

BEST PRACTICES IN ECONOMIC DEVELOPMENT INCENTIVES

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A discussion of the criticisms of economic development incentives, as well as recent studies that address the effectiveness of incentive programs and make recommendations for improving them. The intention is to also help governmental agencies and companies frame the request for and grant of incentives in a manner that helps defend the grant as it undergoes public scrutiny.

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Background:

Although the 2005 U.S. Supreme Court decision in *Kelo v. City of New London* is well known in the governmental takings context, a key underpinning to the ruling is the Court's conclusion that "[p]romoting economic development is a traditional and long accepted governmental function [and] there ... is no principled way of distinguishing it from the other public purposes that we have recognized."¹ Consequently, it is well settled that granting incentives to private companies to promote economic development is an "accepted governmental function."²

Companies often employ site selection consultants, or have internal departments, that lead the site selection search in determining where to locate new projects or expand existing ones. Analytics are now available that allow companies to eliminate most sites before ever reaching out to state or local governments for incentives. Currently, the greatest focus is on the availability of a qualified workforce, which can lead to a company taking the fourth or fifth best economic incentive deal.

Once a few sites are identified as viable, and if the workforce is addressed, incentives move to the top of the list. Companies want to go where they feel wanted and valued, and incentives can create a sense that there is a general public-private partnership that is attractive to the company. Incentives also become a way for local governments to close the deal or to overcome certain cost differentials. Most companies evaluate everything from the cost of the site, site access, site preparation, utility infrastructure and water and other necessary natural resources, to the availability of two competing rail lines to the site so that rail prices may be competitively bid, the cost of power or the availability of green power, the cost of transportation to market based on proximity to the distribution network, labor availability and rates, availability of training programs and education for their workforce, the local tax burden and business environment, the attributes of the community, and sometimes even the perception of the product based on where it is made (such as Texans may think that trucks made in Texas are better). Companies will then do a discounted time value analysis of the cost of a project, and incentives can help make the cost of a proposed site more competitive (with tax breaks that may or may not be used and that would be realized over a long period of time being much less valuable than cash, land or some other item of value that is received up front). Job creation tax credit incentives can, however, change perceptions and give a site an opportunity to be "in the game" by giving a higher tax state the ability to compete with a lower tax one.

Incentives are increasingly under fire. A recent *New York Times* article by Eduardo Porter, for example, asserts – after referencing the Foxconn flat screen plant incentive package in Wisconsin and New Jersey and Chicago's bid for Amazon's HQ2 project – that "[g]iveaways like

¹ *Kelo v. City of New London*, 545 U.S. 469, 484 (2005).

² *Id.*

these are often a waste of public money.”³ Porter’s piece, and many publications critical of incentives, including an article by Steve Stubb in the Nonprofit Quarterly about Nashville, Tennessee placing a moratorium on certain tax increment financing incentives,⁴ refer to a study by Timothy Bartik published by the Upjohn Institute for Employment Research in March 2018.⁵ The Stubb article also refers to a study on incentives by David Merriman published by the Lincoln Institute of Land Policy in September 2018.⁶ My review of these studies and a number of other articles and studies, as well as personal experience, has led to the creation of the list of best practices in requesting and granting economic development incentives set forth in this Article.

Most incentive programs are inherently local, so this article is not intended to discuss incentive programs available to encourage the location decision for projects or expansions, but rather to help those involved in helping site projects or request incentives in framing the request and defending the grant of the incentive.

Common Criticisms of Incentives:

One of the most significant criticisms of incentives is that the company would have undertaken the project without the incentive, with the result that economic development incentives are merely a form of “corporate welfare.” Indeed, a study by Professor Nathan Jensen of the University of Texas,⁷ analyzing the Texas Chapter 313 incentive program targeting capital investment for property tax relief, concluded that of the 257 projects evaluated, only six had the predictive probability of the incentive being pivotal in the decision greater than 50% of the time, and that the mean predictive probability was between 10-13%. Porter’s *New York Times* article references Jensen for the proposition that “85 to 90 percent of the projects benefiting from such incentives would have gone forward without them.” This study and related assertions undermine the concept that the incentive is intended to be an inducement for the company to undertake the project, and meet a “but for” test that without the incentive, the project would not have occurred.

