Local Government Incentives in North Carolina: A legal guide to effective policy implementation

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Table of Contents

Introduction: ... 3

Incentives Legislation: Analysis of G.S. 158-7.1 ... 5

Subsections (a) and (b) ... 5

Subsections (c) and (d) ... 6

Subsection (d2) ... 8

Subsections (e) and (f) ... 8

Subsection (h) ... 9

Errors that may invalidate an incentive agreement: ... 9

Legal Challenges – Maready v. City of Winston-Salem: ... 10

Legal, but effective? A review of the literature: ... 12

1. **Megadeals skew findings.** ... 12
2. **Not-so-comprehensive databases.** ... 13
3. **Studies conflate state spending for local incentives.** ... 14

What the literature recommends: ... 16

1. **Invest in industries with greater job multipliers.** ... 16
2. **Don't forget to Invest in smaller firms.** ... 17
3. **Developing land, sites, and infrastructure is a long-term investment.** ... 18
4. **Require accountability measures.** ... 19
5. **Consider removing "but for" clauses.** ... 19

Traditional and Novel Incentive Models: ... 21

1. **The company controls the start time of grant payments.** ... 22
2. **No cap on the upside of grants as long as capital expenditures match** ... 23
3. **Additional tranches of capital expenditure extend grant terms** ... 23
4. **Multiple counties offer incentives and split the proportion of cost in relation to benefits** ... 24
5. **Construct shell buildings and business parks** ... 24

References ... 26

Executive Summary

Across the United States, local and state government economic development incentives are a cornerstone of economic development policy, with between $45 and $90 billion spent per year on incentives.

In North Carolina, G.S. 158-7.1 authorizes the appropriation of funds to private entities for the purpose of economic development. However, in 1996, local government incentives were challenged in *Maready v. City of Winston-Salem*, on the grounds that taxpayer money to private entities violated the public purpose clause of Article 2 in the NC Constitution, which mandates that tax revenue be spent for promoting public, rather than private, interests. Despite the challenge, *Maready v. City of Winston-Salem* upheld the constitutionality of local government incentives in North Carolina, insofar as incentives created jobs, expanded the tax base, or achieved a reasonable economic development goal.

To ensure the appropriation of funds benefits the public, local governments are required to audit proposed incentives for financial feasibility, hold a public hearing where the public can express views on the incentive, provide appropriate public notice of said hearing, and govern the incentive by contracts with stipulations to recoup investments in the result of underperformance.

Just because something is legal, doesn't mean that it's good policy. Despite the gaps in the literature, there are some general guidelines that, if followed, increase the likelihood that incentives will provide a positive return.

First, invest in industries with greater spillover effects and job multipliers. Investing in manufacturing, research & development, and transportation is safer than service-based investments. Second, invest in small firms, as they tend to perform better than larger, incentivized counterparts. Third, extend utilities and prepare sites rather than only providing cash grants. Fourth, build accountability measures into contracts. Fifth, remove "but for" clauses to lower the costs of deals and prevent bidding wars between local governments.

The jury is still out on the efficacy of local government incentives, but a series of novel incentive structures that capitalize on the five general strengths above may better guarantee a return on investment for local governments that provide incentives to firms.

Introduction:

Across the United States, local and state government economic development incentives are a cornerstone of economic development policy, with municipalities, cities, counties, and states spending between $45 and $90 billion per year on attracting and retaining firms with the intention of expanding the tax base, creating jobs, diversifying the economy, and promoting broader economic goals. (Liu & Parilla, 2019)

Using a conservative estimate, $30 billion is spent on manufacturing and labor-intensive industries, which are primary recipients of incentives. Of this sum, at least $20 billion is appropriated from state governments rather than their local counterparts. (Slattery & Zidar, 2020)

For North Carolina, the estimated annual spending in 2012 was $660 million across state and local incentive spending. (Mulligan, 2012) Additionally, North Carolina kept the amount paid in incentives about the same over the last 10 years, so these past estimates should align well with current spending. (NCEDA, 2022)

The frequent and repeated use of incentives merits a further consideration of how to best utilize such tools to achieve desired economic outcomes without risking legal challenges. However, each state and local government may have specific program requirements, eligibility restrictions, and methods of spending which make it difficult to determine the legality and efficacy of any specific deal in different contexts. Therefore, this paper will serve as a guideline for a typical North Carolina local government incentive deal.

Although the scope of this paper does not cover all incentives in North Carolina, it discusses themes that are well-followed in most parts of the state, ensuring that readers of this brief would develop a basic knowledge of legal incentives in North Carolina. Furthermore, state programs will be discussed, but neither program requirements nor implementation will be covered at length.

In the first section of this paper, the legislation governing local government incentives, G.S. 158-7.1, will be introduced and explained. The second section will discuss *Maready v. City of Winston-Salem,* a ruling which upheld incentives under specific circumstances.

The third section will discuss the efficacy of incentives, accounting for the special circumstances of North Carolina. The fourth section will outline a series of potential incentive structures which align with both legal and effective standards for incentives.

