BALANCING THE SCALES OF PROSPERITY:

BRINGING NEBRASKA'S ECONOMIC DEVELOPMENT POLICY INTO BALANCE

CENTER *for* RURAL AFFAIRS

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Balancing the Scales of Prosperity: Bringing Nebraska's Economic Development Policy into Balance[1]

Introduction and Summary

This paper is designed to review Nebraska's business tax incentive programs, primarily the Employment and Investment Growth Act (LB 775). This paper is not designed to be a comprehensive look at the economic performance of Nebraska's business tax incentive programs and whether they have benefited or harmed the economy of the state. The data and information available do not allow such conclusions to be drawn. Instead, this paper is intended to consider and respond to the following questions:

Through the expression of legislation and public policy, what type and size business does the state's economic development policy support?
To what degree is a certain size or structure of business supported over other business size or structure through the economic development policy of the state?
Are all areas of the state experiencing jobs and investment from the business tax incentive policy of the state? If not, what are the implications for those areas not witnessing such jobs and investment, and what are appropriate public policy responses for those areas of the state?

This report will also provide background on two economic development models and strategies that are supported in varying degrees by state public policy – business tax incentives and small business and entrepreneurial development.

In summary, our analysis of the available data shows the following:

- In the most recent year for which data is available (2001), the total amount of tax benefits (income, sales and property taxes) provided LB 775 beneficiaries was $160,496,673. Compared to the state resources currently provided small business and entrepreneurial development ─ $561,250 ─ state economic policy represents a ratio of 286:1 in terms of support of large corporate business versus small business. In other words, for every dollar of support for small business development, $286 supports large corporate business development. Often that public support by the taxpayers of Nebraska is provided to some of the largest and wealthiest corporations in the world.
- Not all areas of the state have benefited from LB 775 investment and employment. A review of all LB 775 beneficiaries shows that areas where nearly a quarter of the state's population resides have received no LB 775 employment and investment, and areas of the state where 38 percent of Nebraskans reside have received 10 percent of LB 775 investment and 9 percent of LB 775 jobs. Conversely, Omaha – with 23 percent of the state's population – has received 43 percent of LB 775 investment and over half of LB 775 jobs.[2]

These data show a state economic development policy severely imbalanced to serve one type of business size and structure and specific areas of the state. The fact that rural areas in general do not benefit from LB 775 has long been a criticism of a program that was intended to benefit all areas of the state. This report and previous studies on LB 775 find that LB 775 investments and jobs tend to gravitate toward areas of the state that already are seeing strong economic growth, and appear to have widened the gap between rural and urban parts of the state.

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[1]This report is made possible by funding from the Ford Foundation and the C.S. Mott Foundation.
[2]This is consistent with previous findings regarding LB 775. See, "Incentives work best in strong economies," *Lincoln Journal-Star*, January 18, 1998, an article outlining the findings of Professors Ernest Goss and Joseph Phillips of Creighton University in their study on LB 775 "Business Tax Incentives: Do The Rich Get Richer?"

These data show that Nebraska's state economic development policy is dominated by the business tax incentive model that is primarily available to large corporate entities and limited areas of the state. This is despite that fact that Nebraska's economy is more varied than the public policy would indicate. Small businesses are a major part of Nebraska's economy and are an important business form and structure for many Nebraska communities and neighborhoods. A healthy small business sector improves the entire economy, and enhances the capacity of the overall economy to absorb and adjust to economic downturns. Firms with 0-19 employees constituted 86 percent of Nebraska firms, and over one-third of the jobs created in Nebraska are by such small businesses.[3] In rural Nebraska, 70 percent of all job growth from 1987 to 1997 was in nonfarm self-employment and small businesses.[4] Despite all of these facts, Nebraska provides limited public policy resources for the creation and expansion of small businesses.

While this paper does not advocate the repeal of LB 775, it does confirm a state economic development policy that needs greater balance. Recent budget actions have only served to widen the imbalance through cuts to programs intended to develop small business and entrepreneurial activities in rural Nebraska. For rural communities to remain economically viable and attractive to young people and families, the Governor and Nebraska Legislature will have to provide greater balance to the state's economic development policy and the types of businesses and activities it develops and supports.

History of Nebraska's Business Tax Incentive Programs

During the mid and latter 1980s, in an effort to respond to unemployment, a declining tax base, and threats from some businesses to leave the state, Nebraska looked to create an economic development policy that would help retain as well as recruit new industries.