³ Eduardo Porter, *When All Else Fails, Tax Incentives Probably Will, Too*, The New York Times, May 8, 2018, <https://www.nytimes.com/2018/05/08/business/tax-breaks-jobs.html> (last visited Nov. 20, 2018) (“Porter”).

⁴ Steve Stubb, *Nashville Considers Further Restrictions on Tax Abatements*, Oct. 16, 2018, Nonprofit Quarterly, <https://nonprofitquarterly.org/2018/10/16/nashville-considers-further-restrictions-on-tax-abatements/> (last visited Nov. 30, 2018) (“Stubb”).

⁵ Timothy J. Bartik, *Who Benefits From Economic Development Incentives? How Incentive Effects on Local Incomes and the Income Distribution Vary with Different Assumptions about Incentive Policy and the Local Economy*, Mar. 2018, Upjohn Institute Technical Reports No. 18-034, Upjohn Institute for Employment Research, https://research.upjohn.org/up_technicalreports/34/ (last visited Nov. 30, 2018) (“Bartik”).

⁶ David Merriman, *Improving Tax Increment Financing (TIF) for Economic Development*, Sep. 2018, Lincoln Institute for Land Policy, <https://www.lincolninst.edu/publications/policy-focus-reports/improving-tax-increment-financing-tif-economic-development> (last visited Nov. 30, 2018) (“Merriman”).

⁷ Nathan M. Jensen, *Exit Options in Firm-Government Negotiations: An Evaluation of the Texas Chapter 313 Program*, Undated, <http://www.natemjensen.com/wp-content/uploads/2017/02/Jensen-Chapter-313-Policy-Brief-1.pdf> (last visited Dec. 2, 2018).

Other criticisms include, among other things, that incentive programs take money away from schools and education funding, favor new businesses and big companies over existing local ones and small ones, lack transparency, accountability and oversight, and lack analysis before and after the award of the incentive.

Identifying the Goals of the Incentive Program:

Generally, the primary goal of the company in requesting incentives is to make the cost of a proposed site more competitive. The identification of the goals of the governmental agencies in this process may be more varied. Certainly, creating jobs is paramount, but consideration should also be given to whether the jobs pay higher than the current median wage, are very high paying or even pay a living wage, whether the jobs are in a new industry that may be more recession proof than the local economy or that diversifies the local economy, and whether the type of jobs sought may realistically be expected to be attractive to the community. If the goal is to help employ the unemployed or the underemployed, then the goal of increasing the wage rates in the community may be misaligned.

Goals for the program may also include solving a community need. This could include improving the quality of retail or medical services in an attempt to stem population loss to urban areas. Targeting improvements in blighted or underdeveloped areas may also be a worthwhile goal, as may be improving the quantity or quality of hotels and motels to encourage tourism, provide a place for business people to stay, provide quality meeting space or increase the quantity of affordable housing.

The Bartik Study:

The Bartik study is frequently cited in the incentives debate, and merits discussion. In his study, Bartik was primarily attempting to address whether incentives are a good way to increase the incomes of *local residents*. It is interesting to consider whether that question is really aligned with the goals of the applicable incentive program when referring to this study for purposes of examining the efficacy of incentive programs that are designed to accomplish different goals.