Incentives Legislation: Analysis of G.S. 158-7.1

G.S. 158-7.1 authorizes the appropriation of funds to private entities for the purpose of economic development. Originally authorized as the Local Development Act of 1925, counties and municipalities had to opt into the statute, making economic development incentives a patchwork of separate programs ran at the county and municipality levels. However, as incentives have grown in their size and frequency of utilization, the opt-in clause was removed, and all localities are subject to the requirements of G.S. 158-7.1. Aside from the opt-in revision, G.S. 158-7.1 has also been revised to implement procedural and program requirements which have been upheld by the courts and/or are associated with best practices in other states.

Subsections (a) and (b)

Subsection (a) contains a catch-all provision that details the broad scope of situations in which governments can appropriate funds. Specifically, it reads:

> “Each county and city in this State is authorized to make appropriations for economic development purposes. These appropriations must be determined by the governing body of the city or county to increase the population, taxable property, agricultural industries, employment, industrial output, or business prospects of the city or county.”

In applying the broad powers of the statute, the most common test for incentive eligibility pertains to job creation and expanding the tax base, rather than specific industry improvement like agriculture. Though the language may appear to provide broad, discretionary power to counties and cities, the language of the catch-all provision was deemed by the courts to not be “impermissibly vague.”

Additionally, the provision mentions that the appropriations made by local governments may be levied pursuant to G.S. 153A-149 (c)(10b) and 160A-209 (c)(10b), which explicitly permit taxation for incentives. Furthermore, while specific activities mentioned in subsection (b) are mentioned, subsection (a) clarifies that specific activities listed in subsection (b) are not intended to limit the grant of authority outlined by subsection (a).

Subsection (b) contends with the conveyance of real property, a specific method in which counties and cities may encourage economic development. It lists examples of activities that may be undertaken by a county or city. While the following is not a comprehensive list of each activity, it demonstrates the types of activities one would expect to pertain to the section:

1. "A county or city may acquire and develop land for an industrial park..."
2. "A county or city may acquire, assemble, and hold for resale property that is suitable for industrial or commercial use."
3. "A county or city may acquire options for the acquisition of property that is suitable for industrial or commercial use."
4. "A county or city may acquire, construct, convey, or lease a building suitable for industrial or commercial use."
5. "A county or city may construct, extend or own utility facilities."
6. "A county or city may extend or may provide for or assist in the extension of water and sewer lines."
7. "A county or city may engage in site preparation for industrial properties."
8. "A county or city may make grants or loans for the rehabilitation of commercial or noncommercial historic structures."

Subsections (c) and (d)

Subsections (c) and (d) detail some procedural requirements for enacting incentive methods described in subsections (a) and (b). Subsection (c) provides the requirements for all appropriations intended for economic development purposes, noting that any such expenditures must be approved by the governing body after a public hearing, which includes annual budget meetings if the appropriation is listed in such budgets. If the appropriation is not part of the annual budget, the subsection reads as follows:

> “[T]he county or city shall hold at least one public hearing, publishing notice of the public hearing at least 10 days before the public hearing is held.”

If the appropriation entails an acquisition of an interest in real property, the information to be provided to the public includes the property, cost, intention of the governing body to approve the property acquisition, and how the acquisition will be funded. For property improvements, such as utility extensions to facilities, the public must be informed about the proposed improvements, cost, funding source, and public benefits gained by such improvement of the property.

Subsection (d) functions in a similar manner as subsection (c), with additional details on the private negotiations between the governing body and the entity that will receive the real property conveyed. Specifically:

> “A county or city may convey or lease interests in property by private negotiation and may subject the property to such covenants, conditions, and restrictions as the county or city deems to be in the public interest or necessary to carry out the purposes of this section.”

While the property of interest and potential incentives may be discussed in private, to prevent excessive bidding and disruption of the negotiation process, no final decisions concerning the incentive agreement can be made during these private negotiations. The final terms of the agreement must be approved after a public hearing, matching the process described in subsection (c).

A public notice of the hearing must be posted at least 10 days prior to the hearing being held. The public must be informed of the property, its value, the “consideration for the conveyance or lease, and the governing body's intention to approve the conveyance or lease.” Additionally, the governing body is responsible for determining the average wage for workers hired at the conveyed property and estimating the fair market value of the interest. Importantly, “The consideration for the conveyance may not be less than the value so determined.”

Subsection (d2)

As stated, in accordance with subsection (d), "the consideration for the conveyance may not be less than the value so determined." Subsection (d2) details how such value is determined when assessing the real interest of a conveyed or leased property. The governing body may account for prospective property tax revenues, sales tax revenues, and other prospective tax revenues generated over the next 10 years because of the incentive offered.

However, unlike the procedural requirements outlined prior, deals under the scope of subsection (d2) are bound by two additional requirements. First, the governing body must determine that the incentive will result in a "substantial" number of jobs created that pay at or above the median wage in the county as determined by the median wage published by the Department of Commerce in the most recent period available.

Second, the governing body must contractually bind the incentive recipient to an agreement in which, in a period of less than or equal to 5 years, the recipient must make improvements on the property that will generate tax revenue in return for the incentive received. If a sufficient level of tax revenue is not generated in accordance with the contract, the incentive recipient must reconvey the property to the governing body that granted the incentive.

