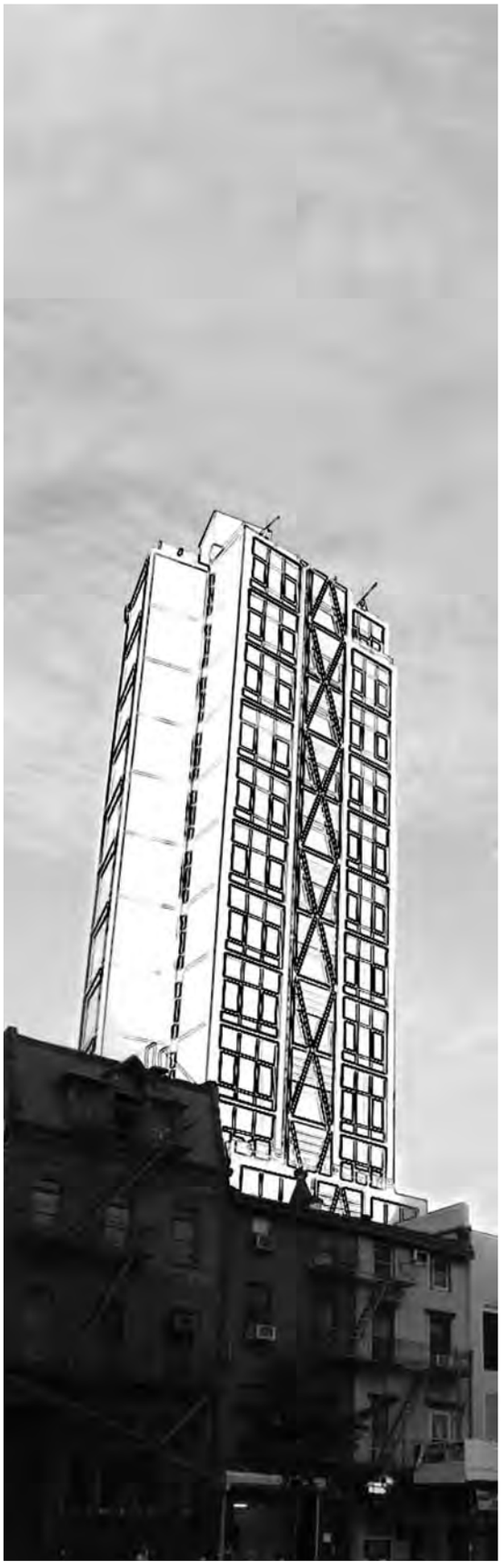
Optimizing the Use of Economic Development Incentives

by Jonathan Q. Morgan



The recent economic downturn has increased the sense of urgency among state and local governments for stimulating private investment and job creation. Tax and financial incentives are widely used tools for promoting economic development. The proliferation of business incentives for economic development is controversial, in part, because public officials often fail to adequately assess the net return on the public investment in incentive deals. Other concerns about the growing use of incentives center on the fundamental question of whether they work and the rationale for using them in the first place. That incentives actually influence business location decisions is the strongest argument offered by proponents for their continued and expanded use. While there is some evidence to support this claim, skeptics counter with numerous studies that show incentives have little to no positive, direct effect on investment decisions.[1]

Despite the ongoing controversy over economic development incentives, there is no end in sight to the escalating competition among jurisdictions—one that has been likened to an arms race. It is foolhardy to think that state and local governments will unilaterally "disarm" and stop using incentives in the near future. Legislation calling for a cease-fire to the economic war among the states has been introduced periodically in the U.S. Congress, but it is unlikely to be enacted any time soon. Since it is likely that many jurisdictions will continue to offer business incentives in the foreseeable future, public officials must be more strategic and judicious in using incentives to bring about desired economic development outcomes.

North Carolina's recruitment, and impending loss, of a Dell, Inc. computer-assembly plant highlights some of the major opportunities and challenges in using incentives. With the Dell project as a backdrop, this article discusses some of the key concerns about incentives, and recommends how public officials can make better use of incentives by taking steps to maximize public benefits and enhance accountability.

State governments offer both tax and non-tax incentives to companies. North Carolina's state-level tax incentives consist primarily of corporate income- and franchise-tax credits, and sales-tax exemptions and refunds.[2] Other state-level, non-tax incentives in North Carolina are in the form of discretionary grant programs (in which funds are awarded on a case-by-case basis), low-interest loans via industrial revenue bonds, job training, and infrastructure assistance.

