

# Constitutional Limits on State and Local Aid to Private Enterprise

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## Introduction

Economic development incentives packages are bundles of tax and non-tax incentives, often with non-tax incentives comprising the largest share. A recent survey of state economic development programs finds that “the percentage of businesses receiving more than \$50,000 through non-tax programs significantly exceeded that percentage for tax programs” (Council for Community and Economic Research 2013 p.19). Comprehensive data are not available; however, some evidence suggests these incentives may comprise as much as three-quarters of state and local resources devoted to economic development (Bartik, Erickcek, and Eisinger 2003). Analyzing the incentive packages contained in the Good Jobs First Mega deals subsidy database from 1985–2000, the reported value of the non-tax portion was 1.7 times greater than the value of the tax incentives.<sup>1</sup> Non-tax incentives are also at the forefront of the public debate on incentives because this type of incentive (cash and near-cash grants, low-interest financing, free land and buildings, etc.) looks most like legalized bribery of companies (Bartik 2005). In economic parlance, these non-tax incentives effectively subsidize capital rather than labor. Job creation, higher earnings, and tax revenues are presumably the indirect outcome of capital attracted by non-tax incentives.

The incentives available in a particular jurisdiction are a response to local economic conditions as well as the “rules of the game” dictated by federal and state constitutions. Unique circumstances in the nineteenth century caused states to impose constitutional constraints on state and local governments’ ability to aid private enterprise through non-tax incentives. The provisions originated in the mid- and

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<sup>1</sup> The total value of non-tax incentives was \$2,925,800,000 compared to \$1,750,120,000 for tax incentives based upon the author’s calculations. These values are exclusive of worker training incentives when possible. Another \$95,000,000 was classified as “other,” incentives classified as other were unspecified in the source data. Analysis is available upon request from the author.

and late-19th century in response to state and local government financial crises caused by participation in risky economic development projects (via railroads, canals, ferries, etc.) (Roy 1969; Rubin 1999; Tarr 1998). The fiscal consequences of investment in private ventures that ultimately failed were serious, including long-term debt obligations, default, and bankruptcy.<sup>2</sup> This culminated in the 1837 collapse, when nine states defaulted on their debts, and states throughout the U.S. enacted constitutional reforms curtailing legislative promotion of economic development and creating barriers to prevent abuses (Tarr 1998). These state constitutional provisions are relevant to today's competitive environment because they continue to limit and structure jurisdictional ability to match and innovate in response to economic circumstances. The type of non-tax economic development incentives available in a location are a direct reflection of the allowable activities under the state constitution.

State constitutional constraints may restrict the ability of governments to provide needed incentives—limiting growth—or allow governments to credibly argue that they cannot offer incentives, which reduces the possibility that they will offer wasteful incentives or overleverage their jurisdictions through offering large incentives. Increasing the available non-tax capital subsidies beyond those allowed under the state constitution requires amendment or revision. In an environment characterized by increasing pressure to offer incentives, the trend over the last fifty years has been to relax the constraints imposed by state constitutions. In 2010, for example, three states amended their state constitutions to allow public entities to use general obligation bonds to finance economic development incentives (Dinan 2011). However, other

attempts to increase available non-tax capital subsidies through constitutional change have been defeated by voters. For example, Texas rejected a 2011 amendment to expand county government issuance of general obligation bonds for economic development (Dinan 2012).

Patrick (2014) develops the Incentives Environment Index (IEI) from state constitutional limits on public aid to private enterprise. The IEI measures the availability of state and local non-tax incentives for capital. It improves upon existing measures which do not account for the dynamics of incentives competition, do not contain data on local incentives, and often include data on tax incentives as well as workforce, labor, marketing, and other activities outside the capital incentive paradigm (Patrick 2014). The IEI measures the ability of state and local governments to use three broad types of economic development incentives—credit, current funds, and equity. Credit incentives use public debt to provide aid to private entities, often through issuing general obligation or revenue bonds. Incentives using current funds entail appropriations of current revenues for gifts, loans, and donations to private firms. Equity incentives imbue the public with ownership in private ventures, such as public-private partnerships and public venture capital funds.