The requirements of living-wage job creation and sufficient investment for the purposes of greater tax revenue, coupled with required accountability measures, are often enforced by counties and cities regardless of whether the incentive falls within the scope of subsection (d2), which will be a topic of further discussion in the third section of this paper.

Subsections (e) and (f)

Subsections (e) and (f) are quite straightforward and brief. Subsection (e) enforces the Local Government Budget and Fiscal Control Acts of the North Carolina General Statutes, depending on the jurisdiction offering the incentive. This requires the disclosure of such discretionary spending to the Local Government Commission.

Meanwhile, subsection (f) describes the maximum allowable cost of incentives that can be offered. Expenditures by local governments for the purpose of economic development cannot exceed .5% of the outstanding assessed property tax valuation for the county or city. Additionally, local governments are required to report their annual financial reports to the Local Government Commission for review to ensure no local government has exceeded the spending limit outlined above.

Subsection (h)

The final and most recently added subsection is subsection (h), which mandates accountability mechanisms to be enforced against incentive recipients upon failure to perform. Every incentive offered must be governed by a contract that clearly states the responsibilities and roles of parties in the agreement. If the firm fails to perform according to the contract, there are required provisions that guarantee "the recapture of sums appropriated or expended by the city or county." These measures are often referred to as clawbacks. Additionally, the grounds upon which a recapture of sums may be initiated is typically the creation of fewer jobs than agreed upon, less capital investment per year than projected, and not maintaining operations for the duration of the incentive term.

Errors that may invalidate an incentive agreement:

Listed in G.S. 158-7.1 are a series of procedural and program requirements which, if not followed, would lead to the invalidation of an incentive agreement. First, failure to include pre-audit certification. Statutes that frequently overlap with G.S. 158-7.1, such as G.S. 158-7.2 requires local governments that appropriate funds to other entities to provide sufficient oversight and accountability of recipient organizations. Additionally, 140 G.S. 160A-16 requires municipal contracts to be in writing, and G.S. 159-28(a) requires a pre-audit certificate for contracts. (Mulligan, 2013) Per the Local Government Budget and Fiscal Control Act, pre-audit certifications must be completed by the County or City Finance Officer, a crucial step in the proposal process outlined throughout G.S. 158-7.1.

Second, avoiding unconstitutional tax abatement. Due to the Uniformity Clause in Article V, Section 2(2) of the North Carolina Constitution, taxes must be "uniform on

all property throughout a particular taxing unit and uniform property tax classifications." (McLaughlin, 2011) Therefore, North Carolina only provides grants after taxes have been paid in full so that firms are compliant with their tax status and established rate. Even if grants are associated with and scaled to prospective tax revenue, the conceptual distinction between a purpose-specific grant and up-front abatement is quite important.

Third, compliance with explicit measures in G.S. 158-7.1. Subsections (c), (d), and (h) include provisions that must be complied with, or an incentive is dead in the water. The specifications mentioned for public hearings depending on incentive type and contract requirements outlined in subsection (h) are non-negotiable in the incentive process. Failure to comply opens the door to legal troubles and the almost certain invalidation of the incentive.

Legal Challenges – Maready v. City of Winston-Salem:

Maready v. City of Winston-Salem (1996) upheld the constitutionality of local government incentives in North Carolina. The plaintiff, William F. Maready, was a citizen and resident of Winston-Salem and Forsyth County who challenged twenty-four economic development incentive programs that were funded by tax revenues.

Per Article V, Section 2(1) of the North Carolina Constitution, "the power of taxation shall be exercised in a just and equitable manner, for public purposes only." Therefore, the court was tasked with determining if the appropriation of taxpayer funds to private corporations for the purpose of economic development served the public purpose and was therefore constitutional.

In situations where the public purpose must be determined, *re Housing Bonds* states that "the initial responsibility for determining what constitutes a public purpose rests with the legislature," however, such legislative decisions act more as a guiding principle rather than an outright determination of constitutionality.

The court values the legislative's intentions when determining if the public purpose has been upheld, but the "ultimate responsibility for the public purpose determination rests with this Court," per *Madison Cablevision v. City of Morganton* (1989). The basis for this

judgment rests on prior cases *State v. Felton* (1954) and *Nash v. Town of Tarboro* (1947), which found that “If an enactment is for a private purpose and therefore inconsistent with the fundamental law, it cannot be saved by legislative declarations to the contrary.” In this sense, even if the legislature were to declare an activity that is clearly in the pursuit of private interests as a promotion of the public purpose, the court has standing to intervene.

There is no clear formula or “slide-rule definition” for determining public purpose, as public and private interests are often overlapping and evolving in such a fashion that establishing a separation between the two would be a fruitless endeavor. The court makes a distinction, however, that even given the importance of context in each case, “for a use to be public its benefits must be in common and not for particular persons, interests, or estates.”