The answer provided by the Nebraska Legislature in 1987 was the Employment and Investment Growth Act (LB 775), a performance-based tax incentive program. In addition to this new legislation, the Legislature revised some of the state's tax polices – business and personal income taxes – to coordinate with LB 775.

The popularity of business tax incentive programs amongst the beneficiaries has been the driving force behind promoting them as an essential and strategic part of the state's economic development policy. Moreover, the Nebraska Legislature has continued to respond by implementing additional tax incentive programs that are more pronounced versions of the current policies as well as some that are designed to respond to other business sectors and regions of the state. This report will briefly describe those programs, but will focus on LB 775, the state's largest business tax incentive program. However, the location of jobs and investment attributable to other programs has been included in the data reported in this report where possible under the public data reported by the Nebraska Department of Revenue.

The Employment Expansion and Investment Incentive Act (LB 1124), was passed in 1986 and later amended in 1987 by LB 270. This tax incentive program is designed to stimulate smaller levels of investment and job creation and cannot be used in any same tax year a company would qualify for benefits under LB 775. The Nebraska Department of Revenue reports jobs and investment under LBs 1124/270 only in the aggregate and by application number and not by company, and the location of such jobs and investment are not attached to any particular company or application. Therefore, it is not possible to report job and investment data herein as done with the other programs. Further, event though LBs 1124/270 were meant to accommodate a slightly smaller level of investment and job creation than LB 775, it is not possible to determine what companies have obtained benefits under LBs 1124/270. For the period 1993-2001, 25 percent of all investment under LB 1124/270 went to applicants creating over 20 new jobs in a given year, so it is likely to assume that not all benefits went to the smallest businesses. For these reasons, any benefits provided under LBs1124/270 have not been considered as public support for small business development, though some portion may have been. We admit, therefore, this may underestimate the

[3]U.S. Small Business Administration data, 1996.
[4]*Trampled Dreams: The Neglected Economy of the Rural Great Plains*, Center for Rural Affairs, 2000.

amount of public resources provided to small business development.[5]
In 2000, Governor Johanns and the Legislature looked to address the decline occurring in the rural areas of the state by passing the Rural Economic Opportunities Act (LB 936), advertised as the "rural LB 775." To date, there had been no qualified applicants for this program. This demonstrates that the industrial economic development model exemplified by LB 775 does not necessarily fit the scale or needs of rural communities and economies.

The final tax incentive program, the Invest Nebraska Act (LB 620), which was passed in 2001, is an inflated version of LB 775 and serves as an attempt to draw in larger amounts of investment and create additional jobs. Similar to LB 936, through 2001 this program had failed to produce any qualifying projects, but some qualified projects have been approved in 2002. The Invest Nebraska Act contained several tiers of required investment and job creation, including a "rural tier" that requires smaller levels of investment and job creation.

Proponents of LB 775 have trumpeted it as an overwhelming success, claiming that it has created a significant number of jobs and provided enormous economic benefits for all of Nebraska. Not many people will dispute the fact that LB 775 has created jobs, because it has. However, as the data presented herein will show, it is also eminently clear that the economic development model and strategy represented by LB 775 cannot be applied statewide as it does not address the needs of the entire state.

The LB 775 Program Basics

The Employment and Investment Growth Act (LB 775) can provide companies the benefit of completely eliminating their corporate income tax, sales and use tax, and personal property tax on certain items for up to fifteen years. This is accomplished by earning credits over a seven-year period for meeting the program requirements. These credits can then be used to eliminate the tax liabilities of the company over a fifteen-year period.

This program covers a wide variety of companies and industries. However, there are some companies and industries that are excluded from participating in LB 775, such as restaurants, farming and ranching, retailers (with a few exceptions), contractors and repair persons.

There are three levels under the Employment and Investment Growth Act a business can apply to meet: 1) $20 million investment and no employees; 2) $3 million investment and 30 employees; and 3) $10 million investment and 100 employees.

Most credits can be reaped under any one of these levels. Exceptions are the employee credit, which can only be attained when new employees are hired, and the personal property tax credit, which can only be given under the largest level — $10 million investment and 100 employees. The program does call for the recapturing of credits when a company fails to fulfill the requirements they agreed to meet.

The Department of Revenue compiles very limited reports on LB 775 as required by law. These reports provide some insight into the program such as where the project is located, the number of jobs that have been created, the amount of credits that have been earned and used, the amount of property tax that has been exempted under the law, and other miscellaneous information. This information will be examined here.

