# What Makes for a "Healthy" Business Climate?

Carl Rist and Bill Schweke

Rapid changes in the world economy have transformed national economies during the last 15 years. The insulation that national borders and federal policies provided have largely dissolved, exposing formerly protected state and regional economies to the challenges of the global economy. Today, a state government must act quickly to meet economic challenges created on the other side of the globe.

In meeting these challenges, state leaders and policymakers often assume that the most effective response is to work to improve their state's business climate. The term "business climate" generally refers to the perceived hospitality of a state or locality to the needs and desires of businesses located in, or considering a move to, that jurisdiction. In recent years, though, the term "business climate" has become almost synonymous with the pressure to cut taxes, limit services, and remove impediments, particularly employment and environmental regulations. Understood in this way, attempts to improve a state's business climate can lead to quite contradictory policies that ultimately harm a state's long-term economic health.

Consider, for example, some recent headlines from North Carolina. In March of this year, at the annual meeting of the North Carolina Citizens for Business and Industry, one of the state's top executives warned that the state's education system could hobble its future success. Noting that high school attainment and math proficiency are below the national average, Hugh McColl of Nation's Bank pointed out that too many North Carolinians are part of "yesterday's economy," and called for greater investment in education. On that same day, however, the state Court of Appeals ruled that, under the state's Constitution, the state's children have no fundamental right to "adequate" educational opportunities. In other words, the court left intact the prevailing system for funding public education — the use of local property tax revenues — and said it was bound by a 1987 ruling that permitted disparities in the quality of education from county to county (Raleigh News and Observer 1996).

Just one month earlier, on the same day that DRI/McGraw-Hill reported that one North Carolina metro area (Raleigh-Durham-Chapel Hill) was expected to have the nation's second highest growth rate over the next two years (Eisenstadt 1996), the state's Economic Development Board approved an enhanced package of business recruiting incentives for the state. Spurred on by Governor Hunt, who argued that North Carolina had lost 30 major prospects and thousands of jobs to Virginia and South Carolina over the previous three years, the Board agreed to expand the incentives offered by the state by reducing the state's corporate income tax rate and creating or expanding a number of other tax credits and exemptions (Nowell 1996).

How is it that policies designed to improve a state's business climate can appear so contradictory? In the paper that follows, we will explore more closely what constitutes business climate, compare traditional and alternative approaches of this concept, outline some principles and policy components that should guide a new approach to improving business climate

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— one that is broader in scope and more in keeping with the needs of both businesses and communities as we approach the turn of the century — and suggest some ideas for spurring action on this new approach.

**The Business Climate Dilemma**

Business climate refers to that combination of factors that determine whether a state or locality is an attractive place to do business. Although every company has a different set of requirements and expectations, there are usually three main components of business climate. The most obvious component is the cost (in land, labor, equipment, and taxes) of opening, expanding or operating a facility. The second is made up of non-cost factors, such as quality of life and amenities, which affect investment and location decisions. The third component is the extent to which an area and its elected and appointed government officials are perceived to be "pro-business."

Government has a major impact on business climate, for it is the combination of public services, taxation, and regulation that, to a significant extent, creates the context within which companies operate. This governmental role in business climate has been attracting much attention in recent years. In fact, as we noted at the outset, the term business climate has come to be identified almost solely with efforts to cut taxes and reduce government regulations. Yet, the arguments being made in this regard are not only economic. They are also intensely ideological, wrapped up in a growing anti-government sentiment, which sees almost any tax as theft and believes that government's most important job is to get out of the way.

*The Dangers of a Traditional Interpretation of Business Climate*

This traditional understanding of business climate is based on an outdated understanding of economic development that assumes closed national borders, relatively fixed levels of technology, and a finite number of jobs. The old view suggests that, in order to get these jobs, a state must offer lucrative inducements and promote its lack of development and wealth relative to other regions in the United States. According to this view, low tax and low wage conditions are touted as a strategic advantage in luring manufacturing companies and other firms which do not require a skilled or educated workforce.

But the world on which the traditional view is based no longer exists. America is now part of a truly global marketplace. A state's strategy of offering the lowest wages, lowest taxes, least bothersome environmental requirements, and lowest welfare benefits may work within the confines of a closed national economy, but it falls flat in a global context. The entire Third World and the emerging market economies of the formerly communist world are in a far better competitive position to use this strategy. States that rely too much on the low cost approach may attract the very firms that are most likely to move overseas a few years later, in search of still lower wages and even weaker environmental and employment protection standards.