Article V, Section 2(7) of the North Carolina Constitution allows for the direct appropriation of taxpayer revenue to private entities if such entities are serving the public purpose. The precedent for determining the public purpose was formed in the decision of *Madison Cablevision v. City of Morganton* (1989), as the court developed a two-prong test which, if passed, ensures that a private entity is acting in accordance with the public purpose and is therefore constitutional. “The Court stated that "[t]wo guiding principles have been established for determining that a particular undertaking by a municipality is for a public purpose: (1) it involves a reasonable connection with the convenience and necessity of the particular municipality; and (2) the activity benefits the public generally, as opposed to special interests or persons."

For the *Maready* case, the first prong was satisfied with little contest. In determining whether economic development was “an activity is within the appropriate scope of governmental involvement,” the court referred to *State ex rel. Util. Comm'n v. Edmisten* (1978), which found that stimulation and development of the economy is “an essential public and governmental purpose.”

For the second prong, appropriation of funds to private entities pursuant to N.C.G.S. § 158-7.1 is constitutional so long as they primarily benefit the public. Per *Briggs v. City of Raleigh* (1914), "It is not necessary, in order that a use may be regarded as public, that it should be for the use and benefit of every citizen in the community." The court found

that not only does the inclusion of, and benefits to, a private actor not preclude an activity from serving the public purpose, more generally, "if an act will promote the welfare of a state or a local government and its citizens," it is for a public purpose regardless of what entity or person conducts the action.

The court goes on to further express, that "viewed in this light, section 158-7.1 clearly serves a public purpose." Since incentives were granted with the goal of more taxable property, a greater population, and better business prospects, these incentives were deemed constitutional. Insofar as "the public advantages are not indirect, remote, or incidental," the private entity may receive funds to promote economic development.

While the court established incentives as constitutional if such incentives were crafted and implemented in accordance with the ruling, there are still attempts to challenge incentives on the grounds of inter-state commerce and private interests.

Legal, but effective? A review of the literature:

There is little reason to believe lingering questions about the constitutionality of incentives would result in successful future legal challenges, as *Maready* is still good law. However, just because a policy is legal does not guarantee its efficacy in achieving stated goals. In this section, the question answered is not "Can governments engage in incentives? "Instead, it shall answer "Should governments engage in incentives?"

In general, and especially in the last few years, the literature on government incentives has produced inconclusive, and at times negative, evidence on the efficacy and benefits of granting incentives to private firms. However, the applicability of such studies only matters insofar as the incentives examined in the literature are like the incentives common to North Carolina, with respect to the differences between local and state incentives and rural-urban distributions of incentive packages.

1. Megadeals skew findings.

Problematically, a significant degree of the literature focuses on megadeals that involve notable corporations. For example, a series of studies call into question the efficacy of incentives based on specific cases in which incentive package prices were viewed as

exorbitant. In 2001, Chicago awarded a large series of incentives to Boeing to encourage the relocation of its headquarters. However, Boeing included stipulations to cover the cost of job relocation, eliminating many of the potential jobs that would be created. (Bartik, 2005) More recently, Virginia offered an incentive package to Amazon worth around $1.4 Billion, with incentives for job training and transportation infrastructure included. (Bartik, 2020) Even globally headquartered firms are competing for incentives, with Wisconsin offering Taiwan-based firm Foxconn $4 billion in incentives over 15 years, with $2.85 billion in the form of cash payments from the State and $700 million in matching funds from Racine County. (Smathers, 2019)

While these deals are significant, they make up an incredibly small portion of incentives and carry a disproportionate impact on the analysis of spending across the board. Indeed, nearly 25% of all business tax incentives are channeled to less than .01% of firms considering relocating and eligible for incentives. (Slattery & Zidar, 2020) Indeed, although the average cost of a typical incentive nearly tripled between 1990 and 2015, incentives that were 10 times as large, per job, contributed to a significant degree of this observed increase in spending. (Bartik, 2020) These deals are unique phenomena, with few states offering these packages to a few companies.

2. Not-so-comprehensive databases.

Beyond these specific case studies, there have been attempts to create a comprehensive database of all incentives offered nationally. A significant share of the literature uses the database from the W.E. Upjohn Institute for Employment Research, which tracks incentives for 47 cities in 32 states and DC. (Bartik, 2017) When looking for comprehensive data in other states, this may be the ideal tool, as a greater share of incentives goes to urban areas in most states. However, the study goes on to say that incentives in North Carolina, South Carolina, and Georgia are more likely to be offered in low-income, rural counties which fall outside the scope of the model.

