Coates' Canons Blog: Local Government Economic Development Powers "Clarified"

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On October 20, 2015, the Governor signed Session Law (S.L.) 2015-277, placing into effect several "clarifications" to the primary economic development statute used by local governments, G.S. Chapter 158, Article 1, "The Local Development Act of 1925." The modifications fall into three categories: first, broad discretionary language was removed; second, new procedural requirements were imposed; and third, historic rehabilitation was explicitly included within the penumbra of allowable economic development activities, subject to the same limitations that have long been imposed on such activities by the statute and the North Carolina Constitution. Each will be addressed in turn.

Discretionary Language in G.S. 158-7.1(a) Removed

G.S. 158-7.1, up until S.L. 2015-277 became law, contained fascinating language in subsection (a) that can be traced back to the original language enacted in 1925, at a time when economic development incentives weren't permitted (incentives wouldn't be approved by the North Carolina Supreme Court until the seminal 1996 case, *Maready v. Winston-Salem*, 342 N.C. 708). The pre-2015 language did not contain the term "economic development," but it described activities that conveyed a similar meaning:

> "Each county and city in this State is authorized to make appropriations for the purposes of aiding and encouraging the location of manufacturing enterprises, making industrial surveys and locating industrial and commercial plants in or near such city or in the county; encouraging the building of railroads or *other purposes which, in the discretion of the governing body* of the city or of the county commissioners of the county, will increase the population, taxable property, agricultural industries and business prospects of any city or county."

The italicized language, in particular, appeared to grant remarkable discretion to governing boards—leading me to write in a law review article about economic development incentives that "it is difficult to say what appropriations are *not* permitted under the catch-all provision [subsection (a)]." Indeed, that article concludes that the most important limitations on economic development incentives are imposed not by the broadly written statute, but by the North Carolina Constitution. That's still the case—more on that later in the post.

S.L. 2015-277 removed the broad, discretionary language quoted above and replaced it with a simpler formulation:

> "Each county and city in this State is authorized to make appropriations for economic development purposes."

The new language could be read as narrower because the broad discretionary language (italicized above) has been removed. In my opinion, however, the scope is probably roughly the same with the new language as it was under the original formulation, for two reasons.

First, the term "economic development" is a general term imbued with little specific meaning. My colleague Jonathan Morgan writes in the introduction to his Economic Development Handbook that economic development is "both a process and a set of desired outcomes." The term encompasses activities ranging from workforce training, to marketing the local jurisdiction in trade publications, to hiring a staff of development professionals, to constructing shell buildings in industrial parks. The term itself resists being bounded.

Second, in *Maready*, the North Carolina Supreme Court itself used shorthand similar to the new formulation when it

summarized the statute this way: “Section 158-7.1 allows local governments to appropriate funds for the purpose of economic development.” The court was more concerned about the evil that local governments were addressing with the statute—competition from other states for jobs and investment—than it was about the specific boundaries of the statute.

New Procedural Requirements Imposed

The North Carolina Supreme Court in *Maready*, when it decided in 1996 that economic development incentives offered pursuant to G.S. 158-7.1 are constitutional, asserted that the “strict procedural requirements” of G.S. 158-7.1 would prevent abuse of this new incentive power. As support for its assertion, the *Maready* court pointed out that the local governments in the case all adhered to the G.S. 158-7.1 procedures, including issuing notice and holding public hearings, prior to approving each incentive.

However, as a technical matter, the pre-2015 statute only required a local government to issue notice and hold a hearing for activities related to improving real property listed in G.S. 158-7.1(b). Of course, this included all incentives anyway, because incentives can only be paid when a company promises to create jobs and increase the property tax base—and essentially the only way to do that is to make taxable improvements to real property.

But local governments were also appropriating funds for economic development purposes that had nothing to do with incentives—or improving real property for that matter—such as paying for an advertisement about the local industrial park, or contracting with the local Chamber of Commerce for networking and small business support services. In the pre-2015 statute, there was no statutory imperative to hold a public hearing prior to approving such appropriations.

That has changed with S.L. 2015-277, which adds a new notice and hearing requirement. By deleting some words in G.S. 158-7.1(c) that tied the public hearing requirement only to property-related activities described in subsection (b), the statute now mandates notice and public hearing for *every appropriation* under the statute regardless of whether or not it is connected to an incentive or improving real property. It seems clear from the bill summary that the General Assembly intended this result.

Unfortunately, the statute imposes this new notice and hearing requirement but fails to provide guidance on the form of notice to be issued. The form of notice for *incentives* should continue to follow the specific requirements of G.S. 158-7.1(c) and (d) for activities involving improving real property. For other (not incentive or property related) expenditures, in the absence of other guidance, presumably local governments may simply describe the general nature of the activity to be funded by the appropriation.

In addition to imposing the new notice and hearing requirement described above, S.L. 2015-277 also requires governing boards to make a specific finding prior to approving any appropriation for economic development, regardless of whether or not the appropriation is connected to an incentive. Specifically, the governing body must determine that the appropriation will “increase the population, taxable property, agricultural industries, employment, industrial output, or business prospects of the city or county.” The vast majority of typical economic development expenditures will meet this standard, so making this finding is not anticipated to be much of a hurdle for local economic development efforts.