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In today's economy cost still matters, but value matters more. As one development expert notes:

> The name of the game is value-added. The more value added on a per employee basis, the more wealth is created by the enterprise and the greater the economic return to workers, managers, and investors. Value added is not strictly a matter of productivity; it also reflects quality and service. Value is not the same thing as cost; a firm cannot necessarily add more value simply by reducing cost. Cost is established by the producer. Value is determined by the price the customer is willing to pay. [Williams 1990]

Thus, from a public policy point of view, a business climate strategy should try to foster an economy that can produce the highest value goods and services, rather than trying to create the lowest cost environment. In other words, the goal of economic development should be to create the most profitable climates for new and existing businesses, not necessarily the cheapest. In this way, American firms can produce goods of such value that they can pay higher wages and salaries that will contribute to a rising standard of living.

Within the context of today's global economy, pursuing the traditional business climate approach to growth and competitiveness through indiscriminately cutting taxes, services, and regulations can lead to perverse consequences. By undermining necessary investments in research and development, primary and secondary education, physical infrastructure, adult retraining, and higher education, a state will likely *diminish* its long-term economic vitality. In today's economy, the measure of how a state or regional economy is likely to do in the future — that is, its potential both to compete in the face of rapid economic change and to generate sustained and widely shared economic opportunities — depends on its investment in its "development resources." These resources, such as the education and skills of the workforce, the extent to which new technologies and technically-oriented individuals and institutions are available, and infrastructure and amenities, are the building blocks of which state economies are composed, and upon which businesses depend.

At the same time, it is clear that government waste and inefficiency, poor accountability, outmoded budgeting systems, and inappropriate civil service, tax, regulatory, and public service systems are important contributors to creating unfriendly business climates. In building the case for an active public role in creating healthy business climates, policymakers must also be aware of the potential for these government failures.

*Following the Traditional Recipe: Business Climate and the Southern States*

No group of states has stuck more closely to a traditional approach to business climate than those in the southern United States. Modern industrial recruitment in the U.S. was born in Mississippi when the state's Balance Agriculture With Industry program began in 1936 to recruit manufacturing branch plants from the North with low-wage, non-union labor, inexpensive land, and low taxes. For most states in the region, this standard marketing approach has changed little over the years. Moreover, the southern states have enhanced their image among footloose firms by gaining a reputation as some of the most generous when it comes to offering tax and non-tax incentives. In what still counts as the blockbuster of all incentive deals, Alabama successfully recruited a Mercedes-Benz assembly plant in 1993 in return for $250 - $300 million in incentives.

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Yet, the South's apparent success using this formula typifies the dilemma inherent in adhering to a traditional approach to creating a healthy business climate. The southeastern states have added 14 million jobs since 1970 — far outpacing the nation — but jobs in the region continue to pay below the national average. One of the reasons for the region's relatively poor job quality is the low skill level of its workforce. In one well-known benchmark of state economic performance, *The 1996 Development Report Card for the States* (see box), no Southern state earned above an average grade for its human resources and all five failing marks handed out went to states in the South. According to *The Development Report Card,* "the South is still lacking many of the key ingredients for future economic success, most notably an educated workforce" (Corporation for Enterprise Development 1996). Clearly, traditional business climate policies that undermine investment in critical development resources, such as education, can actually harm long-term economic health.

## What States and Local Communities Should Do

Fresh thinking is required about the way economic development is heading in the United States. Development officials, elected officials, business leaders, and the general public have to move the debate about business climate away from simplistic notions of tax competitiveness or "getting the government off our backs" to focus on the real disincentives to economic competitiveness and opportunity. States and local governments interested in improving the business climate need to follow two main directives:

- Design policies that improve the conditions for profitability and job creation, and
- Increase the accountability of tax and other incentives, if they are used as part of the overall development strategy.

*The Policy Components of a "Positive" Business Climate*

There are five key components of a *positive* business climate: education, physical infrastructure, regulation, taxation, and modernization. Policymakers must give serious attention to these components and not short-change them in an effort to appear "pro business."

***Education.*** We have reached the stage where global competitive advantage is based primarily on the education and skills of the labor force. Other factors such as natural resources and proximity to markets and suppliers are clearly important, but the next leaps forward in productivity and innovation will require more flexible, articulate, thinking workers. Thus, wise investment in public education is an absolute must for creating a positive business climate. Yet investment should not imply simply throwing more money at education, but rather getting the most value out of additional education spending. This means focusing attention on goals such as improved student outcomes and increased accountability on the part of schools.