A second model, developed by Princeton Economics in 2019, selected a specific set of subsidies from the pre-existing Goods Job First (GJF) database. By only examining firms with fully published incentive information, such as competing locations, the sample was narrowed down to just over 500 discretionary incentives offered between 2002-2017. (Slattery, 2018) Even with the narrowing down to larger deals, North Carolina performed

well, as one of eight states that spent the least on per-job costs pertaining to incentive deals. However, it is important to note that incentives less than $5 million were excluded, effectively removing a significant share of incentives offered to small and medium-sized businesses. This is particularly important for North Carolina, as a greater share of North Carolina's incentives go to smaller firms. Despite North and South Carolina distributing a greater share of their incentives to low-income, rural counties not captured by the first model, South Carolina's incentives are twice as large as North Carolina's, demonstrating a tendency for North Carolina to engage in incentive deals with smaller firms. (Bartik, 2020) Furthermore, economic developers in North Carolina confirm this trend, as the most popular job creation threshold for incentives is 0-10 and 11-20 jobs added, with an additional investment threshold of $1-1.99 Million. (NCEDA, 2022)

The third and final model, developed by the University of Connecticut and the University of North Carolina-Chapel Hill, was constructed in a similar fashion to the Princeton Economics Model. Using the subsidy tracker from GJF, coupled with data from the National Established Time Series (NETS) and Council for Community and Economic Research (C2ER), the researchers identified 315,563 deals. (Donegan, Lester, & Lowe, 2019) However, despite their best efforts to remove megadeals, they also removed deals that didn't promise to create or retain at least 100 jobs, far above the most common threshold used by local NC governments. This ultimately brought the sample down to 13,324 deals, demonstrating the significant share of smaller deals excluded from the study.

These studies are not at fault for this lack of coverage concerning local and smaller incentives. As it stands, local governments present a significant challenge to accurate measurement, as they "do not usually report the exact amount of tax credits and incentives each establishment in their jurisdiction receives." (Slattery & Zidar, 2020) Additionally, even for successful attempts which measured local policies to a sufficient degree, these studies date back to the 1990s and do not account for incentives, but "marginal state and local business tax rates" with some mention of incentives. (Bartik, 2012)

3. Studies conflate state spending for local incentives.

Much of the literature surrounding fails to distinguish state funding for incentives from discretionary spending at the county, city, and municipality levels. As stated, around $660 million is spent per year on incentives in North Carolina. While the total spending estimates do not distinguish between spending at the state, county, and municipality levels, a significant share of spending comes from state incentives, rather than local jurisdictions.

For the state, the two main programs are:

1. the Job Development Investment Grants (JDIG) – a discretionary incentive program providing annual grants to new and expanding businesses relative to a percentage of withholding taxes paid by new employees each year for a stated number of years.
2. One North Carolina Fund – non-recurring appropriations by the NC General Assembly to help recruit targeted jobs, which provides grants based upon a negotiated amount for each new job. (Pearson, 2019)

The distinction is key, as large-scale increases in spending are often driven by state spending during observed periods of time. For example, between 2001 and 2007, the largest increase in incentives occurred in New Mexico, Missouri, Indiana, North Carolina, Nebraska, and Texas. (Bartik, 2017) For context, during this time, North Carolina approved a particularly large incentive with Dell to construct a computer manufacturing and assembly plant. Dell received $279.7 million in incentives, with $242.5 million from the state and the remaining $37.2 million covered by the local government. Of this $37.2 million, $17.2 million was given in the form of cash grants over 30 years with assistance from the Golden Leaf Foundation. The other $20 million came in the form of land valuation and site preparation. (Morgan, 2009) In cases of large deals, the state tends to contribute to the incentive deal, lessening the financial burden on local governments. Even if the state receives a return on its investment in the form of tax revenue, the increase in property taxes and high-quality jobs is concentrated in the municipality where the plant is located, often leading to a concentrated, local benefit. While studies may look at the impact on North Carolina as a whole, the distribution of benefits is non-uniform, and a closer look at the county or municipality of interest would indicate more meaningful results in terms of job creation, taxable property, and outcomes of interest.

Since the megadeal with Dell, North Carolina has recouped some of its investment and is stricter with its disbursement of funds. For both programs (JDIG and OneNC), state funds are only disbursed for actual jobs created under these grants. For example, between 2007 and 2022, the Department of Commerce announced 1,112 incentive awards through both programs worth roughly $4 billion. However, of the $3.06 billion dedicated to specifically the JDIG, only $160.8 million has been disbursed to date. The projected spending represents the cap on spending set by agreed-upon contracts, whereas disbursements align with firm performance and prevent overspending on underperforming firms. (NCDOC, 2022) Therefore, while certain discretionary spending by the state may be considered exorbitant, most job creation tax credit programs are viewed in a more favorable light by the literature.

Separately, but equally important, is the need to decouple the motivation behind state discretionary incentives from local ones. Whereas local incentives tend to be smaller and less politicized, "per capita incentive spending increases by more than 20% in half of the cases in which it is an election year and the governor is up for re-election versus one-fifth of the cases otherwise." (Slattery & Zidar, 2020) When incentives are motivated by political gain and optics rather than the economic needs of a community, the tendency to overspend weakens the perceived efficacy of incentives across the board. But the evidence is quite clear, the effect of politics on incentive spending is present at the state level, as it persists for Governor elections, indicating the degree to which this overspending is driven by top-level, state factors rather than local conditions.

What the literature recommends:

The literature on the efficacy of incentives is mixed, but there are certain recommendations that, if implemented, increase the benefits and likelihood of recouping the investment in the context of a typical incentive deal.