Many local governments in the U.S. use property tax abatements as a discretionary tax incentive to promote economic development.[3] However, property tax abatement is not legal in North Carolina[4] and some other states, so local governments in those states provide discretionary cash grants to businesses instead. Cash grants are typically paid out over a number of years, though some portion is often provided at the onset. The grants are usually performance-based, which means that they are tied to the number of jobs and level of capital investment the business creates, and the recipient may be required to forfeit some or all of the grant monies if it fails to meet certain performance thresholds in a given year. Some cities and counties base the amount of the grant on a percentage of the property taxes paid by the recipient company. According to a recent survey of North Carolina local governments, only zoning and infrastructure improvements are used more readily than cash-grant incentives.[5] Other common local incentives include tax-increment financing, low-interest loans, subsidized training for workers, and relocation assistance.

The Dell Project

The recruitment of Dell, Inc. to North Carolina is instructive on how various state and local incentives are used to promote economic development. The largest part of the state package for Dell was a tax credit, tied to the number of computers produced at the new North Carolina facility. The General Assembly enacted this special tax credit in 2004, during an extra legislative session, in order to ensure that Dell would locate somewhere in the Piedmont Triad Region of the state.[6] Other components of the state incentive package included statutory corporate income-tax credits, job creation/development grants, and funds for job training.

Once Dell chose North Carolina, local governments in the Triad region—Davidson County, the City of Greensboro and Guilford County, and the City of Winston-Salem and Forsyth County—proposed separate local incentive packages to lure the facility to their respective jurisdictions.[7] Winston-Salem/Forsyth had been rumored to be the preferred location and offered the largest package, which consisted of cash grants, subsidized land, and funds for surveying, grading, paving, road construction, public utilities, and other site improvements. It is not entirely clear how influential the local incentives were, but Dell ultimately decided on the Winston-Salem site in Forsyth County. The state and local incentives for Dell were largely dependent on the company meeting certain performance targets with respect to employment (1,500-1,700 jobs) and capital investment ($100 million). Most of the incentive dollars were to be paid out annually over a period of time. In October 2009, Dell announced that it would be closing the North Carolina plant in 2010, after just four years in operation.

The Dell project raises questions about whether incentives are worth the public investment, and offers lessons on how incentive deals should be structured. North Carolina's experience with the recruitment and eventual loss of the Dell facility suggests that public officials should address at least three points of contention to optimize the use of economic development incentives, namely: the extent to which incentives are effective, fair, and used with accountability. It is important for state and local officials to understand incentives within the context of these three issues if they are to make better and wiser use of incentives as tools for fueling economic growth and prosperity.

Effectiveness

If tax and other financial incentives are to be considered as economic stimulus tools rather than mere "corporate welfare," they should directly sway business investment and job-creation decisions. However, the research findings here are mixed. A study of state incentives in Ohio identified different effects on the actual employment growth of firms versus the employment levels they initially promised.[8] Researchers found that incentives had a negligible effect on actual employment growth in firms, but had a positive correlation to announced job growth. These findings suggest that incentives may cause firms to overstate the number of new jobs they will create. A recent analysis of North Carolina's state tax credits suggests that "tax incentives go to firms without significantly influencing their decisions on investment and employment."[9] A possible explanation for this is that taxes and incentives account for only a small portion of business operating costs and, therefore, do not matter all that much. However, in surveys, companies tend to emphasize the importance of incentives (and they have a vested interest in doing so), but business surveys show that incentives are only one of several factors that companies consider when making a decision on where to locate. For example, in *Area Development* magazine's most recent corporate survey, incentives ranked seventh out of 25 site-selection factors.[10]

Assuming that incentives are effective at promoting state and local economic growth overall, to what extent do they work for the people and places most in need? This question is related to the fairness concern discussed below, but also has implications for the overall effectiveness of incentives, especially those that target economically distressed areas. Some studies suggest that poor people and places can experience the greatest gains from economic development incentives,[11] and North Carolina's tax-credit program seeks to steer jobs and investment to poorer communities by offering larger credits to businesses that located in counties with higher unemployment rates and lower income levels. There is evidence that this aspect of the incentive program is "particularly effective in encouraging firms to invest more and hire more workers in economically distressed areas."[12] In some other states, traditional incentives appear to only stimulate growth in prosperous areas, such that growth begets growth.[13]

In sum, the research to date suggests that economic development incentives do not always induce firms to create substantial jobs and investment that would not otherwise occur without the incentives, despite the fact that companies say incentives are important factors in their business location decisions. Ultimately, the empirical research findings must be interpreted in light of the economic and political realities that states and localities face in a turbulent economy. In a climate of intense global competition, manufacturing plants continue to close and move off-shore, and residents continue to lose jobs; in turn, local governments lose revenues and are left, sometimes, with underutilized public infrastructure. This generates political pressure to act, or at least appear to be taking action, to improve economic conditions. In this context, economic development incentives might prove "effective" in ways that are difficult to capture in numbers.