***Physical Infrastructure and Public Services.*** Often neglected in the anti-tax debates is the importance of basic services — effectively and efficiently delivered — to the creation of a positive business climate. The repair and maintenance of highways and sidewalks, the management and operation of schools, the prevention of crime, the safeguarding of public health, and the care of public parks, are all essential to a community's quality of life. The reduction of tax revenues to the point where these services can no longer be adequately provided signals a reduction in an area's competitiveness.

***Regulation.*** The main targets of those wishing to deregulate industry are employment and environmental regulations, which exist both to guard the health, safety, and welfare of the citizenry and to place some constraint on the more unacceptable aspects of the free market. Unfortunately, regulators have brought much of the present hostility on themselves. They have used overly bureaucratic procedures, focused on compliance rather than finding workable preventive solutions, and have applied uniform standards regardless of circumstances, cost or size of business. Business focus groups have shown that it is not the regulations themselves that cause them grief, but the way they are administered. A positive business climate is created by regulators who seek to work *with* business to achieve acceptable standards, whether in the workplace or in the environment, while at the same time ***not*** compromising their ability to enforce the law on behalf of public health and safety.

***Taxation.*** There has been an overwhelming emphasis in recent years on tax competitiveness and tax rates. What gets lost in these discussions is the opportunity to strengthen state and local tax systems so that they can enhance business climate. In addition to tax competitiveness, other equally important goals of a tax system include: *reliability* — stable and certain revenue generation and consistent rates; *balance* — a spread across a range of tax sources without over-reliance on any one; *equity* — a fair system which shields subsistence income from taxation, is progressive, and imposes the same tax burden on households earning the same income; *efficiency* — easy to understand, minimal compliance costs, simple administration; and *accountability* — public information on sources and uses of tax revenues, and information about revenues effectively lost due to tax breaks. The best tax climate is one which adequately addresses each of these objectives, along with tax competitiveness.

### The Development Report Card for the States

*The Development Report Card for the States*, published annually by the Corporation for Enterprise Development (CFED), is an assessment of the strengths and weaknesses of each state's economy and its potential for future growth. *The Development Report Card* grades each state's economy (A to F) in three "subject" indexes using over 50 socioeconomic data measures. The three graded indexes are structured to measure:

**Economic Performance**: What are the economic benefits and opportunities provided to citizens by the state's economy?

**Business Vitality**: How vital and dynamic is the state's business sector?

**Development Capacity**: What is the state's capacity for future growth and recovery from economic adversity?

The following explanation of North Carolina's grades is excerpted from the state's 1996 *Report Card.*

**Economic Performance - C**
North Carolina continues to ride along in the middle of the pack with a strong, growing economy whose benefits may not be reaching everyone. The state has one of the nation's best overall employment situations (including the 11th best unemployment rate). In addition, the earnings and quality of existing jobs are good (the 10th best average pay growth). Yet, it is poor rankings in most of the equity measures that mar the economic picture. Meanwhile, the state's excellent environmental surroundings are countered by poor social conditions (including a very high infant mortality rate).

**Business Vitality - A**
The biggest improvement for North Carolina is a three grade jump in Business Vitality. This progress is due to significant improvements in the competitiveness of existing businesses and a large increase in the rate of new companies being formed. Meanwhile, the state maintains a better than average mix of industries.

**Development Capacity - C**
North Carolina's development resources have inched upwards in rank, if not yet in grade. The state's biggest strength is the nation's best overall financial resources (not just due to its banks: venture capital and small business investment corporations also rank near the top). But human resources and infrastructure are weaknesses: the state ranks 41st in high school graduation, and highway conditions are among the nation's worst.

*The Development Report Card for the States* can be purchased for $75 from CFED at 777 North Capitol Street, NE, Suite 410, Washington, DC 20002, (202) 408-9788.

***Modernization and Entrepreneurship.*** For years, much of economic development has also focused on the "homegrown economy" by providing financial support through grants, low interest loans, and advisory services to businesses. The focus has been on retaining and modernizing businesses in a particular area or on encouraging successful entrepreneurial initiatives. The challenge is to turn these programs into effective delivery systems. Systems such as these must include public and private providers and address the pressing need for businesses to modernize and to upgrade their technologies to maintain competitiveness. Communities need economic development efforts that pursue the high-road of greater skills, higher productivity and better wages, and deliver these development services with greater quality, customer friendliness, accountability and cost-effectiveness.