Background on Small Business and Entrepreneurial Development

A. Nebraska's Budget Situation and Small Business and Entrepreneurial Development

Nebraska is recognized nationally as a leader in innovative and highly effective entrepreneurial development programs, particularly in rural communities. Nebraska's approach has been community focused and based on support-

[5] Despite this, LB1124/270 tax credits in 2001 were only $4,438,000, about 3 percent of LB 775 credits. A large disparity in large corporate business development vs. small business development remains.

years much of the support for this approach has been lost to budget cuts, program termination and administrative actions. The ability to leverage local and non-state support has been greatly reduced and in many cases lost.

Table 1 summarizes the maximum annual resources committed by the State of Nebraska to rural economic development through various programs and the current amounts remaining in these programs.

Program	Maximum Amount (Annual)	Amount Remaining
Partnerships in Economic Development	$500,000	$0
Capacity Building Grants	$250,000	$0
Rural Development Commission	$365,000	$0
Value-Added Grants	$1,000,000	$0
Main Street Program	$125,000	$113,750
Microenterprise Partnership	$250,000	$250,000
TOTAL	**$2,510,000**	**$363,750**

Table 1.

In addition, the Department of Economic Development devotes approximately $197,500 annually in Community Development Block Grant (CDBG) funds to microenterprise development. CDBG funds are federal funds passed through a state agency. Therefore, a total of $561,250 in state and state administered CDBG funds goes toward small business and entrepreneurial development in Nebraska.

B. Microenterprise Partnership Program

Nebraska is unique in that new business startup and survival rates in rural areas are as strong or stronger when compared to metro areas.[6] One reason for this success is Nebraska's nationally recognized network of rural microenterprise development programs supported by the Nebraska Microenterprise Partnership Fund (NMPF). Nationally recognized organizations such as the Rural Enterprise Assistance Project (REAP), GROW Nebraska and EDGE have been recipients of state microenterprise funds, and have created numerous businesses and jobs in rural Nebraska. Budget actions in 2001 and 2002 reduced state support for this program by half.

The 2001 Special Session reduced the appropriation to the Nebraska Microenterprise Partnership Fund by a total of $40,000. LB 1309 in the 2002 regular session of the Legislature reduced the Nebraska Microenterprise Partnership Fund by an additional $210,000 annually to its present funding level of $250,000 annually.

<u>Who are the Primary Beneficiaries of LB 775?</u>

Table 2 on the next page divides population centers of the state according to municipal classifications of Nebraska law. The population percentages for each classification are based on total state population according to the 2000 Census. According to Nebraska law, Omaha and Lincoln are separate municipal classifications; Class 1 cities are those with a population of 5,000 to 199,999; Class 2 cities include those with populations between 800 and 4,999; and villages are those communities with a population between 100 and 799. The classification each municipality falls into was determined by the listing in the *2002 Nebraska Directory of Municipal Officials* published by the Nebraska League of Municipalities. The "Other" classification includes the remainder of the state's population that does not reside in one of the municipal classifications – unincorporated communities or rural areas.

[6] *Small Cities Abuzz with Business in Nebraska*, Edward L. Fitzsimmons, Business in Nebraska (Bureau of Business Research, University of Nebraska-Lincoln, April 2002).

The percentage of LB 775 investment and employment by municipal and geographic placement was determined though an analysis of all approved LB 775 applications as outlined in reports from the Nebraska Department of Revenue. Most LB 775 projects list a specific project location; for those projects that list their location as "statewide" or where multiple locations were indicated, their location was determined to be in the municipal classification of the company or business headquarters.[7]

The Employment and Investment Growth Act (LB 775) technically is a statewide program. However, the reality appears to be much different than the hypothetical goal. As indicated by Table 2 below, a majority of the projects approved since the birth of LB 775 are located within metropolitan areas, particularly Omaha. In relation to Omaha's percent of the population, the program is heavily disproportionate in its favor, claiming 43 percent of investment and 53 percent job creation, while representing only 23 percent of the state's population. Lincoln's use of LB 775 is generally in proportion to heir share of the state's population, while Class 1 cities have also received a disproportionate share of LB 775 benefits. The more rural parts of the state – Class 2 cities, villages and rural areas – have received a disproportionate share of LB 775 jobs and investment significantly less than their share of the state's population.

Table 2 demonstrates the inability of the business tax-incentive strategy to be a statewide program providing statewide benefits. This should send a signal to state policymakers that this "one-size fits all" model cannot hope to meet the needs of all communities in the state and that different economic development models need to be considered and supported for different parts of the state.

