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The Sembler Retail Incentive Deal: An Economic Analysis

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As the South Carolina General Assembly convenes for the 2010 session, legislators are putting the finishing touches on another targeted tax incentive deal (H 3722) aimed at attracting jobs and investment. This time The Sembler Co., an Atlanta-based firm, is being offered a variety of sales tax incentives to build a high-end retail center in Jasper County. Providing financial incentives to this type of "extraordinary retail establishment" has been tried in South Carolina and around the country, but has yielded little success in the way of sustainable growth and employment.

Another Cabela's?

In 2006, lawmakers pushed through legislation (H 4874) extending sales tax rebates and other incentives to Cabela's in a failed bid to entice the company to build a retail megastore in North Charleston. The legislation marked the first time the state had extended tax incentives that it typically reserves for manufacturing to "extraordinary retail establishments." The law defined these establishments as follows:

> *An extraordinary retail establishment is a single store located in South Carolina within two miles of an interstate highway or in a county with at least three and one-half million visitors a year, and it must be a destination retail establishment which attracts at least two million visitors a year with at least thirty-five percent of those visitors traveling at least fifty miles to the establishment. The extraordinary retail establishment must have a capital investment of at least twenty-five million dollars including land, buildings and site preparation costs, and one or more hotels must be built to service the establishment within three years of occupancy.*[1]

The Sembler incentives package expands upon the Cabela's legislation by permitting counties to create a multicounty business park that may be designated as an economic development site for "extraordinary commercial facilities," including retailers. Under the

[1]S.C. Code of Laws, Section 12-21-6520.

version of H 3722 passed by the House, the Sembler development will receive a 75 percent break on a portion of its state sales tax obligation and a 3 percent sales tax break to aid with infrastructure costs associated with the development of the property. In return, Sembler must invest a minimum of $100 million and hire a minimum of 1,000 employees.

Net New Job Creation Unlikely

Ultimately the goal of incentive packages like the Sembler deal is to create jobs in South Carolina. The economic evidence, however, does not suggest that this will occur. Consider the following studies:

- Gabe and Kraybill (2002) evaluated firm-level tax incentives on more than 350 Ohio firms, examining whether incentives contributed to job growth, and whether recipient firms overstated expected employment gains. They found no evidence that the incentives promoted employment growth.

- Examining more than 2000 programs across all states, Saiz (2001) found no evidence of overall growth in state gross domestic product or employment levels as a result of using financial incentives. Saiz also observed negative impacts in certain industries.

- In 2008, Hoyt *et Al.* analyzed the effects of state government incentives to attract businesses in Kentucky counties. The authors examined the actual incentives claimed by these businesses and found that there were weak positive effects associated with tax incentives, but only in border counties. They also found no evidence of spillover effects in adjacent counties. Since Kentucky's incentive packages are similar to most states, these findings can be generalized.[2]

- A separate study by Peters and Fisher (2004) examined the most commonly cited reviews of this literature and arrived at the same conclusion. The authors concluded that: "The most fundamental problem is that many public officials appear to believe that they can influence the course of their state or local economies through incentives and subsidies to a degree far beyond anything supported by even the most optimistic evidence."[3]

In addition to economic data that suggests targeted incentives don't work, there are good reasons for questioning the job creation and investment numbers that economic incentive packages often promise. The economic benefits to a region from a targeted investment are calculated using economic impact studies. Such studies, however, often contain serious flaws. As a result, they may overstate the employment and economic gains associated with a new development.

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[2]Hoyt *et al.* (2008).
[3]Peters and Fisher (2004). For a more detailed analysis of the economic literature on financial incentives see Chapter 7 of *Unleashing Capitalism: A Prescription for Economic Prosperity in South Carolina*.

Several concerns are pertinent here. First, there is no one accepted methodology for counting jobs and income. While new jobs may be created by the targeted firm (in this case, Sembler) there is likely to be a reshuffling of the local labor force in an effort to fill the new jobs. In addition, it is not known from the impact study provided in relation to the Sembler deal (see link to study in references below) whether the jobs that workers might leave to take a retail position at the Sembler site will be filled, remain vacant, or be eliminated. Further, the benefit of these jobs to the state can be mitigated depending on whether labor migrates from out-of-state to fill these positions. Given that Jasper County borders Georgia this is entirely possible, especially considering that the neighboring Georgia counties had an 8.3 percent unemployment rate in October 2009.[4] Finally, the benefits of new jobs are subject to overstatement and double counting when indirect or ripple effects are evaluated, which attempt to measure the economic benefits new jobs create throughout the economy.