1. Invest in industries with greater job multipliers.

Incentives have the potential to strengthen individual firms and increase population, employment, and wages, all of which contribute to indirect job increases and firm creation referred to as "spillover." The size of the multiplier matters, as the cost per job created when evaluating the efficacy of current incentives accounts for both direct and

indirect job creation. For example, incentives commonly cost between $10,000-$20,000, with $16,000 as the average cost per direct job created through an incentive. The additional jobs created because of this firm would reduce the cost per job and generate a greater return on investment for the governing body that issued the incentive, increasing the favorability of enacting further incentives in the future.

For high-tech manufacturing firms, the average spillover (indirect jobs created per new job at a firm) tends to be 4. Therefore, the cost per job would drop to $2,500-$5,000 per job, resulting in a new average cost of $4,000 when accounting for all jobs created by incentive spending. Even general manufacturing, without high-tech labeling, carries a spillover value of 2 which halves the "true cost" of any given incentive. (Bartik, 2018) Fortunately, North Carolina prioritizes such industries, as manufacturing, distribution, Information, and research & development lead as the four industries with the most eligibility for receiving incentives. (NCEDA, 2022) Additionally, the wages in these sectors are highly competitive, increasing the quality of life for recipients of newly created jobs. In North Carolina, industries with 10% higher wages receive 6% more in incentives, ensuring that spending goes towards jobs with the greatest returns, rather than those that marginally meet wage requirements. (Bartik, 2017)

2. Don't forget to Invest in smaller firms.

Megadeals may garner political attention and appear in the news cycle, but recognition does not guarantee results. Investing in smaller, up-and-coming firms may prove less risky than intuition would suggest. Smaller, younger firms have a greater capacity to grow, add jobs, and expand to new locations, compared to more established counterparts. For this reason, small firms that receive incentives outcompete their non-incentivized counterparts, generating more positive, significant results than large firms that receive incentives. One reason for this may not be the performance of firms themselves, but the leverage held by government negotiators when agreeing upon the terms of the incentive. Economic developers "are more likely to gain the upper hand when negotiating incentives with smaller, resource-constrained firms." This can include more closely monitoring firms and enforcing accountability measures, ensuring some degree of return whether the firm is successful or not. (Donegan, Lester, & Lowe, 2019)

Additionally, these smaller firms are more likely to request a customized extension of infrastructure/utilities or job training. These services may be "10 times more effective" than similar value incentives that take other forms, as they overcome financing and information difficulties faced by small firms. (Bartik, 2012) Indeed, the effects of such services may produce value like the spillover effect, as service extension and job training lower business costs by at least five times, making the cost per job created closer to $2,000-$4,000 on average (identical to large spillover cost prediction). (Bartik, 2018)

North Carolina has proven uptake of such programs but could stand to do more. In 2009, 56.2% of economic developers reported offering infrastructure improvements, 19.4% offered site preparation, and 9.2% offered workforce training. (Morgan, 2009) Progress has been made since then, as 65% offer infrastructure services, 35% offer road construction, 30% offer workforce training, and 26% offer site preparation. The significant increase in employee training is significant, as it indicates a greater degree of local labor sourcing, rather than attracting external talent to fill newly created jobs. (NCEDA, 2022)

3. Developing land, sites, and infrastructure is a long-term investment.

While the costs of developing and extending infrastructure are concentrated up-front, making these incentive types appear more costly than longer-term methods, there are some immediate advantages and long-term benefits to employing infrastructure-based incentives. Infrastructure improvements come with implicit clawbacks as the infrastructure will remain in place even if the company leaves or fails to meet incentive requirements, ensuring resources can go towards attracting a future entity to fill the vacant space. (Bartik, 2005)

Developing land also has an indirect positive effect on other local firms. "Local business costs can also be reduced, and local job growth induced, by increasing the effective supply of local land available for development." Counties that possess viable business sites with up-front costs towards infrastructure service extension are associated with greater future job creation, as businesses can more quickly and easily expand with fewer financial barriers. While anecdotal at best, business executives have indicated that the availability of a developed, affordable site is a key contributor to location-based decisions. (Bartik, 2018)

As stated, the second most frequent form of incentive offered by North Carolina economic developers is infrastructure improvements (65%), demonstrating the degree to which the state and individual municipalities act in accordance with these recommended practices. (NCEDA, 2022)

4. Require accountability measures.

Per the *Maready* ruling, North Carolina incentives should be governed by contracts that attempt to hold firms accountable for failing to achieve outcomes that serve the public purpose. First, the implementation of clawbacks is recommended to encourage good-faith behavior by firms and mitigate risk. These clawbacks are set up to recover a portion (if not full value) of the funds disbursed to private firms in situations where firms fail to uphold their responsibilities as governed by the contract. (Bartik, 2005)

North Carolina encourages the adoption of clawbacks, as subsection (h) of G.S. 158-7.1 requires accountability measures and protections to be built into incentive contracts. In 2006, prior to subsection (h), 51.2% of local economic developers required contracts to enter incentive deals. (Mulligan, 2012) In 2009, two years after the implementation of subsection (h), the portion of incentives with clawbacks was 60%. (Morgan, 2009) Since then, 98% of incentives offered in North Carolina are now governed by contracts, with 65% enforcing clawbacks.

