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Economic Development or Risky Business: A Citizen's Guide to Issue 3, 2016

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Economic Development or Risky Business?

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EXECUTIVE SUMMMARY

Issue 3 of 2016 is a complicated ballot measure that seeks to broaden state and local government authority to issue public debt. While the ballot measure spans nine pages of legal text and amends at least six sections of the Arkansas Constitution, it comprises only two main components:

1) removing the existing cap on issuing state debt; and

2) affirming the right of local governments to appropriate money for economic development.

Proponents of Issue 3 argue that by removing the limit on the amount of debt the state can issue for economic development, Arkansas may be able to attract economic-development projects it would not otherwise be able to secure. The argument regarding local governments is similar. By allowing local governments to appropriate money for economic development, municipalities around the state may be able to land companies they otherwise could not.

However, issuing debt and using tax dollars for economic development comes at a cost. Arkansas and its cities would take on significant risk by issuing public debt to attract select companies under the change from Issue 3. Arkansas's cities are also likely to find themselves in bidding wars with each other for economic development, which ultimately will increase the tax burden for residents. Without proper oversight of the public's money, Arkansas could find itself in a similar situation to that of 1933, when the state went bankrupt over debt incurred to finance road construction.

INTRODUCTION

Since our current state constitution was adopted in 1874, Arkansas voters have been asked at least 30 times (about twice per decade) to consider the issuance of state or local government bonds. The high-water mark for restricting state issuance of debt was Amendment 20. During the 1920s, local governments had incurred debt to finance road construction, and many were not able to repay the debt following the double whammy of the 1927 flood and the depression. The state absorbed the debts of many local governments but was unable to service the debt. Arkansas was forced to declare bankruptcy in 1933. Voters reacted to the debt default with Amendment 20, which limited all issuance of debt by the state not directly approved by voters. Subsequent amendments have loosened this restraint, and Issue 3 would be another, huge step away from it.

Issue 3 of 2016 is a complex ballot measure, consisting of nine pages of legal text and amending at least six sections of the Arkansas Constitution.[1] However, it comprises only two main components:

1) removing the cap on the issuing of state debt; and
2) affirming the right of local governments to appropriate money for economic development.

Each has positive and negative consequences for Arkansas's economy and its residents. Much is at stake, and voters should be aware of the costs and benefits when deciding whether to support or oppose Issue 3. In this policy brief we examine the issues to help voters better understand the potential consequences of the ballot measure.

REMOVING THE CAP ON ISSUING STATE DEBT THROUGH AMENDMENT 82 BONDS

Amendment 82 (from 2004) of the Arkansas Constitution allows the state to issue general-obligation bonds (a form of state debt) for funding economic-development projects. To date, the only financing under Amendment 82 has been a $125 million bond issued to fund Big River Steel in Osceola, and that came only after the amendment was modified in 2010 because the original amendment proved too restrictive.[2] For a company to benefit from Amendment 82 bonds, the general assembly must approve the bonds.

Currently, the state is authorized to issue bonds of up to 5 percent of the state's general revenues collected during the most recent fiscal year. However, Issue 3 proposes to completely remove this cap, expanding the state's ability to fund economic-development projects.

What Are the Pros?

By eliminating the cap on Amendment 82 bonds, Arkansas could attract huge economic-development projects that are not possible under the current constitutional restrictions. According to Sen. Jon Woods the 5 percent cap means that Arkansas "can't pull the trigger [on some economic-development projects] because our hands are tied."[3] For example, Mississippi beat out Arkansas for a Toyota assembly plant in 2007 because Mississippi could give more than $293 million[4] worth of incentives to Toyota while Arkansas could only offer $200 million.[5] Removing the cap on Amendment 82 bonds would give Arkansas the ability to write a check big enough to attract an auto factory or any other large project that would likely never come to Arkansas without incentives.

An additional benefit is that Arkansas might be able to secure megaprojects without incurring fiscal costs.[6] If Arkansas disburses Amendment 82 bond proceeds as a loan rather than a grant, there is no cost to the state's budget, provided that the company continues to make its payments. The company pays the state, and the state uses those payments to retire the bonds. Arkansas may even benefit fiscally if the interest rate the company pays the state exceeds the interest rate the state pays bondholders. But the "no fiscal cost" condition is contingent on the firm locating in the state based solely on the use of Amendment 82 bonds.