Incentives for Retailers Not Effective

Incentive packages for retailers have been shown to be particularly ineffective. One reason for this is because such incentive packages rarely account for the effect that a new retailer will have on existing retail firms. In order to create net new economic growth, the Sembler development will have to result in increased retail sales (and thus jobs) over and above what already exists. To the extent that Sembler's development displaces shopping at existing stores, there would be no net change in total sales (or jobs) in the region. The potential of increased sales arising from customers traveling more than 50 miles to shop at the proposed facility would also add little to total sales (or jobs) in the state if these travelers are South Carolinians. In order to have an incremental impact on tourism related sales, Sembler's retail outlet would have to draw tourists from out-of-state who have come specifically to their shops. Given that Jasper County borders Georgia this is possible, with the caveat that residents of Georgia may also fill some of the positions created at the Sembler mall.

All in all, however, the economic evidence suggests that extraordinary retail establishments like Sembler will not increase local employment. Hicks' study (2007a, 2007b) of the economic impact of large retailers like Walmart and Cabela's on local economies found no increase in employment in counties where a new retail firm is established. He concludes from his analysis of 9 establishments in 9 different counties from around the country that: "… from a public policy standpoint there is nothing to recommend regional polices to attract or dissuade the location of retail firms."[5] Hicks discovered that any employment effects from the opening of a new retail establishment disappeared within three months. From a public policy standpoint South Carolinians must wonder what kind of research was conducted by policymakers to justify the extension of targeted tax incentives to this type of firm.

Finally, it should be noted that when selective incentives attract individuals from other states or cities to the local labor force, additional public services may be needed to

[4]See http://www.dol.state.ga.us/pr/laborforce.htm
[5]Hicks (2007a, p. 121).

accommodate them. If the new company in the area has been granted relief from state and local taxes, and the tax revenue generated from the new firm does not cover these additional costs, the increased government spending will fall on other existing businesses. This tax shifting may destroy as many jobs as the incentives given to the new firm are intended to create. In the case of The Sembler Co. retail development it is predicted these jobs will be store clerks and managers, maintenance personnel, and security guards, and that these positions may be mostly part-time and seasonal.[6]

Picking Winners and Losers

Why Jasper County?

Local leaders have billed the Sembler development as a Boeing or BMW for Okatie Crossing. What does The Sembler Co. deal offer Jasper County? It has been suggested the retail establishment might create as many as 2,500 jobs, and may generate as much as $175 million in sales tax revenue over 15 years (just over $11 million annually). But why Jasper County? Is Jasper County uniquely qualified for extraordinary retail? It is off of I-95, which is required by the legislation in a bid to attract tourism dollars. Does Jasper have a high unemployment rate? Yes, in October 2009 Jasper County reported an 11.4 percent unemployment rate. During the same period, however, the state average was 12.1 percent, with Jasper's unemployment ranking 34th out of 46 counties.[7] In other words, 33 other counties in South Carolina have a higher unemployment rate than Jasper County.

Granted, business decisions should not be based on the unemployment rates of different counties. A better measure, it would seem, is the relative tax rate of the county. Here, though, Jasper County is at a competitive disadvantage. The tax quotient for Jasper County is greater than 1.5. The tax quotient is the amount of a county's revenue generated through county and local taxation relative to the same measure for all counties in the United States. A tax quotient greater than 1.0 implies that the county has an above average reliance on tax collections relative to other counties in the United States. Such counties are likely at a competitive disadvantage in terms of business and household location decisions. Thus, as based on its own merits, at least as far as tax structure goes, there is little reason for The Sembler Company to choose Jasper County over any other similarly located site. This leads to questions regarding why Sembler wants to build in Jasper and what incentives were promised to entice the company to do so.

Why Sembler?

An even more pressing question that must be asked about the Sembler deal concerns why extraordinary retail establishments, as opposed to any other retailer or industry, should be eligible for special tax breaks. A related question is why the Sembler site – and not some other retail development like the existing Tanger Outlet in Hilton Head?

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[6]See Senator Pinckney's economic impact estimate below.
[7]See http://www.sces.org/lmi/news/October_2009.pdf

While the tax break created by H 3722 would seem to apply to any "extraordinary commercial facility" that meets the necessary investment and job creation requirements, the package – not unlike the Cabela's legislation, as well as the more recent Boeing deal – is specifically tailored to one company. Establishing legislation that is this specific generates a number of questions. What happens if a company wants to locate in South Carolina and does not belong to a favored cluster or a targeted industry? Does the General Assembly convene to pass new legislation to benefit every new company that wants to relocate to or expand in South Carolina? What about existing firms that are profitable, employ a small number of people, and pay the existing tax rates? In terms of economic development why are these companies not treated as assets in the communities in which they are located?[8]

Rather than engage in an economic development strategy that benefits existing industry and attracts a variety of new firms, South Carolina policymakers have focused on clusters and other targeting tools in economic development that primarily relies on government support. The intent of the Sembler legislation is to target specific large retailers and induce them to locate to South Carolina. The tourism provision presumably was included in the hope that customers would travel more than 50 miles to shop at the new establishment. This tourism concept does not necessarily bring in additional spending to the state, unless the establishment is located near a border and North Carolinians and Georgians travel to shop there. While Sembler is located near neighboring Georgia, how many North Carolinians, or residents from the Upstate will it attract? And how many tourists must the mall attract to claim it will create tourism revenue?