If nothing else, it appears likely that incentives improve the competitive positions of states and localities and help them close deals. To appreciate this requires an understanding of the site-selection process that businesses (often assisted by hired consultants) use when making the decision about where to locate or expand.[14] Incentives do not typically matter until a firm has narrowed the list of possible locations to a few that meet all of its other requirements (i.e.,

continued on page 26



Jonathan Q. Morgan is an Assistant Professor of Public Administration in the School of Government at the University of North Carolina (UNC) at Chapel Hill, where he teaches, advises, and conducts applied research on economic development. Prior to joining UNC in 2003, he worked for Regional Technology Strategies, Inc., an economic and workforce development consulting firm located in Carrboro, N.C., and served as Director of Policy and Research for the N.C. Department of Commerce. He holds a B.A. in economics from the University of Virginia, an M.P.A. from Clark Atlanta University, and a Ph.D. in public administration from North Carolina State University.

 continued from page 25

for a site, building, infrastructure, and workforce). At that point, the incentives offered can tip the scale in favor of one location over another.

Fairness

The concern about whether or not incentives are fair addresses who reaps the benefits and who bears the costs of economic development policies. With incentives, some businesses clearly benefit, but others may lose out. When a government provides tax concessions, grants, and other assistance to certain businesses and not others, it has the appearance, if not the effect, of treating comparable taxpayers unequally.[15] The perception that incentives go mostly to new companies locating in a community can breed resentment among established firms, particularly those that are direct competitors of the aid recipient. Moreover, the minimum job creation and investment requirements of most incentive programs typically make small businesses ineligible. The counter-argument is that it is sensible to discriminate and provide special treatment to those that create large numbers of jobs and make significant investments in a community, because this benefits the greater good. For example, some evidence suggests that, when economic development policies stimulate local growth, they also improve the distribution of income by enhancing job opportunities for minorities and the less-educated.[16] Accordingly, if economic development incentives do indeed serve a larger public purpose, their benefits should extend beyond private companies to other taxpayers. This is more likely to occur if the companies receiving incentives hire local residents and invest in distressed areas with high unemployment.[17] While most recruitment projects are likely to boost economic activity in a location, there is no guarantee that local residents will get many of the new jobs.

If incentives convince a company to build in a place where it otherwise would not, taxpayers will gain economic opportunities and resources that might justify the millions of dollars in incentives. On the other hand, if the incentives were not the determining factor, they might be an inequitable transfer of business costs from selected corporations to other taxpayers. Is it "fair" for the taxpayers of one jurisdiction to subsidize a business that creates jobs for the residents of another jurisdiction, particularly where taxpayers in one locality are on the hook for the incentives? Indeed, this was the case with the Dell project—the City of Winston-Salem and Forsyth County anted up for the incentives, while jobs at the plant undoubtedly went to workers from multiple surrounding jurisdictions.

Accountability

One of the most common criticisms of incentives is that they are frequently provided without sufficient accountability being available to taxpayers and the broader public interest. Corporate mergers, changing economic conditions, and intense global competition can lead companies to drastically change their investment plans, creating the possibility that they will fail to deliver on their promises to create a certain number of jobs or meet a specified level of capital investment.

As mentioned, Dell plans to close its North Carolina facility in 2010, a few short years after being enticed with an aggressive incentive package. The incentives contract between Dell and the local governments is performance-based and contains clawback provisions, such that the company is expected to repay $26.5 million, a sum that represents nearly all of the local funds received in incentives so far. Beyond $1.5 million in job-creation grants, it is unclear precisely how much of the state incentives can be reclaimed.