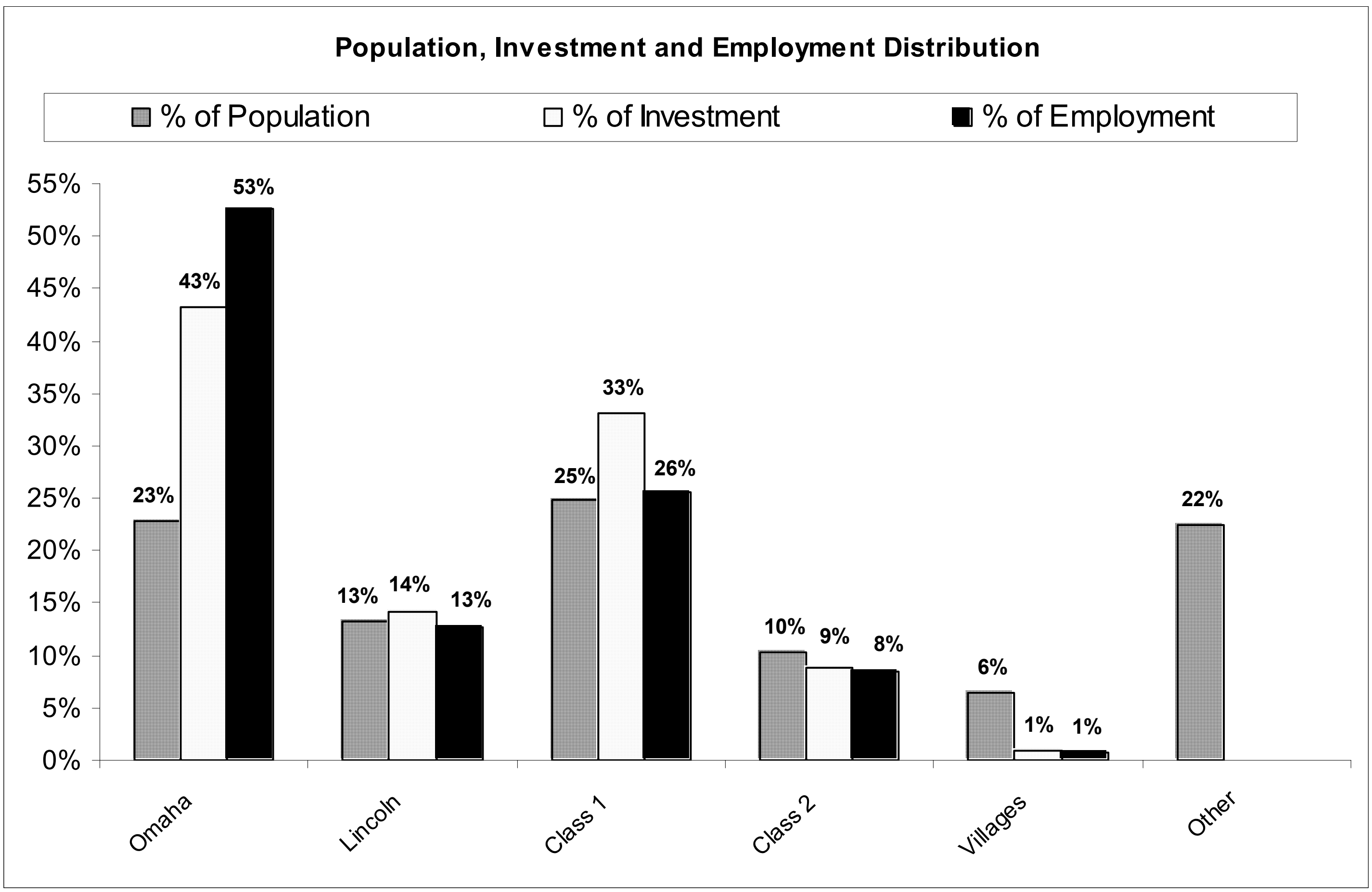

Table 2.

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[7]The percentages in Table 2 may not equal 100 due to rounding

Job Creation Cost Under LB 775

The old saying "There is no such thing as a free lunch" can also be applied to LB 775 because there are costs associated with it. While it is true that this program has created jobs, they do come at a high cost – much higher than the amount devoted to promoting entrepreneurship and small business.