Bartik creates a base model that assumes that 85-90% of the jobs would have come anyway (note that this is consistent with Jensen's article), that the normal new job has a 2.5 job multiplier (1.5 additional jobs are created for each new job), that the incentive costs 2-3% of the wages of the incented job, and that, in the short run, about 2/3 of the incented jobs go to the local unemployed and 1/3 to in-migrants. In the long run, 15% go to local residents and 85% to in-migration. He also assumes that moderate increases in employment rates modestly increase local real wages and local housing prices, and that the higher local wages have some negative effect and reduce other local jobs. Bartik assumes that half of the cost of incentives are financed by spending cuts and half by tax increases. Based on typical budgets, he assumes that 22% of spending cuts reduce funding for K-12 education, and notes studies indicating that a 10% cut in K-12 education reduces long-run wages 8%, affecting the quality of the local labor market. After working through his model, Bartik concludes that these base assumptions result in a cost benefit of 1.22 (a return of 22 cents on the dollar).

Bartik then varies from the base model by changing certain assumptions and testing them. For example, by targeting only high paying jobs with a multiplier of 6 (high tech), the income increase per capita would go from a 0.2% increase (at the 2.5 multiplier) to a 3.0% increase (an increase of 12.5 times over the 2.5 multiplier), and the lowest income group would increase 5.7%. Similarly, if the incentives are targeted at high quality customized services to locally owned small and mid-sized businesses, the net benefits would increase the resident's per capita income by 5.8%, and the lowest income group would see a 9.5% increase.

The Merriman Study:

The Merriman study is also often cited in the incentives conversation. The article notes that every state except Arizona has tax increment financing incentives ("TIF"), and that if used properly, TIF can be an important tool to nurture economic development, but it is often flawed in practice. In principle, the most important and distinctive feature of TIF is that the revenues used to fund economic development are generated by that same economic development. This makes it difficult for developers to get something for nothing. A developer may ask the local government to make an investment in public infrastructure that enhances the value and development potential of her property, but the local government would like to see the private investment first to make sure that the developer is committed. A TIF solves the dilemma by the government promising that if the developer makes her investment, the property tax increase can go to pay for the public infrastructure (and more). It ensures a mutual commitment and a mutual benefit that the developer can perform.

This study takes the position that, "if used properly, TIF can be an important tool to nurture economic development in the public interest."⁸

Merriman notes that TIF may capture revenues that would have otherwise gone to various governmental entities, such as schools, but that if the "but for" test is real, then the schools would not have received more revenue without the TIF because no development would have occurred. His article notes that Minnesota's auditor reviewed the state's "but for" decisions and concluded that "it is difficult to imagine a development that would not meet the 'but for' test in some sense."⁹

Recommended Best Practices Based on Bartik, Merriman and Other Studies:

With respect to the Bartik study, a brief summary of his suggested reforms includes:

- Target incentives at firms with high job multipliers
- Target firms that pay a high wage premium
- Target creating jobs for the local under and unemployed
- Minimize long term incentives; try to make them upfront
- Do not finance incentives by cutting education spending
- Finance incentives by increasing taxes on out-of-state business owners

⁸ See Merriman at 4.

⁹ See Merriman at 16.

- Focus less on tax incentives and more on customized services to small and medium-sized businesses, particularly locally owned businesses

Some of these suggestions are aligned with Bartik’s initial question of whether incentives are a good way to increase the incomes of *local residents*, such as paying for them by increasing taxes on out-of-state business owners, which may be problematic to accomplish.

Merriman recommends the following as to TIF:¹⁰

- States should monitor and track the use of the incentives.
- Counties, school districts and overlying local governments should be allowed to opt out of the incentive.
- “But for” tests should be reviewed for effectiveness.
- Governments should provide easily assessable information about the use of the incentives.
- More research should be done to explain why the incentives work in some instances and not in others.