However, history suggests it is unlikely that new Amendment 82 bond proceeds would be delivered solely as loans. Companies often negotiate for grants instead of loans. The entire $87 million approved for Lockheed Martin (an Amendment 82 project that ultimately did not come to fruition) was approved as a grant, and just $50 million of the $125 million assigned to Big River Steel took the form of a loan.[7]

What Are the Cons?

Frédéric Bastiat claimed that "the good economist takes into account both the effect that can be seen and those effects that must be foreseen."[8] Arkansas may be able to land large economic-development projects with Amendment 82 bonds, but doing so comes with hidden costs that may not be foreseen without digging deeper. Arkansas and its taxpayers take on significant risk when the state issues economic development bonds. Consider the following hypothetical example:

> Arkansas legislators approve a $300 million Amendment 82 bond issue to lure an auto assembly plant. The state sells the bonds to the public and disburses the proceeds to the auto company, with $180 million as a grant and $120 million as a loan. Arkansas taxpayers must repay bondholders for the $180 million grant, and the auto company is responsible for the $120 million loan. Now, imagine that the auto manufacturer files for bankruptcy; it is not hard to imagine since GM and Chrysler both essentially did so in 2009 (only to be saved by federal government bailouts). Arkansas will no longer receive payments from the business and must find another way to repay the Amendment 82 bondholders. Taxpayers must now pay for the entire $300 million issue.

Supporters of Issue 3 argue that the 5 percent cap on Amendment 82 bonds puts some economic-development projects just out of reach. But the proposed amendment would not simply raise the cap to, say, 10 percent or 15 percent of state revenue. Instead, the cap on state debt is completely removed.

How much debt would Arkansas issue to attract a few companies? 100% of state revenues? $1 billion dollars? Positing $1 billion in incentives seems hyperbolic, but Nevada recently gave $1.3 billion to Tesla and Washington State gave $8.7 billion to Boeing (after Missouri offered them $1.7 billion).[9] Removing the cap on Amendment 82 bonds would open the door for Arkansas to do likewise. It would provide Arkansas officials an opportunity to gamble with taxpayer dollars limitlessly for economic-development projects. The debt issued is ultimately backed by the taxpayers of Arkansas if anything should go wrong.

AFFIRMING THE RIGHT OF LOCAL GOVERNMENTS TO APPROPRIATE MONEY FOR ECONOMIC DEVELOPMENT

Issue 3 also proposes two other changes. First, it would amend Article 12, Section 5 of the Arkansas Constitution to allow municipalities to appropriate money to private organizations to finance economic-development projects or to provide economic-development consulting services on behalf of the municipality. Currently, the constitution prevents counties, as well as cities, towns, and other municipalities, from using taxpayer money to directly fund economic-development projects. Specifically, no municipality is allowed to "become a stockholder in any company, association, or corporation; or obtain or appropriate money for, or loan its credit to, any corporation, association, institution or individual."[10]

Yet many municipalities currently bypass this constitutional restriction by indirectly funding private companies. Rather than providing tax dollars directly, cities and counties resort to purchasing land, constructing buildings, performing site preparation, or improving infrastructure for the benefit of a specific company. For example, the city of Conway attracted HP in 2008 in part by spending $2.1 million on site preparation and $3 million on improvements to the transportation corridor near the office park where HP sits.[11] Furthermore, the Conway Development Corporation provided HP with a 150,000-square-foot custom building that HP now leases for an undisclosed amount.[12]

Cities and counties frequently work to attract firms by contracting with organizations such as chambers of commerce for economic-development services. These *economic-development organizations* use local tax dollars to provide marketing for municipalities and to recruit firms, including by issuing them incentives. For example, the Economic Development Alliance of Jefferson County, which consists of the Pine Bluff Regional Chamber of

Commerce and the Jefferson County Industrial Foundation, manages proceeds from a countywide three-eighths of a percent sales tax increase devoted to economic development. Most recently, the alliance committed $3.925 million to "purchase land, conduct site preparation, and support the installation of infrastructure" to recruit Energy Security Partners to Pine Bluff.[13]

However, the longstanding tradition of cities contracting with economic-development organizations came under question when a Pulaski County Circuit Court judge ruled in 2015 that payments made by the cities of Little Rock and North Little Rock to local chambers of commerce were in violation of Article 12.[14] Issue 3 proposes to resolve the legal question by creating an exception to Article 12, Section 5 that would allow municipalities to appropriate money for private organizations to finance economic-development projects or to provide economic-development consulting services on behalf of the municipality.