According to the 2001 report produced by the Nebraska Department of Revenue, qualifying companies have created 71,460 jobs through 2001 and have reaped nearly $1.3 billion in tax credits, which includes sales and income tax exemptions. Assuming all of the jobs were created due to the presence of LB 775, each job cost $18,225 to create (compared to the average wage of such jobs of $27,396, as reported in the same Department of Revenue data). Additionally, when figuring in the amount of property tax avoided through LB 775, which totaled over $120 million through 2001, the cost per LB 775 job increases to $19,905.[8]

This cost per job figure is lower, but consistent with a previous study on LB 775 by Ernest Goss and Joseph Phillips of Creighton University in 1997. In their study "Business Tax Incentives: Do the Rich Get Richer?" Goss and Phillips assumed that all LB 775 jobs are "new" (as has been here), and determined that the cost per job in 1993 dollars was $28,685.[9]

Contrary to the cost of creating the jobs mentioned above, the costs associated with creating jobs through entrepreneurial and small business development remain much lower. The Nebraska Microenterprise Partnership Fund figures that each job created through a loan made by NMPF grantees costs $729; for the state's investment in the NMPF, the cost per job for all jobs created by loans and trainings associated to NMPF grantees is $176 per job.[10]

LB 775 Program Cost

Tables 3 and 4 below outline the cost of LB 775 since its inception to 2001. The amounts are broken down by both revenue type and state and local costs. All data is from the Nebraska Department of Revenue Annual LB 775 reports.

Revenue Type	*1988-99*	*2000*	*2001*	*Total*
State Income Tax Credits	$347,812,532	$58,909,065	$43,246,720	$449,968,317
State Sales Tax Credits	$554,013,078	$74,872,536	$86,095,486	$714,981,100
City Sales Tax Refunds	$104,151,763	$15,061,578	$18,187,979	$137,401,320
Total Credits Used*	$1,005,977,373	$148,843,179	$147,530,185	$1,302,350,737
Property Tax Avoided	$95,634,957	$11,427,525	$12,966,488	$120,028,970
Total Program Cost	$1,101,612,330	$160,270,704	$160,496,673	$1,422,379,707

Table 3.

[8]Unpublished data, Appleseed Center for Law in the Public Interest; Associated Press article, August 28, 2002.
[9]The Goss/Phillips report also stated that if only 30 percent of LB 775 jobs are "new," the cost per job soars to $95,947. Goss and Phillips speculate the true cost is probably somewhere between $28,685 and $95,947. The 30 percent estimate of new job creation is also an estimate of the Nebraska Department of Revenue in 1992. If the 30 percent "new" job figure were used in this report, the LB 775 cost per job would be $66,349.
[10]*Report to the Legislature on the Nebraska Microenterprise Development Act (LB 327)*, January 2002, pages 6 and 13. A total of 1,421 were created or retained by loans and/or trainings associated with NMPF grantees. The state's appropriation to the NMPF during the period in question was $250,000; 250,000/1,421 = 175.93.
*LB 775 credits used are net of recapture

State and Local Costs	*1988-99*	*2000*	*2001*	*Total*
State Income Tax Credits	$347,812,532	$58,909,065	$43,246,720	$449,968,317
State Sales Tax Refunds	$554,013,078	$74,872,536	$86,095,486	$714,981,100
Program Cost – State	$901,825,610	$133,781,601	$129,342,206	**$1,164,949,417**
City Sales tax Refunds	$104,151,763	$15,061,578	$18,187,979	$137,401,320
Property Tax Avoided	$95,634,957	$11,427,525	$12,966,488	$120,028,970
Program Costs – Local	$199,786,720	$26,489,103	$31,154,467	**$257,430,290**
Total Program Cost	$1,101,612,330	$160,270,704	$160,496,673	$1,422,379,707

Table 4.

Conclusion and Policy Recommendations

While we do not dispute that LB 775 has created jobs and economic benefits in many communities of the state, it is clear it has done so at a price and has not directly benefited many rural communities through jobs and investment. Nebraska, therefore, cannot be said to have an effective, statewide economic development policy.

Meanwhile, Nebraska has a cost-effective program that helps develop small businesses – many in rural areas – at a low cost per job. Yet this program and other rural economic development programs have suffered significant budget cuts, and in some cases termination, over the past several years.