The Dell project is a case study on the importance of having proper safeguards in place to protect taxpayers in the event that a business fails to perform as expected. Even when companies fulfill employment and investment expectations, the impact estimates of the ripple effect on a community are mere forecasts based on imperfect economic models. For example, a recent report suggests that the model used by the North Carolina Department of Commerce to assess incentive packages tends to overstate the economic benefits that firms will provide, and leads to overbidding.[18] Using more conservative assumptions, the authors estimated that the Dell project would have had a much smaller effect on the state's economy than initially projected, illustrating that economic and fiscal-impact analysis is imprecise, and must be interpreted with caution.

Another accountability concern is the secretive nature of early incentive negotiations. Companies require that their investment plans be kept confidential in order to protect trade secrets and avoid "tipping their hand" to competitors; also, because they do not want information on pending plant closures elsewhere to leak out,[19] and to avoid excessive real-estate speculation that might drive up the costs of land acquisition.[20] Under certain conditions, North Carolina state law allows for confidentiality, the withholding of public records, and protection of trade secrets on economic development projects.[21] As a result, state and local officials often commit public dollars before the details of a deal are widely known to the general public, and face the dilemma of balancing a company's need for confidentiality and anonymity against the public's right to know.

Getting the Most Out of Incentives

Incentives are not inherently good or evil, right or wrong, wise or foolish. They are tools that public officials can use more prudently—or less so—depending on their application. Public officials are at a disadvantage in incentive negotiations because a company has access to much more information on what other jurisdictions are offering, and which alternative locations are viable—and only the company knows, for sure, the amount of incentives that will tip the decision in favor of one location over the others. As a result, public officials should be armed with as much information as possible, and be equipped to assess the trade-offs among effectiveness, fairness, and accountability in using incentives to promote job creation and private investment. Taking steps to address each of these issues will make expenditures

on economic development incentives more defensible.

Several mechanisms exist that can help jurisdictions win in using incentives but avoid the "winners curse" of paying too much for too little in return.[22] These include certain safeguards already adopted in many states and localities, such as tying incentives to business performance, targeting distressed areas, and wage/job quality standards. In addition, North Carolina's experience in attracting (and subsequently losing) the Dell facility suggests that the following features are among those than can improve the use of economic development incentives:

- enforceable contracts that clearly specify performance standards, monitoring and disclosure requirements, and penalties for noncompliance (e.g., clawback provisions);[23]
- a rigorous and realistic cost-benefit analysis based on conservative assumptions to better estimate, at the onset, the net economic and fiscal impacts of a project in order to determine a reasonable amount of incentives to offer;
- greater transparency, reporting, and evaluation in order to keep taxpayers informed about the amount of public dollars being spent on incentives relative to the expected and actual returns on that public investment;[24]
- regional cooperation in sharing the costs of incentives among the multiple jurisdictions that will enjoy the economic and fiscal benefits of a project;[25]
- stronger inducements to hire local residents and the unemployed. One way to do this without harming local competitiveness is to encourage firms receiving incentives to participate in "First Source" employment screening and referral programs;[26] and
- a greater focus on providing effective and meaningful incentives for small businesses, existing industries, and job training as a way to promote "homegrown" development.

Taken together, these incentive policy enhancements will help jurisdictions strengthen their negotiating position with companies, maximize public benefits, and protect the public investment in incentive deals.

Author's Note: This article is adapted from "Using Economic Development Incentives: For Better or For Worse," published in Popular Government, vol.74, no.2, © 2009 UNC School of Government.