Patrick (2014) uses the IEI to estimate the job creation effects of increasing available non-tax capital incentives in continental U.S. counties from 1970-2002. She finds a negative medium-term effect on rural county employment and no significant effect on rural county employment growth, urban county employment levels, or urban county employment growth. In new research funded in part by the W.E. UpJohn Foundation, she finds subsidy-induced capital-labor substitution and changes in county industry composition. This research suggests that increasing available non-tax capital subsidies is an ineffective job creation policy; however, it may be an effective productivity-enhancing policy.

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<sup>2</sup> The risk of similar fiscal consequences still exists for public entities in states whose constitutions contain few restrictions on non-tax incentives. For example, Rhode Island's state constitution is one of the least restrictive in the U.S. (see Table 1 below). Rhode Island recently enticed Curt Schilling's now defunct Studio 38 video game company with a rich incentive package, including \$75 million in state guaranteed financing. The State's obligation to repay debt incurred on behalf of the failed venture continues and is the subject of much public debate (Bray 2012; Cohan 2012).

## Constitutional Provisions on Public Aid to Private Enterprises

State and local efforts to attract or retain economic activity with non-tax incentives take place within the context of state constitutional provisions limiting and structuring official's freedom to use public credit, money, and property for the benefit of private enterprises (Pinsky 1963; Green 1990; Schaefer 1996). Gray and Spina (1980) analyze the various incentives available across U.S. states. They assert constitutional prohibitions as the primary reason that gifts of land and money are the least used incentives. Industrial Revenue Bonds (IRBs) provide another example. Low-cost financing provided through IRBs became widespread during the 1960's and 1970's. The few states whose constitutions prohibited IRBs were disadvantaged from competing for new firms and amended their constitutions to be competitive (Reich 1983; Eisinger 1988).

It is generally accepted that there are three state constitutional provisions governing public aid to private enterprises: (1) Credit Clause(s), (2) Current Appropriations Clause(s), and (3) Stock Clause(s) (Pinsky 1963; Roy 1969; Gray and Spina 1980; Gelfand and Amdursky 1986; Marks and Cooper 1988; Green 1990; Schaeffer 1996; Rubin 1999). The Credit Clause governs the use of public credit to aid private enterprises. It covers activities such as industrial revenue bonds (IRBs), loan guarantees, bond financed grants provided to private firms, debt financed industrial park land, etc. The Current Appropriations Clause determines allowable appropriations for economic development donations, grants, loans, etc. The Stock Clause governs the financial relationship between public and private entities, including public-private partnerships and public venture seed capital funds.

State constitutional constraints may restrict the ability of governments to provide incentives available elsewhere—limiting growth—or allow governments to credibly argue that they cannot offer the same incentives as competing jurisdictions. Eisinger (1988) describes the proliferation of economic development programs in the 1960s. Although

aggressive incentives were first used by economically underdeveloped Southern and Western states, Northeastern and Midwestern states had taken the lead by 1966.

Northeastern and Midwestern states responded by matching the available Southern and Western programs as well as creating programs unavailable in those areas.<sup>3</sup> If there are no constraints on jurisdictions, then they may create incentives in order to match competing offers. Constitutional constraints bound the types of incentives that state and local governments' may use in strategic bidding games with competing jurisdictions. If the rules governing incentives allow them to create incentives similar to those offered by competing jurisdictions, then the location may feel more pressure to do so; otherwise, state legal limitations may credibly constrain their jurisdictions from offering those incentives.

## Measuring Constitutionally Available Non-Tax Incentives—The IEI

The Incentives Environment Index (IEI) is created for every state and year 1970–2000 from the three constitutional clauses governing non-tax economic development incentives. An index based on these provisions of state constitutions measures the ability of locations to provide a certain level of non-tax incentives or capital subsidies. The types of non-tax economic development programs available in locations across the United States are a direct reflection of the limits placed by these constitutional provisions. Thus, they measure both available programs as well as the limitations placed on the nature of the response.

The IEI is the sum of the state and local credit, current appropriations, and stock clause scores. Adding the individual state and local clause scores allows the summary index to reflect substitution of one type of incentive for

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<sup>3</sup> The IEI reflects the fact that Northeastern and Midwestern states could respond with additional programs. The average 1970 IEI is higher in the Northeast and Midwest than in the South and West.

another.<sup>4</sup> A higher score means more freedom to use incentives governed by that clause. The clause scoring methodology is similar to Ameil, Deller, and Stallman (2009)'s Tax and Expenditure Limitation Index. Each clause is scored based on sub-categories and the sub-category scores are then summed. The scoring system for each clause captures variation in the type of activity covered, the scope or entities restricted, explicit exemptions, and the approval process. Additional detail on the clauses and scoring may be found in the web appendix to Patrick (2014).