Issue 3 would also clarify Amendment 62, which covers local bond issues for capital improvement. Amendment 62 currently allows for local bonds to be issued for "industrial development" but not for "economic development." Issue 3 proposes to modify this wording by defining "economic development" and allowing municipalities and counties to issue bonds for that purpose, expanding the number of projects for which debt can be issued.[15] Governments currently retire "industrial development" bonds with a special property tax of not more than five mills.[16] However, Issue 3 proposes to allow the general assembly or local legislative bodies to authorize "other taxes" to retire the bonds.

What Are the Pros?

By allowing municipalities to finance economic-development projects or contract for economic-development services with local tax dollars, cities and counties might be able to attract companies they would not otherwise be able to. Mike Preston, executive director of the Arkansas Economic Development Commission, recently stated that "when a local community has no defined ability to spend funds for economic development purposes, it is at an immediate disadvantage versus communities that have this ability."[17] Issue 3 addresses Mr. Preston's concern. Many of the arguments in favor of allowing local governments to issue debt for economic development are the same as those discussed above for the state as a whole, so we will not discuss them in detail again.

What Are the Cons?

Fayetteville city attorney Kit Williams warns that allowing municipalities to finance economic-development projects means that "Arkansas cities will likely be invited into bidding wars with each other for new 'economic development'."[18] If each Arkansas city was allowed to use tax dollars to recruit businesses, companies would have negotiating power over cities. Businesses might threaten to leave if a city did not write a bigger check for the company's benefit, which would put Arkansas cities into a competition to see who can write the biggest check. Ultimately, this would force taxpayers to fund private companies despite the fact that many Arkansas cities currently develop without using tax dollars or public debt. Taxpayers would also face a higher tax bill as the price tag for private businesses got bid up.

Furthermore, using local tax dollars or local debt to recruit businesses also puts undue financial strain on municipalities. Consider the case of Port St. Lucie, Florida.[19] In March 2015, more than one-third of Port St. Lucie's debt ($335.5 million) was from "failed or faltering economic-development deals for which the city fronted money with a promise of repayment." In other words, Port St. Lucie taxpayers are paying $335.5 million (plus interest) for projects they will see no economic benefit from. The massive amount of economic-development debt led Moody's to downgrade the city's credit rating.[20]

How many Arkansas cities would place an undue financial burden on their taxpayers to chase economic-development projects? How many Arkansas cities are willing to risk their credit rating for the promise of jobs? How much taxpayer money would Arkansas cities waste if they forced taxpayers to fund private businesses that ultimately failed? After all, Arkansas taxpayers have seen taxpayer-funded projects, such as Nordex[21] and Beckmann Volmer,[22] fail before.

CONCLUSION

Proponents of Issue 3 largely argue that passing the ballot measure will lead to more jobs, higher incomes, and a stronger economy. Yet, real-world examples fail to support these claims. Since 1980, there have been 26 peer-reviewed academic studies examining the effect of tax breaks and subsidies on local economies.[23] Of these 26 studies, 25 find no clear positive economic effects from providing businesses with financial incentives. In other words, tax breaks and subsidies do not do what proponents claim they do.

With Issue 3, voters are in large part being asked whether Arkansas should go back to the pre-1934 situation, with very few limits on state and local issuing of debt for economic development. The risk is that Arkansas could wind up in a similar situation to that in 1933 if large projects fail and taxpayers must step in to service the debt. The potential upside is that Arkansas could attract some large economic-development projects that it could not attract under the current constitutional constraints. Can we trust the legislature to be cautious with the state's credit? In 1798 Thomas Jefferson wrote, "Let no more be heard of confidence in man, but bind him down from mischief by the chains of the constitution." On November 8, voters in Arkansas will decide whether they prefer the chains of the constitution or confidence in the men and women of the legislature to restrain themselves in issuing debt.

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[15] Issue 3 defines economic development as "the land, buildings, furnishings, equipment, facilities, infrastructure, and improvements that are required or suitable for the development, retention, or expansion of: (A) manufacturing, production, and industrial facilities; (B) Research, technology, and development facilities; (C) Recycling facilities; (D) Distribution centers; (E) Call centers; (F) Warehouse facilities; (G) Job training facilities; (H) Regional or national corporate headquarters facilities. Infrastructure is defined as "(A) Land acquisition; (B) Site preparation; (C) Road and highway improvements; (D) Rail spur, railroad, and railport construction; (E) Water service; (F) Wastewater treatment; (G) Employee training which may include equipment for such purpose; and (H) Environmental mitigation or reclamation."
[16] $5 dollars of taxes for every $1000 of assessed taxable property value.
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