A separate measure is the inclusion of performance agreements, in which firms are required to report jobs created and total investments while complying with government oversight of the private firms' activities. With broader uptake than clawbacks, 83% of North Carolina incentive contracts require performance reporting by the incentive recipient. (NCEDA, 2022) This far surpasses the national average, as 45% of cities nationwide require performance agreements and risk controls, including clawback clauses. (Ha, 2013)

5. Consider removing "but for" clauses.

In general, "but for" clauses are well-intentioned, with the goal of only providing incentives to firms that would not have selected their business location without the

incentive offered. However, the efficacy of such clauses is generally stunted by the lack of ability to determine if companies are genuinely entertaining multiple offers or just trying to sweeten the deal. Using the W.E. Upjohn Institute model, “but for” incentives only tipped a company’s destination preference between 2 and 25 percent of the time. (Bartik, 2018) As discussed, this model only looks at incentives for cities, which are attractive business destinations regardless of incentive deals. The established infrastructure, educated workforce, and general appeal of metropolitan areas (social life, etc.) may contribute to a majority of firms preferring these destinations without much genuine concern for incentives. However, rural areas, with less access to infrastructure, education, and firm-preferred resources may have a greater proportion of firms that would not have relocated or expanded in their location without the incentive.

Regardless of the gap in the literature, “but for” clauses still disadvantage local governments and economic developers during negotiations. Companies are aware of the offers presented by each municipality, whereas local governments do not have access to the deals they’re competing against. In this sense, companies can entertain offers, drive up the price through competition, and select a destination at a higher cost than they would have selected without the bidding process. In North Carolina, Google openly admitted to this process when selecting a destination for a server facility in 2007. (Morgan, 2009)

While “but for” provisions are intended to protect local governments, the overwhelming advantage for firms during negotiations often leads to higher spending than would have taken place without the explicit requirement to prove competition. Of course, companies have the incentive to entertain multiple offers given these advantages, regardless of whether “but for” clauses are implemented and enforced. However, the existence of such provisions has created a “false sense of security” for local governments, as they provide the optics of accountability but are far easier to circumvent and incredibly difficult to enforce. (Weber & Santacroce, 2007)

The *Maready* ruling mentions competition between states as a reason for considering incentives, noting to some degree the importance of a “but for” condition to be satisfied, which makes incentives without “but for” conditions far less frequent as its inclusion is additional legal protection. This makes the removal or non-application of such a clause more difficult, but it is quite clear that the negotiating leverage with

applied “but for” clauses benefit the incentive recipient and disadvantage local government negotiators, harming the party the clause is intended to protect.

Traditional and Novel Incentive Models:

When offering incentives, local government leaders and economic developers in North Carolina tend to offer annual grants marked to a pre-determined proportion of property tax, however, specific cases of sales tax or other taxes on input goods such as utilities (ex. google) have also been used to calculate the total value of such annual grants. The percentage of jurisdictions offering cash grants as a primary incentive method declined from 94 percent in 2011 to 81 percent in 2022. Alternative incentive methods, such as infrastructure improvements, help to explain some of this decrease in the use of cash grants.

Despite the decline in the frequency of cash grants, they are still the most common form of incentive. Among all grants, the typical deal includes a 5-year term worth either 51-60 percent or 71-80 percent of owed property tax per year. In 2011, 71-80 percent was the most common offer, indicating a greater proportional cost in 2011 compared to typical incentives in 2022.

With the rise in contract-governed incentives, which are offered by 98% of jurisdictions, local governments have instituted thresholds for job creation, investment, and compliance with stipulations on average wages, benefits, and other factors. To qualify for an incentive, companies likely must create 0-20 jobs, which pay at least average county wage, and invest $1-1.99 million per year. Additionally, certain benefits like employer-sponsored health insurance are required in 68% of counties, up from 30% in 2011, indicating the prioritization of not just jobs, but jobs that have tangible, positive effects on the quality of life for workers in incentivized firms.

Prior to 2011, certain incentive types were frequently employed, including up-front cash payments for site improvements and decreased land costs. As of 2022, only 39% of counties tend to use free or reduced land costs to attract firms, and up-front cash payments are less common than grants, which function as reimbursements on taxes to circumvent tax abatement. (NCEDA, 2022) The trend away from up-front payments is

noted at the state level as well, as both the JDIG and OneNC programs only disburse funds after sufficient job thresholds have been met, mitigating the risk of paying for results that never come to fruition.

While the most common incentive types have been discussed and popular alternatives have been mentioned throughout this paper, the following recommendations are novel incentive structures that have limited samples to demonstrate their efficacy. The intuition and reasoning behind each incentive will be explained, but empirics would require a greater utilization and subsequent review of such activities, which isn't available at this time.

1. The company controls the start time of grant payments.

When companies enter into an incentive agreement with local governments, the term of the incentive begins upon signing the contract. However, the valuation of the contract is dependent on the investments made by the firm, which are reflected by commensurate increases in property taxes. For certain firms, the scaling of investment over time does not occur in a uniform fashion. Instead, after the incentive term has expired, firms may make substantial investments that would maximize the return of the incentive had the term not expired. Therefore, if the duration of the incentive is not extended to accommodate for this, delaying the start of the incentive period would achieve a desirable effect for the firm with no significant loss to the county.