The clauses originated in the mid- and late-19th century in response to state and local government financial crises caused by participation in risky economic development projects (Roy 1969; Rubin 1999; Tarr 1998). Changes to these clauses occur through the adoption of new state constitutions and amendments. The changes are generally due to political movements focused on the role of government and/or to allow the location to provide the new relevant baseline incentives (Tarr 1998). For example, Idaho's 1982 amendment was specifically designed to allow IRBs. Prior to the amendment, Idaho had the most restrictive local credit clause in the country.<sup>5</sup> The amendment allowed city and county authorities to issue IRBs, and also enabled revenue-secured debt in general. Tax Increment Financing (TIF) enabling legislation followed. Amendment to allow additional incentives provides evidence that these constraints are binding.

Table 1 provides the IEI ranking for each of continental U.S. state in 1970 and 2000. Connecticut, Missouri, and Vermont have the highest possible IEI score in both 1970 and 2000. Therefore, Connecticut, Missouri, and Vermont tie for first, meaning their constitutions allow the most types of non-tax economic development incentives among

the states at that time. Over one-third of the states change their constitutions at least once between 1970 and 2000, with approximately thirty percent changing multiple times. The vast majority of these changes increase the ability of public entities to aid private entities; thus the states that did not amend their constitutions moved down in the rankings from 1970 to 2000. With the exception of Connecticut, Missouri, and Vermont, the states that maintained their ranking from 1970 and 2000 did so through constitutional change increasing the ability of public entities to provide non-tax capital subsidies. For example, a 1983 amendment to the state and local credit clause of the Washington Constitution removes restrictions on the issuance of IRBs. The resulting increase in Washington's IEI score maintains its ranking among states, but is not a sufficient increase in Washington's available non-tax incentives to increase its ranking.

State constitutional change occurred most frequently in the South and West during the 1970's and 1980's. Approximately 13.6 percent of the changes occurred in the 1990's compared to 40.9 percent and 45.5 percent in the 1970's and 1980's, respectively. States located in the South Census region account for 43.75 percent of the states that changed these provisions of their constitutions from 1970 to 2000 but represent only 33.33 percent of continental states. Similarly, 22.92 percent of all states are located in the Western Census region, but Western states account for 31.25 percent of the states that change their constitutional provisions on public aid. Less frequent change among Midwestern and Northeastern states reflects the generally less restrictive constitutions in the Midwest and Northeast in 1970. Relative economic activity, as measured by Gross State Product (GSP) per capita, also varies among the changers. Approximately 59 percent of constitutional changes occurring in states with lower GSP per capita than the average state in the year of the change and 41 percent in states with higher than average GSP per capita.

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<sup>4</sup> Summing gives equal weight to each clause. In the composite index, a value of 0 indicates the most restrictive combination of clauses possible, and values are interpreted with respect to it. A state with no state or local restrictions on the use of public funds to aid private enterprise would achieve the highest possible value indicating that it has the ability to provide economic development incentives in any manner.

<sup>5</sup> Idaho's local credit clause score in 1982 is 3, which is well below the next lowest score of 11.

**Table 1. State IEI Rankings**

STATE	1970	2000	CHANGE	STATE	1970	2000	CHANGE
Alabama	22	27	-5	Nebraska	27	31	-4
Arizona	30	37	-7	Nevada	35	39	-4
Arkansas	29	29	0	New Hampshire	18	21	-3
California	40	41	-1	New Jersey	42	46	-4
Colorado	44	47	-3	New Mexico	25	25	0
Connecticut	1	1	0	New York	33	34	-1
Delaware	31	38	-7	North Carolina	10	10	0
Florida	47	48	-1	North Dakota	5	6	-1
Georgia	45	42	3	Ohio	15	18	-3
Idaho	42	44	-2	Oklahoma	23	27	-4
Illinois	13	16	-3	Oregon	24	30	-6
Indiana	13	16	-3	Pennsylvania	21	25	-4
Iowa	20	23	-3	Rhode Island	6	8	-2
Kansas	8	5	3	South Carolina	35	24	11
Kentucky	41	42	-1	South Dakota	26	32	-6
Louisiana	48	6	42	Tennessee	15	18	-3
Maine	11	12	-1	Texas	34	15	19
Maryland	8	10	-2	Utah	28	33	-5
Massachusetts	12	13	-1	Vermont	1	1	0
Michigan	19	22	-3	Virginia	31	36	-5
Minnesota	6	8	-2	Washington	45	45	0
Mississippi	37	40	-3	West Virginia	17	20	-3
Missouri	1	1	0	Wisconsin	4	4	0
Montana	39	14	25	Wyoming	37	34	3