*Making Development Incentives More Accountable*

The choice of whether to offer development incentives presents a fundamental dilemma for state and local policymakers. On the one hand, most economists agree that they are not good development policy — due to cost, risk, questions of effectiveness, etc. On the other hand, there seems to be no doubt that incentives *can* make a difference in the site selection process, particularly when the choice comes down to one of two similar locations. Thus, business attraction should not be seen as a worthless exercise. Rather, the challenge for state and local governments is to find a better way to respond to this dilemma *and* to act with greater fiscal integrity.

To do this, innovative state and local governments should act on the following five directives:

***Strengthen Accountability and Disclosure.*** If incentives remain in a government's development policy portfolio, they must be accompanied by a range of accountability and disclosure provisions, including:

- Full public disclosure of incentive costs. Some states even disclose how much an individual company benefits from the incentives.

- Rigorous and standardized approaches for calculating the costs of each job created or retained.

- Accurate tax expenditure reporting if tax-based incentives are used.

- "Sunset" reviews to assess the effectiveness and impact of tax and non-tax incentives.

- Establishment of benchmark "return on investment" targets, if incentives are to be enacted or maintained.

***Limit Development Incentives to Strategic Uses.*** Incentives must be designed much more strategically: they should be "custom-fit," not "copy-cat." They must create significant numbers of jobs cost-effectively and fit with the state's highest development priorities. Moreover, policymakers should set clear goals and criteria for what sorts of projects deserve financing. For instance, after a careful evaluation of a jurisdiction's needs, priorities, and opportunities, policymakers might focus on any of the following goals: overall job creation, job growth in slower growing areas, industry diversification, increased minority employment, the attraction of high tech industries, or the creation of "quality" jobs.

***Pick the Right Incentives.*** Since not all incentives are the same, policymakers must give special attention to allocating scarce resources to the types of incentives that have the greatest potential accountability and that are likely to provide the broadest benefits beyond the company assisted. For example, investments in training or physical infrastructure accrue to the broader community and remain in a community, whether a particular company stays or not. Cash grants, on the other hand, belong to private businesses alone.

***Link Incentives and Employment Programs.*** States should also explore how to link "first source" hiring agreements with their incentive efforts. Such agreements require private companies that receive public monies to agree to consider hiring displaced or economically disadvantaged workers through a public or nonprofit operated job referral and training service. One strategy might be to encourage the use of first source agreements in fast-growing areas of a state. This would ensure that recruitment efforts indeed help those most in need of jobs and would also "level the playing field" between high-growth and lower-growth areas. In addition, states should consider cutting incentives for capital investments and using these monies instead for employment-based incentives, such as for new hires, for training, and for above average wages. This is essential if a state is focusing on employment generation more than productivity goals.

***Show Political Leadership.*** Far-sighted state leadership should look for ways to slow the "arms race" by:

- Working with other states to devise workable compacts for responsible incentive competition.

- Exploring the feasibility of federal legislation to restrict interstate bidding wars.[2]

- Educating their constituencies about: (1) the dangers posed by an unregulated incentives arms race and the fact that most new jobs come from expansions and new business start-ups — *not* from relocations, and (2) the fact that creating the conditions for profitable companies (i.e. delivering quality public services in an efficient manner) has a much greater impact on job growth than the combined effects of a state or local community's entire economic development arsenal.

## How Do We Get There?

What are the actions required to begin moving on this new approach to creating healthy business climates? After all, there are many players in the current business climate arena. Economic development is viewed very differently by these myriad actors. And despite the strong case that can be made for a new business climate approach, it will not be easy to get policymakers to adopt a more inclusive concept of economic development. Many interests also benefit from the current state of affairs. Leading spokespersons, representing all political persuasions, are wedded to old ways of conducting public business.

Economic development, furthermore, is not just a technical profession. It is also about politics, contested values, interests, and ideologies. Rational discourse is not something that can be accomplished through governmental edicts and powerful speeches from the "bully pulpit."

But we do need a wider, not a narrower, debate. Economic development is just too important to be left to economic developers. Everybody has a stake in its outcome. Moreover, getting rid of the old paradigm is a practical matter, because practical solutions to our largest challenges require creating partnerships outside the typical department of development or chamber of commerce orbit. Schools, community action agencies, regulators, business trade associations, utilities, banks, trade unions, community development organizations, and many others must be engaged in the solutions. With their help communities can tackle issues like combining increased competitiveness with rising living standards, raising productivity while increasing employment opportunities, or protecting the environment while still creating jobs.

But if we are to succeed at this new development agenda, various constituencies must talk about the issues of jobs and competitiveness differently than they do now. A wide range of key constituencies or opinion leaders can best use these ideas and advance a new positive business climate agenda by playing the following roles.