Nebraska's state policymakers should take immediate steps to bring the state's economic development policy into greater balance. Those programs that help develop small businesses and entrepreneurial activities will not achieve perfect balance with LB 775 benefits, but neither should they accept policies that leave them state funding crumbs. With the objective to bring the state's economic development policy into better balance, we offer the following policy recommendations:

- **No further budget cuts to small business development programs.** As the Nebraska Legislature faces the prospect of creating a new biennial budget and the need for additional budget actions, programs devoted to small business development and rural development should not be cut any further. As outlined above, these programs have already been cut significantly. The impacts in rural Nebraska – one of the lowest income areas of the nation – would be significant, and at a time when jobs and businesses are desperately needed in rural Nebraska, programs that provide them should be retained and nurtured, rather than damaged through budget cuts.
- **The Nebraska Legislature should establish a target for public investment in small business and entrepreneurial development as a percentage of corporate job creation and investment subsidies.** To begin to bring the state's economic development policy into better balance, we recommend that the Nebraska Legislature establish a target for public spending and resource allocation for small business and smaller-scale entrepreneurial development in comparison to LB 775 tax benefits. We would recommend this target for small business development and smaller-scale entrepreneurial development be at least 20 percent of LB 775 benefits.
- **Provide additional resources for small business development and entrepreneurial activities through modifications to LB 775.** We believe that the state's economic development policy can be brought into better balance through modifications to LB 775 in ways that will not damage the basic benefits provided to beneficiaries of LB 775 and which will not adversely affect the state budget. We propose:

♦ Raising revenue by increasing the LB 775 application fee and the LB 775 recapture percentage to one-third of allowable refunds, credits and tax reductions (the same recapture percentage in the Employment Expansion and Investment Incentive Act, LB 1124 and LB 270).
♦ Devote such revenues to: 1) reauthorization and refunding of the Nebraska Agriculture Opportunities and Value-Added Partnership Act (LB 1348); 2) restoration of the funding cut to the Nebraska Microenterprise Partnership Fund during the 2001 and 2002 regular and special sessions of the Legislature; 3) the Small Business Investment Tax Credit outlined below; and 4) the state General Fund. We estimate items 1 through 3 would cost $2.25 million annually. As such, that will still result in a 62:1 ratio of state support for large corporate development versus small business and entrepreneurial activities. That would leave a state policy still grossly out of balance, but not quite as imbalanced as current policy.

- **Create and fund a Small Business Investment Tax Credit.** As this report has shown, the state of Nebraska has a public policy that provides large subsidies for large corporate business development through tax credit and other tax allowances. Yet nothing similar is provided to small businesses that are developing or expanding. Small businesses are a major part of Nebraska's economy and are an important business form and structure for many Nebraska communities and neighborhoods. A healthy small business sector improves the entire economy, and enhances the capacity of the overall economy to absorb and adjust to economic downturns. Firms with 0-19 employees constituted 86 percent of Nebraska firms, and over one-third of the jobs created in Nebraska are by such small businesses.[11] In rural Nebraska, 70 percent of all job growth from 1987 to 1997 was in nonfarm self-employment and small businesses.[12] Despite all of these facts, Nebraska provides limited public policy resources for the creation and expansion of small businesses and smaller-scale entrepreneurial activities.

Missouri and Vermont currently have laws that provide tax credits for the creation and expansion of small businesses.[13] We believe Nebraska – given the disparity highlighted here and the importance of small business to the state economy – should adopt similar policy. We propose:

♦ The creation of a Small Business Investment Tax Credit that would provide an individual and business income tax credit for the investment of funds in the creation and expansion of a small business.
♦ The credit would equal 20 percent of up to $25,000 in investment over five years for qualifying small businesses.
♦ Qualifying small businesses would include: 1) creation of new start up small business with no more than 20 employees); 2) expansion of existing microenterprise businesses (5 or fewer employees). Qualifying businesses would also be required to be independently owner operated non-production agriculture commercial entities with its principal place of business in Nebraska.
♦ Investment would be any legitimate business expense for qualifying business.
♦ The initial cost of the credit would be limited to $1 million annually.

Together we believe these policy options would bring greater balance to the state's economic development, both in terms of resources and geography. These policy options will lead to a state policy and plan that truly is statewide and meets the needs of communities, neighborhoods and individuals across the state.

[11] U.S. Small Business Administration data, 1996.
[12] *Trampled Dreams: The Neglected Economy of the Rural Great Plains*, Center for Rural Affairs, 2000.
[13] Missouri Revised Statutes, Chapter 135, Section 135.403; Vermont Statutes Annotated, Title 32, Section 5930g.

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