It would be ideal to have similar measures of non-tax economic development incentives to compare to the IEI. However, reviewing the available incentives data and indices for the period, only *Site Selection* magazine produced consistent tabulations of state financial assistance programs over multiple years. The magazine produced yes/no listings of available state financial assistance programs from 1985–2000. The IEI is positively and significantly correlated with a state financial assistance policy measure created from these yes/no listing, with a correlation coefficient of 0.3 significant at the one percent level. Creating another measure from the portions of the *Site Selection* listing which are most related to credit and relating it to the IEI credit scores yields a significant 0.4 correlation coefficient. The yes/no measures are blunt

measures and do not account for allowable sources and uses of funds. Considering these points, the correlations are relatively high.

The IEI measures the type of incentives which can be used in response to local economic conditions. When these constraints are lifted, like in the Idaho case discussed above, policy-makers respond with statutory and policy changes. Another example is provided by the 1987 Texas constitutional amendment authorizing grants and loans to private entities for the purposes of economic development as well as allowing political subdivisions to finance loans or grants through bonds. The *Site Selection* magazine listings reflect the policy responses to this change. The post-amendment listings

include new city and state incentives for investing in high unemployment areas, new state matching funds, state loan guarantees, city or county loans, and city and county general obligation debt financing; all of which were unavailable prior to the 1987 amendment.

## The Effects of Increasing Non-Tax Capital Subsidies

Non-tax and discretionary economic development incentives (cash and near-cash grants, low-interest financing, free land and buildings, etc.) effectively subsidize capital. The idea is to increase capital in a location and thereby increase employed labor, earnings, and tax revenues. Patrick (2014) investigates the U.S. county job creation effects of increasing capital subsidy availability and Patrick (2013) examines the capital effects. This section summarizes the major findings from these two studies.

Patrick (2014) estimates the direct effect of increasing non-tax incentive availability (as measured by the IEI) on U.S. county jobs from 1970-2002, controlling for wages, state and local tax rates, service levels, outstanding debt, industrial composition, and the location-specific growth path. As suggested by previous studies of incentives, she finds rural and urban areas respond differently to incentives as a job creation stimulus. Her results indicate that increasing the available non-tax economic development incentives has a significant negative medium-term effect on rural county employment levels but otherwise has no effect otherwise. Specifically, a one standard deviation increase in incentives is associated with a decrease in five-year county employment of approximately 1,390 jobs. Only a one standard deviation increase in individual income taxes has a larger negative impact on county employment levels. There is no statistically significant effect on urban levels, rural growth, or urban growth.<sup>6</sup>

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<sup>6</sup> It should be noted that the five-year urban estimates are not very powerful due to small sample size. The estimated coefficients imply that urban county employment levels increase by 11 percent—double the estimated five-year level effect from the full urban county sample.

Patrick (2014) controls for potential indirect effects on wages, taxes, public service, etc. Thus, the estimated negative and insignificant effect is the direct effect on jobs. If there are no positive direct effects, then it is unlikely that the indirect effects are positive. Patrick (2014) postulates two potential reasons for the negative and insignificant direct effects:

- 1) either increasing the availability of incentives in an area does not result in a net capital increase, or
- 2) the net new capital does not result in new jobs.

Increasing the availability of incentives could fail to increase capital in an area for a variety of reasons, including:

- Incentives do not fundamentally change firm location decisions, but use valuable public resources. Incentives go to firms that already find the location an attractive place to do business. The costs of the incentives are borne by existing residents or firms through changes in public services and taxes—altering their location, wage, and production decisions.
- Induced capital might replace, displace, or prop up outdated existing capital. For example, an existing firm may use capital subsidies to purchase new machines. The new machines do not increase productive capacity or the firm's capital stock, though—either because they replace old machines or make it cost-effective for firms to continue using obsolete technology.
- Increase in competition may force existing firms to close. As new firms enter an area, they compete with existing firms for customers, land, and labor. Competition for customers drives output prices down, while competition for land and labor puts upward pressure on input prices. This combination may be untenable for some existing firms.