In their article *The Importance of Evaluating City Tax Incentives*,¹¹ Josh Goodman and Thomas Ginsberg suggest periodic evaluation of incentive programs and the following:

- Incentives should have a clear goal.
- High-quality evaluations should have a mix of quantitative and qualitative analysis. Data can indicate the net impact of incentives on a local economy, but evaluations should also consider the design of incentive programs and whether they are administered efficiently.
- Evaluations help form policy decisions. Use the information to improve existing programs, expand those that work well, merge those that overlap, and eliminate those that are underutilized or ineffective.
- Evaluators should combine expertise with independence. They should have an impartial, nonpartisan perspective.
- Evaluations are often an iterative process and take time and effort.

Summary from the Company’s Perspective:

Be aware that certain elected officials, academics, non-profit think tanks and especially the media are scrutinizing incentives. Some of the studies mentioned in this article, particularly Bartik, are being cited repeatedly by those criticizing incentive programs, sometimes out of context, and often without scrutiny as to whether the assumptions as to the goal of the incentives as defined in the article align with the goals of the community’s incentives program.

¹⁰ See Merriman at 4.

¹¹ Josh Goodman and Thomas Ginsberg, *The Importance of Evaluating City Tax Incentives*,” Dec. 13, 2017, The Pew Charitable Trust, <https://www.pewtrusts.org/en/research-and-analysis/articles/2017/12/13/the-importance-of-evaluating-city-tax-incentives> (last visited Nov. 30, 2018).

The company should be aware that most incentives are based on the concept that they are awarded to induce the company to come, expand, invest and/or employ more people, so care should be taken to demonstrate that the “but for” test is met. This can be satisfied in a number of ways, including, for example, that the project is too expensive to develop in this location without assistance; the development will be bigger or better with the incentive; the incentive enabled the municipality to make public improvements that would not have otherwise been made; the development will occur sooner or will be enhanced in a manner requested by the municipality with the incentive; or the incentive enabled the project to be developed in a location preferred by the municipality.¹²

With workforce quality being a key consideration in the company’s location or expansion decision, it is difficult for it to then ask that significant money be diverted from schools to fund the incentive. Companies should consider offering up front that they make a sufficient tax or in lieu of tax payment to protect most or all of the local K-12 school funding. However, because the local legislative body allocates funding to schools and could receive the company’s payment and then not allocate it to school funding, or it could allocate it to schools but then reduce the portion of the budget otherwise allocated to schools and keep the funding flat, consideration could be given to entering into an inter-local or company public-private partnership agreement addressing the issue so that the company payment results in additional school funding.

The company or the community should have a third party independent economic impact analysis of the cost and benefits to the community of the incentive and the project prepared and available to the public. The company may also wish to consider entering into a Community Benefits Agreement (“CBA”), which addresses many of the “soft” benefits of the its decision to locate or expand in the community with the applicable project. A CBA could cover a range of topics, including that the project aligns with local “smart growth” initiatives, such as that it enhances transit options, includes affordable housing requirements, focuses on green jobs, utilizes local contractors in building the project and local suppliers in operating the facility, or allocates a percentage of contracts to disadvantaged business enterprises. A CBA can also highlight that the company will support local social and charitable organizations or participate in the life of the community. These economic impact analyses and CBAs enable the parties and stakeholders to demonstrate the value of the partnership between the governmental agencies and the company and the decision to award the incentives.

The company should be prepared to enter into a Performance Agreement, pursuant to which the incentive is reduced on a going forward basis if the fulfillment of the promised jobs, or some significant portion thereof, is not met, or if the contemplated capital investment is substantially less than promised. If free land or cash grants are given, then a Claw Back Agreement pursuant to which the company would be obligated to repay some or all of the incentives may be reasonable if the company does not fulfill its promises. These agreements should require reporting and these requirements should be enforced, but they should be flexible enough to enable the governmental agency to waive or delay the requirements during a down turn in the applicable industry or a recession.

¹² See Merriman at 15-16.

Whether you like them or not, economic development incentives have become a meaningful part of the site location and development decision for projects of all types and sizes, and as one site selection consultant said on a panel at our firm's annual Economic Development Forum, "you can't play without them!"