For example, some manufacturing facilities may spend the first year or two creating the foundation and exterior structures for a facility, paying fewer taxes on the property than they expect to pay when they outfit the facility with equipment and other investments that contribute to a substantial increase in property taxes. By delaying the incentive term, the local government receives immediate returns in the form of tax payments, whereas the company bears full costs until the benefits of incentives would be maximized. In North Carolina, since the most common form of repayment is grants matched to property taxes, these payments occur only after the governing body has received the tax revenue from the firm. The governing body may pay more in incentives, but the increase in incentive value is due to the substantial increase in property taxes which they will continue to receive after the incentive expires. For equipment that depreciates over time, the depreciation rate is determined by the "useful life span," but

most firms that remain in operation will continue to invest in equipment over time, leading to cyclical increases and subsequent decreases in property taxes.

2. No cap on the upside of grants as long as capital expenditures match.

For incentives tied to a proportion of taxes, some municipalities, cities, and counties have a set "maximum" value for payments that, if exceeded by the projected value of the grant, would prevent local governments from paying out the "true" value of the grant. This placement of an "up to" condition creates a hard cap on company investment, in which each additional dollar of investment above the maximum return of the incentive experiences a declining return on investment (ROI). This declining ROI establishes a disincentive for the company, which ultimately stunts the long-term return on the investment. As companies adjust and spend less on facilities during the term of the incentive, the property taxes for the firm in the immediate years following the expiration of the incentive will be less than if they had spent more during the incentive years. Depreciation and other factors may reduce the benefit of this approach longer-term, but the recapture of greater expenditure in the years following should offset the cost. Though this method of future benefits does not account for a discount rate amongst local government leaders and economic developers, the net costs (rather than perceived costs) still favor local government action and offering of full-value incentives.

3. Additional tranches of capital expenditure extend grant terms.

According to subsection (d2), the calculation of consideration for incentives includes 10 years of tax revenue resulting from the conveyance or lease provided for activities encompassed within the subsection. The average incentive period is 5 years, however, the catch-all provisions and flexibility built into G.S. 158-7.1 allow for local governments to extend incentives beyond the initial 10-year valuation term. For example, Google agreed to 30 years of tax reimbursements on a portion of their utility costs and sales taxes.

For the typical firm which only receives 5 years of incentives, the shorter duration is governed by the incentive contract. There may be a limited possibility for renegotiation, but changing the deal duration and valuation may give rise to uncertainty and public disapproval. Instead of making such decisions as they arise, local governments can

proactively include clauses that allow for extended incentive duration if certain investment thresholds are met. For example, if a local government provides a firm with an incentive that includes provisions that for each year above a set level of investment the deal is extended, a firm has the incentive to continue investing more than they would without the incentive. If the threshold is reasonably high enough to alter the actions of the firm (set the threshold above their projected typical spending without the incentive), the firm must continue to exceed expectations to receive incentives, encouraging more investments that could induce more hiring and industry spillover.

4. Multiple counties offer incentives and split the proportion of cost in relation to benefits.

This incentive structure is highly specialized to circumstances that likely only apply to firms with proprietary technology and machinery utilized in a third party's facility. For example, a plastics manufacturer headquartered in the Research Triangle may own the product molds and machinery operated by a third-party manufacturer in Appalachia. These molds and machinery employ a specific portion of the manufacturer's workers due to the size of the contract, ensuring that expansion of the patent holding company would result in an expansion of property leased to and subsequent products manufactured by the third party. In a real scenario modeling such an example, both the county where the firm is headquartered and the county where the technology to manufacture is located gave incentives in proportion to the benefits received by each county in the form of jobs create and increased tax revenue. Since the proprietary machinery created real employment opportunities in the other county, the rationale behind the dual incentives was reliant on the property holder in a separate county proving a direct effect in the third party's county through employment opportunities that would not have existed otherwise.

5. Construct shell buildings and business parks.

As stated, the availability of land and constructed facilities is a major determinant for companies seeking to relocate, regardless of the incentives offered. Cities and Counties can capitalize on this by offering to do the initial construction and site preparation for firms interested in relocating. Since the government does not have to pay sales tax on

its own constructed assets, the price of raw materials for constructing a government-owned property is far cheaper than commercially available alternatives. The lower input costs allow for the government to offer the land and constructed shell-building at a lower market rate, without incurring a great degree of loss.

Recipient firms would still have to make capital investments in the property and hire workers to sustain operations, but the front-loaded savings would make the deal enticing. Primarily, offering cash grants up-front is declining in frequency, but firms that operate with a greater "discount rate" of future benefits may be more inclined to accept assets in the present at the cost of lower or no cash grants in future years. Understanding the time constraints and preferences of recipient firms will help to navigate this balance and ensure the incentive package can tip the scale at the lowest cost, preventing overspending and generating a meaningful return to the local government.

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