However, it is possible that the subsidies attract new capital without increasing employment. There are several possible reasons this could occur, including:

- Induced capital could redirect capital from productive activities into overcapacity. Unsubsidized firms face a cost disadvantage compared to subsidized firms and cannot outbid subsidized firms for capital. Lowering the cost of capital causes subsidized firms to get too much capital, some of which is underemployed.
- Managers may engage in additional rent-seeking as a result of increased incentive availability. Managers divert time and resources to extracting subsidies that would otherwise be used to enhance productive efficiency.
- Managers may adjust to public aid by substituting capital or public inputs for labor. Reducing the cost of capital causes firms to adjust their input mix in favor of capital—buying more machines and hiring fewer workers.
- Capital subsidies may induce changes in local industry composition, with more capital-intensive firms replacing more labor-intensive firms. Capital-intensive firms experience larger total cost reductions from capital-subsidies, enabling them to outbid labor-intensive firms for land and other inputs.
- Increasing capital subsidy availability is associated with both capital-labor substitution and changes in local industry mix.
- Consistent with previous findings, urban and rural counties respond differently to an increase in the IEI. Increasing available capital subsidies induces substitution of manufacturing capital for labor in urban counties and multi-state MSA counties, as evidenced by the increase in capital expenditure and capital expenditure per employee.
  - Capital incentives do result in more capital in urban areas, but capital-labor substitution limits the job creation effects of the induced capital.
- Capital subsidies do not appear to induce additional manufacturing capital expenditure in rural counties. Similarly, manufacturing firms do not spend significantly more on capital per employee as available capital subsidies increase.
- As restrictions on non-tax capital subsidies are relaxed, relatively capital-intensive industries increase their establishment shares at the expense of relatively labor-intensive industries with which they compete for land.

New research funded, in part, by the W.E. UpJohn Foundation investigates the latter two explanations for “jobless capital” effects of reducing constitutional restrictions on public aid to private enterprises. Theory presented in Patrick (2013) predicts capital subsidies will have two effects:

- 1) Capital-labor substitution, whereby firms that can easily substitute between capital and labor adjust their input mix in favor of capital.
- 2) Subsidy-induced changes in total production costs will cause changes in locations’ industry mix.

Patrick (2013) employs the IEI and five year county panels to test these theoretical predictions on county manufacturing capital expenditure, manufacturing capital expenditure per employee as well as industry establishment and employment shares by SIC major division. The preliminary results indicate:

## Concluding Remarks

Although the U.S. incentive environment is characterized by a lack of federal level constraints on lower level jurisdictions, unique circumstances in the nineteenth century caused states to impose constraints on state and local governments’ ability to aid private enterprise with non-tax incentives. These state constitutional provisions enacted in response to historic events are relevant to today’s competitive environment. They determine the available non-tax capital subsidies in a jurisdiction, which comprise a substantial portion of many economic development incentive packages.

Patrick (2014) develops the IEI from state constitutional provisions on aid to private entities. Comparing the state scores in 1970 and 2000, it is clear that the general trend has been to relax restrictions and increase the ability of

governmental entities to aid private companies with non-tax incentives. Recent efforts to amend state constitutional restrictions on public aid indicate that this trend is likely to continue. Patrick (2014) uses the IEI to estimate the job creation effects of increasing available non-tax capital subsidies. The results summarized above suggest this strategy does not result in job growth. In fact, employment in rural counties may be harmed by increasing non-tax economic development incentives. Preliminary results from Patrick (2013) indicate that Patrick's (2014) findings are caused by subsidy-induced capital-labor substitution and changes in local industry composition. Taken together, these results suggest that increasing available non-tax capital subsidies is an ineffective job creation policy, but may be an effective productivity-enhancing policy.

To the extent that additional capital makes workers more productive and more productive workers earn higher wages, increasing non-tax incentives for capital may produce desirable economic development. However, the rhetoric surrounding economic development incentives often focuses on job creation. These results suggest that policy-makers should clearly differentiate between economic development incentives directed at capital and labor. Capital-labor substitution and changes in local industry composition limit the job creation effects of capital subsidies.

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