Notes

1. For a review of these studies, see Alan Peters & Peter Fisher, *The Failures of Economic Development Incentives*, 70 J. Am. Plan. Ass'n 27 (2004).
2. Jonathan Q. Morgan & David M. Lawrence, *Economic Development, Article 26, County and Municipal Government in North Carolina*, UNC School of Government (2007).
3. Steven G. Koven & Thomas S. Lyons, *Economic development: What local governments do*, ICMA Special Data Issue 2:1-12.
4. N.C. Const. art. V, § 2(2) (stating that "[o]nly the General Assembly shall have the power to classify property for taxation, which power shall be exercised only on a State-wide basis and shall not be delegated…").
5. Jonathan Q. Morgan, *The Role of Local Government in Economic Development: Survey Findings from North Carolina*, UNC School of Government, June 2009.
6. 2004 N.C. Sess. Laws 204 Extra Session (S 2).
7. *See* Matt Harrington, *Regional Plan Won't Happen for Dell Deal*, The Business Journal of the Greater Triad Area, Nov. 29, 2004; *see also*, Matt Harrington, *With Dell Confirmed for the Triad, Economic Developers Must Now Compete with Each Other*, The Business Journal of the Greater Triad Area, Nov. 09, 2004.
8. Todd M. Gabe & David S.Kraybill, *The Effect of State Economic Development Incentives on Employment Growth of Establishments*, 42 J. Regional Sci. 703 (2002).
9. Michael I. Luger & Suho Bae, *The Effectiveness of State Business Tax Incentive Programs: The Case of North Carolina*, 19 Econ. L.Q. 327, 339 (2005).
10. 23rd Annual Corporate Survey, Area Development, 2008, at http://www.areadevelopment.com.
11. Timothy J. Bartik, *Who Benefits from State and Local Economic Development Policies?*, Kalamazoo, MI: W.E. Upjohn Institute for Employment Research (1991).
12. Luger & Bae, *supra* note 9 at 338.
13. *See* Ernest P. Goss & Joseph M. Phillips, *Do Business Tax Incentives Contribute to a Divergence in Economic Growth?*, 13 Econ. Dev. Q. 217 (1999).
14. *See* Mark Sweeney, *The Challenge of Business Incentives for State Policymakers: A Practitioner's Perspective*, 77 Spectrum J. St. Gov't 8 (Winter 2004); Phillip D. Phillips, *Site Selection: Corporate Perspective and Community Response*, 9 Econ. Dev. Rev. 4 (1991).
15. David Brunori, *Principles of Tax Policy and Targeted Tax Incentives*, 29 St. & Loc. Gov't Rev. 50 (1997).
16. Bartik, *supra* note 11.
17. Timothy J. Bartik, *Jobs for the Poor: Can Labor Demand Policies Help?*, New York: Russell Sage Foundation and Kalamazoo, MI: W.E. Upjohn Institute for Employment Research (2001).
18. *See* Elaine Mejia, Kristopher Nordstrom & William Schweke, *Getting Our Money's Worth? An Evaluation of the Economic Model Used for Awarding State Business Subsidies*, N.C. Budget & Tax Center and CFED (Mar. 2007).
19. David M. Lawrence, *Economic Development Law for North Carolina Local Governments* (Chapel Hill, NC: UNC Inst. of Gov't, 2000) at 90.
20. Zach Patton, *Hush Money: Why are Tax Incentive Deals Almost Always Negotiated in Private?* 21 Governing 50 (Aug. 2008), available at: www.governing.com.
21. N.C. Gen. Stat. § 132-1.2 (2009) (Public Records Law); N.C. Gen. Stat. § 66-152 (1981) (Trade Secrets Protection Act); N.C. Gen. Stat. §132-6(d) (2005).
22. Charles J. Spindler, *Winners and Losers in Industrial Recruitment: Mercedes-Benz and Alabama*, 26 St. & Loc. Gov't Rev. 192 (1994).

continued on page 38

Pandemic

cont. from page 37

3. For more information, see The Centers for Disease Control and Prevention (CDC), *CDC Guidance for Businesses and Employers To Plan and Respond to the 2009–2010 Influenza Season* (Oct. 21, 2009); OSHA, *Worker Guidance: Precautions For All Workers during the 2009-2010 Flu Season* (Nov. 05, 2009), and OSHA, *Guidance on Preparing Workplaces for an Influenza Pandemic*, OSHA 3327-02N 2007 (Feb. 01, 2007) at http://www.osha.gov/Publications/influenza_pandemic.html.
4. *CDC Guidance for Businesses and Employers To Plan and Respond to the 2009–2010 Influenza Season* (Oct. 21, 2009).
5. 29 C.F.R. § 541.602 (2004).
6. For additional information, see *Pay and Absence Concerns for Exempt Employees*, by the Boardman Law Firm.
7. CDC, *People at High Risk of Developing Flu-Related Complications* (Nov. 10, 2009).
8. *See, e.g.*, the Americans With Disabilities Act, 42 U.S.C.§ 12111(3) (West 2009).
9. For example, a major exception to many states' at-will employment doctrines is "discharge against public policy."
10. The CDC suggests, for example, that employers develop flexible leave policies to allow workers to stay home, and not require a doctor's note for workers who are ill with influenza-like illness to validate their illness or to return to work, since doctors' offices and medical facilities may be extremely busy and not be able to provide such documentation in a timely way. CDC Guidance, *supra* note 4.
11. Freeman v. Chertoff, 604 F. Supp.2d 726 (D. N.J. 2009).
12. Robinson v. Bodman, 333 Fed. Appx. 205 (9th Cir. 2009).
13. "[O]ver the course of the 477 hours that Robinson worked from home, the only work she produced was one half-page report." *Id.* at 208.
14. No. 2:2009cv00289 (E.D. Wis., filed Mar. 15, 2009). *See also*, Abdelkhaleq v. Precision Door of Akron, No. 5:07 CV 3585, 2009 WL 2762356 (N.D. Ohio Aug. 28, 2009) (employee on "pager duty" sued under FLSA claiming time spent on-call constituted time spent working). ML

