Center’ to ‘Cluster’: Restructuring, Regional Development, and the Teesside Chemical Industry.” *Environment and Planning A*, 37(4). 2005.
[xiii] Ibid.
[xiv] Frederic Sautet and Pierre Desrochers, “Entrepreneurial Policy: The Case of Regional Specialization vs. Spontaneous Industrial Diversity.” *Entrepreneurship: Theory and Practice*, 32(5). 2008.
[xv] Justin M. Ross, “A Primer on State and Local Tax Policy: Trade-Offs among Tax Instruments.” Mercatus Center at George Mason University, 2014.
[xvi] This is also known as the tax “incidence,” which refers to determining whom a tax actually falls on. For example, property taxes are borne solely by landowners, but the corporate tax incidence is generally considered to fall largely on labor (although this is still debated). For an in-depth look at tax incidence, see Laurence Kotlikoff and Lawrence Summers on the matter: http://www.kotlikoff.net/sites/default/files/Tax%20Incidence.pdf. For more on corporate income tax incidence, see the Tax Foundation’s special report “The Corporate Income Tax and Workers’ Wages: New Evidence from the 50 States.”
[xvii] “Complexity in the Federal Tax Code.” Joint Committee on Taxation, March 2015.
[xviii] Keon S. Chi and Daniel J. Hoffman, “State Business Incentives: Trends and Options for the Future.” Council of State Governments, 2000.
[xix] Chi and Hoffman, p. vii.

[xx] Pew Center on the States, "Evidence Counts: Evaluating State Tax Incentives for Jobs and Growth," 2012.
[xxi] Frederic Sautet and John Shoaf, "Local Tax Incentives in Action: The Payment-in-Lieu of Tax Program in Memphis, Tennessee." Mercatus Center at George Mason University, 2006.
[xxii] Terry Buss, "The Effect of State Tax Incentives on Economic Growth and Firm Location Decisions: An Overview of the Literature." 2006.
[xxiii] Sautet and Shoaf, pp. 11–12. Companies may also hold more than one PILOT parcel in the county.
[xxiv] Here, loss is defined as the tax revenue that Memphis would have received if these same businesses had moved there without the PILOT program incentives.
[xxv] Tennessee Advisory Commission on Intergovernmental Relations, "Property Tax Abatements and Payments in Lieu of Taxes: Impact on Public Education. February 2004. https://www.tn.gov/assets/entities/tacir/attachments/prop_tax_abate.pdf
[xxvi] Ibid.
[xxvii] Again, this is an example of a region that experiences harsher economic downturns because of its reliance on one industry.
[xxviii] Michael Hicks and Michael LaFaive, "The Influence of Targeted Economic Development Incentives on County Economic Growth: Evidence from Michigan's MEGA Credits." *Economic Development Quarterly*, 25(2). 2011.
[xxix] Patrick L. Anderson, Alex Rosaen, and Hilary Doe. "Michigan's Business Tax Incentives." Anderson Economic Group, LLC. 2009.
[xxx] Ibid., p. 4.
[xxxi] Scott Drenkard, "State and Local Sales Tax Rates in 2014." *Tax Foundation,* March 2014. http://taxfoundation.org/article/state-and-local-sales-tax-rates-2014. Tennessee does tax certain forms of interest and dividend income at 6 percent. For specific examples, see http://www.tn.gov/revenue/faqs/indincome.shtml
[xxxii] Pew Center on the States, "Evidence Counts: Evaluating State Tax Incentives for Jobs and Growth," 2012, p. 11.
[xxxiii] Ibid., p. 43.
[xxxiv] "Incentive Fact Sheet." http://www.tnecd.com/incentives-fact-sheet/
[xxxv] Stan Chervin and Reuben Kyle, "Economic and Fiscal Impact Analyses: A Primer for Local Governments in Tennessee." Staff Research Brief, Tennessee Advisory Commission on Intergovernmental Relations, May 2009.
[xxxvi] "FastTrack Grants." http://www.tn.gov/transparenttn/topic/openecd-fasttrack
[xxxvii] Greg Johnson, "Bumper Crop: Sevier County Planting the Seeds for Tourism Renewal." March 2013. http://www.knoxnews.com/business/bumper-crop
[xxxviii] Ibid.
[xxxix] "Annual Financial Grants, Sevier County, Tennessee." Tennessee Comptroller of the Treasury. http://www.comptroller.tn.gov/repository/CA/2013/SevierAFR.pdf, p. 76.
[xl] http://bridgemontland.com/pdfs/BridgemontFacts.pdf

[xli] "Annual Financial Grants, Sevier County, Tennessee." Tennessee Comptroller of the Treasury. http://www.comptroller.tn.gov/repository/CA/2013/SevierAFR.pdf, p. 76.
[xlii] Ibid.
[xliii] Interview between Allen Newton and Courtney Michaluk. February 24, 2015.
[xliv] "FastTrack Grants." http://www.tn.gov/transparenttn/topic/openecd-fasttrack
[xlv] Jake Old, "Report: Ripken Project Will Generate $46M in First Year." February 2015. http://www.themountainpress.com/news/x43876217/Report-Ripken-project-will-generate-46M-in-first-year
[xlvi] Ibid.
[xlvii] Kelsey Pape, "Cal Ripken, Jr. Kicks Off New Project in Pigeon Forge." November 2014. http://www.wbir.com/story/sports/baseball/2014/11/13/cal-ripken-jr-kicks-off-new-project-in-pigeon-forge/18985967/