When taxes are imposed on consumers or businesses the tax burden can be shifted back to businesses, or on to consumers, respectively. Furthermore, the taxation process costs society much more than is generated in revenue. The additional costs come in many forms, including: administrative costs, enforcement costs, compliance costs, "excess burdens," and costs associated with resources spent by individuals and groups to avoid the tax, both before the tax is implemented (lobbying) and afterwards (evasion). Not to mention, the behavioral changes that can result in lost production.

Similarly, when state governments offer businesses tax credits or subsidies it can create an inefficiency that creates a "wedge" between the price consumers pay and the price businesses receive. This type of "wedge" creates a distortion in the market by redirecting resources into a specific industry. Specifically, the process of receiving the tax credit lowers costs for the business to which the credit applies. This encourages greater production of this product by this business than would otherwise occur in South Carolina if directed purely by free market forces. In addition, the benefits of the tax credit may be shifted from the targeted businesses to existing businesses, employees, or consumers, which again can distort the behavior of consumers, or the production of other businesses. While these types of targeted incentives seem to benefit business and consumers, they instead create distortions that require us to ask how these resources would have been allocated in South Carolina if the tax credit or subsidy had not been offered to these specific businesses in the first place.

[8]Hefner (2009).

The Incentives Game Is Not Working

One question remains. If this investment opportunity is sound and will yield a positive return for investors why does the state need to offer any incentives at all? Furthermore, policymakers note that Sembler will not receive the tax breaks unless the development results in the requisite number of investment and jobs. But, again, if Sembler can reach the stated goals for revenue and jobs does it really need these incentives to succeed?

One reason South Carolina policymakers argue incentives are necessary is because our property tax rates are too high to attract new business. Commercial properties, commercial farms and personal vehicles are assessed at a 6.0 percent rate. Transportation companies are subject to a 9.5 percent rate, and manufacturing, utilities and personal property other than personal vehicles are assessed at 10.5 percent.[9] More important, South Carolina specifies the rates for each classification of property in the state constitution. The definition of the properties within each category is left to the General Assembly.[10] Policymakers claim we need to offer incentives to remain competitive with other states because incentive packages allow them to adjust these rates. But these incentives are a second best solution that is unpredictable and subject to political preferences. Existing industries continue to pay their taxes based on the mandated assessment ratios; thus shifting the burden of taxes from new firms to existing firms. Amending the state constitution to provide for a rate that is more competitive with other states would do more to attract industry and benefit existing firms.

Since the efficacy associated with these types of policies is in serious doubt it begs the question, why are they so popular with state governments? Numerous economic studies point out that there are clear political benefits from using selective financial incentives.[11]

Industries seeking preferential treatment dominate the political process because voter-taxpayers have very little incentive to be well informed about the costs associated with these tax incentive programs and to create any means of organized opposition. The jobs "created" at new businesses are easily visible to the state or local community; communities will not see the jobs lost elsewhere in the economy due to higher tax burdens imposed on other businesses and consumers. Nor will they see the economic loss from the use of scarce resources spent on lobbying government officials to obtain these favors. These resources could have been better used to fund productive ventures that could have produced real output and growth. Likewise, lobbying for incentives often creates a bidding war between two or more state and /or local governments that can increase the value of the incentives the firm can extract from government agencies – thus exacerbating the loss to taxpayers.

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[9]Walker and Arsenault (2009).
[10]S.C. Constitution, Art. X, §§ 1 and 2.
[11]See Bennett and DiLorenzo (1983); Esinger (1989); Buss (1999a, 2001); Ellis and Rogers (2000); Saiz (2001); and Calcagno and Hefner (2007).

Instead of creating mutually beneficial exchange, the financial incentives created by lobbying for special tax breaks are zero-sum activities. One party's gain (e.g., the subsidy or tax break) is offset exactly by another party's loss (e.g., the taxes). However, because these types of financial incentive packages require an investment of resources in lobbying to be secured, their overall impact on the economy is negative. The problem is only made worse by the fact that others will devote resources to political lobbying on the "defensive side" – in this particular case Pittsburgh-based Costa Land Co. is opposed to the Sembler deal. The resources devoted toward securing (and fighting against) zero-sum political transfers have a real cost: What economist William Baumol refers to as unproductive entrepreneurship. It is unproductive because it uses up resources in the process of capturing zero-sum transfers and these resources have alternative, productive uses.[12]

South Carolina offers a wide variety of selective tax incentives that create distortions in the economy and limit the ability of the private sector to generate economic growth. The Sembler development is just one more case of such a misguided policy. South Carolina needs to reform its property tax and sales tax laws and stop using high tax rates as an excuse to offer special-interest incentives. A lower tax rate for business and property across the board will do more to generate economic growth in South Carolina than any selective incentive package.

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[12] Sobel and Leeson (2009).

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Nothing in the foregoing should be construed as an attempt to aid or hinder passage of any legislation.

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