Merger of Adjoining Parcels

cont. from page 17

29 Cal.4th 990 (Cal. 2003) (holding that lots shown on an 1865 map but never individually deeded were not entitled to grandfather status, absent any law then authorizing divisions of land by map).
4. *See, e.g.*, San Diego, Calif. Code § 125.0760 (2000).
5. Cal. Gov't Code § 66451.10, *et seq.* (West 2009). For a thorough account of California's merger law, see *Merger and Local Governments* (1986), available from the California Governor's Office of Planning and Research.
6. *See* Stell v. Jay Hales Dev. Co., 11 Cal. App. 4th 1214 (Cal. Ct. App. 1992); *see also*, Citizens for Covenant Compliance v. Anderson, 12 Cal. 4th 345 (Cal. 1995) (disapproving a ruling in *Stell* regarding enforceability of restrictive covenants).
7. 11 Cal. App. 4th at 1223-24.
8. Cal. Gov't Code § 66451.10, *et seq.* (West 2009).
9. Cal. Gov't Code §§ 66451.12 to 66451.17 (West 2009).
10. 11 Cal. App. 4th at 1224-25.
11. Cottone v. Zoning Hearing Bd. of Polk Twp., 954 A.2d 1271 (Pa. Commw. Ct. 2008).
12. *Id.* at 1276.
13. *Id.* at 1279.
14. *Id.*
15. 151 Cal. App.4th 827 (Cal. Ct. App. 2007).
16. *Id.* at 834. ML

Economic Incentives

cont. from page 27

23. Rachel Weber, *Do Better Contracts Make Better Economic Development Incentives*, 68 J. Am. Plan. Ass'n 43 (2002).
24. Greg LeRoy, *Nine Concrete Ways to Curtail the Economic War Among the States, in Reining in the Competition for Capital*, Ann Markusen, ed. (Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 2007).
25. Scott J. Ziance, *Making Economic Development Incentives More Efficient*, 30 Urb. Law. 33 (1998).
26. Timothy J. Bartik, *Solving the Problems of Economic Development Incentives*, 36 Growth & Change 139, 143 (2005). ML

Supreme Court

cont. from page 23

process right of the plaintiffs." By the time the case reached the oral argument stage before the Supreme Court, all of the underlying property disputes had been resolved, either because the property had been returned or because the plaintiff had relinquished a claim to the property. The Supreme Court, in an opinion authored by Justice Breyer, vacated and remanded on the basis that, in such circumstances, the case no longer presented an Article III "case or controversy." An actual controversy had to exist at all stages of review, not just when the complaint was filed, and the complaint before the Court sought only declaratory and injunctive relief, not damages (a damages claim was launched only after the Seventh Circuit issued its ruling). Because the "case more closely resemble[d] mootness through 'happenstance' [rather] than through 'settlement,'" the exception to vacating the judgment set out in *U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership*, 513 U. S. 18, 21 (1994), did not apply (namely, that, by virtue of a settlement, a party had "voluntarily forfeited his legal remedy by the ordinary processes of appeal or certiorari"). The Court concluded that "we should follow our ordinary practice, thereby 'clear[ing] the path for future re-litigation of the issues.'" The upshot? Local governments will need to wait for this future re-litigation to clarify how long law enforcement officers may retain seized property without providing for administrative review and without offending due process. ML

Ordinances

cont. from page 29

District of Columbia voters adopted an initiated ordinance in 1998, which has not been adopted by Congress.
2. Joel Warner, *Medical marijuana has become a growth industry in Colorado*, Westword, Feb. 5, 2009.
3. Colorado Constitution, Article XVIII, §14(1)(a).
4. Littleton calls their sales tax license a business license, although a lawyer who

continued on next page