***Community activists and leaders.*** Leaders have been described as those "who work to transform the world for the better and who inspire others to do the same." Their role is to become more knowledgeable about the issue of business climate and to seek to broaden the discussion of development alternatives and their pros and cons in all relevant public forums. They are in the ideal position to ask the sorts of questions raised in this paper. These questions need more informed and wider public discussion. *In other words, help communities to apply new development concepts to the real world and think more strategically about issues and options.*

***Tax and budget advocates.*** Lobbyists for responsible tax policies and decent human services and income maintenance policies for the poor need to face head-on the challenges posed by governmental budget-cutters by linking their proposals to public and business concerns about jobs and international competitiveness. Practicing responsive and accountable government, in fact, is a sound business climate strategy. A state or locality can spend too much on traditional economic development activities and too little on honest, well-delivered, "bread and butter" public services. Moreover, well-planned and implemented investments in education, health care, and child development should be part of an overall development strategy and should be maintained in both good and bad fiscal times. *In essence, make the case for well-financed and delivered public services and responsible investments in people.*

***City councils and state legislators.*** Elected officials must ensure that the public sector spends its money wisely. Given both tight budgets and growing demands on local government, providing basic public services requires government to act strategically and frugally. Nowhere is this more important than in the area of financing economic development services and business incentives. Just because a policy is in the name of economic development does not mean that it is, indeed, in the public interest. *In short, act as fiscal watchdogs.*

***Mayors and governors.*** We agree that chief executives are the public dealmakers, but we think that their job is to close *good* deals, not just *any* deals.

They must act as prudent investors and not just spenders of taxpayer monies. And given their larger responsibilities for delivering public services responsibly and cost-effectively, they must use their economic development programs and investments to preserve and enhance the state's or locality's assets — its human, physical, financial, natural, and social capital. These fiduciary duties must also be discharged in the most effective manner possible. This means making use of a variety of tools and strategies, inlcuding public provision of services, tax incentives, public-private partnerships, regulation, vouchers, charter schools, labor-management cooperation councils, and so forth. *Hence, be smart investors and do not neglect improving the quality of all development-enhancing public services.*

***Educators.*** Quality public education is an important element of an attractive business climate. But additional investments in education need to take place in the context of reform, rather than providing more funding for "business as usual." *Thus, create an educational system that invests its resources more effectively in preparing all of a state's citizenry for economic and civic success in today's society.*

***Unions.*** Today's unions have new roles to play. Organized labor must cease playing just "nay-saying" roles in economic development debates. They must take a more central place at the table where business climate decisions are made. Moreover, they need to act much more pro-actively in shaping regulatory and tax reforms that are simultaneously pro-worker, pro-business, and pro-consumer. Through their collective bargaining and advocacy roles, they need to explore new ways to create the conditions for more high performance workplaces that combine higher skills, more productivity, and better quality jobs (higher wages, better fringe benefits, more employee input, real career ladders, etc.). *Unions then should shape regulatory and tax reforms whereby the vast majority wins and help to foster more "good jobs."*

***Businesses.*** The private sector is the ultimate creator of jobs. But increasingly in today's economy, the solutions to increased profitability and better and more economic development require building partnerships with other actors. As a result, businesses must find new ways to balance the multiple hats they wear — the pro-education hat, the United Way hat, and the cut-our-taxes hat. Squaring these positions requires seeking creative solutions that give more than lip service to each concern and honestly recognize the real trade-offs and compromises that are inevitable in our imperfect world. *Businesses, above all, must collaborate with other partners in new development efforts and seek new "win-win' alternatives to the traditional business climate conflicts.*

***Media.*** Journalists can add further value to the dialogue we need over appropriate aims and means for economic development by ceasing to frame the larger public debate in the typical "us versus them" ways (for instance, a battle between those that are pro-development versus those who seem to be pro-environment, pro-union, or pro-tax-and-spend.) Instead, they should shine a brighter light on economic development policy and practice to help it meet a higher public standard. Here, the real issue for both taxpayers and development professionals is the same: *How do we achieve greater accountability and make more intelligent public investments?*

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## Endnote

[1] See work done by economists Melvin Burstein and Arthur Rolnick at the Federal Reserve Bank of Minneapolis in *Congress Should End the Economic War Between the States*. Burstein and Rolnick propose that Congress impose sanctions such as taxing imputed income, denying tax-exempt status to public debt used to compete for business, and impounding federal monies owed states involved in such competition. Others have proposed restricting the use of incentives to those areas with high unemployment or slow job growth.