Historic Rehabilitation as an Economic Development Expenditure

Local governments have long possessed authority to make expenditures for historic rehabilitation. Historic preservation commissions, after being established by a city (G.S. 160A-400.7) or a county (G.S. 160A-400.2), are empowered to acquire, hold, restore, and manage historic properties, and to convey historic property "subject to covenants or other legally binding restrictions which will secure appropriate rights of public access and promote the preservation of the property" (G.S. 160A-400.8). All local governments are also permitted to acquire real property "for the preservation or restoration of historic sites" (G.S. 160A-457(1)(d) and G.S. 153A-377(1)(d)), and they may rehabilitate buildings so acquired (G.S. 160A-457(2) and G.S. 153A-377(2)). Subsequently the local governments may sell those properties through competitive bidding procedures outlined in Article 12 of G.S. Chapter 160A, or they may select their buyer through special private sale procedures for historic properties (G.S. 160A-266(b)). These statutes do not authorize a local government to sell property for less than fair market value nor to give gifts of cash or property for historic rehabilitation projects. Rather, they allow local governments to make investments in historic rehabilitation that result in some form of ownership or control for the local government.

Even if those statutes above were to authorize making outright grants to private entities for historic rehabilitation, the state constitution's prohibition on gifts of property would step in. A grant may be paid only if the local government receives valid consideration (such as partial ownership or delivery of a service) in exchange for the appropriation. See posts here and here regarding the North Carolina Constitution's prohibition on making gifts to private entities and the requirement that all expenditures serve a constitutional *public* purpose. The courts alone—not the legislature, not statutes—determine what is a constitutional public purpose, and enactments by the General Assembly cannot override this constitutional imperative. The concern is particularly acute when the entity requesting a grant is a for-profit development firm or a nonprofit working with for-profit partners, as is the case when historic preservation is accomplished for private ownership or control (such as a privately owned apartment building) rather than for a public facility (such as a museum).

If a developer requests financial assistance from a local government for historic preservation, then the local government should act like any other investor and insist that its appropriation be treated as an equity investment that results in some public ownership of the structure. The form of public ownership can be flexible. For example, the public ownership could come in the form of a historic preservation easement. Some local governments have even acquired ownership over the façade of a building. Other local governments have purchased a specific portion of a development, such as a share of the parking spaces. Whatever form the public ownership takes, however, the price paid for the public's ownership should reflect market value. An overpayment is an unconstitutional gift. The same applies to loans, which should be offered under the same terms and with the same level of security as similar loans offered in the market, as described in this post.

There are three instances, however, in which the North Carolina Supreme Court arguably has approved the payment of cash subsidies for rehabilitation of privately owned or controlled historic structures without requiring an equivalent ownership stake in return (see also this post):

1. Community Development and Affordable Housing: S. 153A-376 and G.S. 160A-456 authorize local governments, as part of community development programs for the benefit of low and moderate income persons, to make appropriations "for the restoration or preservation of older neighborhoods or properties," to include "the making of grants or loans." Rehabilitation of historic properties arguably fits under the statute and serves a constitutional public purpose when it is undertaken *primarily for the benefit of low and moderate income persons*, such as affordable housing. See *In re* Housing Bonds, 307 N.C. 52 (1980).
2. Urban Redevelopment of Blighted Areas: Local governments may designate urban redevelopment areas (URAs) in which they exercise special development powers as described in this blog post on URAs. An area may be designated as a URA only after it is determined to be blighted—meaning the growth of the area is impaired by the presence of dilapidated or obsolete buildings, overcrowding, or other unsafe conditions—or in danger of becoming blighted. The powers include "programs of assistance and financing," possibly including grants, for "rehabilitation … of residential units and commercial and industrial facilities in a redevelopment area." Rehabilitation of historic properties within a URA arguably could be supported, and the exercise of redevelopment powers within a designated URA serves a public purpose. Redevelopment Comm'n of Greensboro v. Sec. Nat'l Bank, 252 N.C. 595 (1960).
3. Economic Development: As explained in this post, G.S. 158-7.1 authorizes local governments to make cash incentive payments to companies that promise to create jobs and make taxable investments that "might otherwise be lost to other states." *Maready v. Winston-Salem*, 342 N.C. 708 (1996). The broadly written pre-2015 language in subsection (a) of G.S. 158-7.1, which was eliminated by S.L. 2015-277 as explained above, arguably always

> included implied authority to engage in historic preservation when all other statutory and constitutional requirements for economic development grants were met. However, two concerns caused some jurisdictions to question whether rehabilitation was a proper activity under the pre-2015 statute. First, the property-related activities listed in G.S. 158-7.1(b) included acquiring, holding, and constructing buildings suitable for commercial use, but *rehabilitation* was not specifically listed. Second, historic rehabilitation often includes a mix of commercial and residential uses, and there was some question whether the noncommercial portions of a mixed-use rehabilitation project could be "counted" as part of the capital investment by a company.

To clear up the confusion about historic rehabilitation, S.L. 2015-277 added the following *within subsection (b) of G.S. 158-7.1* as an allowable economic development activity:

> "A county or city may make grants or loans for the rehabilitation of commercial or noncommercial historic structures, whether the structure is publicly or privately owned."

By placing this new historic rehabilitation provision *within subsection (b)* of G.S. 158-7.1, along with other property-related activities, the General Assembly ensured that any appropriations pursuant to the provision would fit within the existing legal framework for economic development. That existing framework is explained in great detail in my law review article —a summary of the statutory and constitutional requirements is provided below.

Statutory requirements for grants for historic preservation under G.S. 158-7.1

Under G.S. 158-7.1(b), a local government may acquire an interest in property, invest in improvements to the property, and then sell its interest at private sale for a price that "may not be less than" the fair market value of the interest (G.S. 158-7.1(d)). The governing body must determine the probable average hourly wage to be paid by the business to be located on the property, but so long as the interest in property is sold for fair market value, no minimum number of jobs is required. If, however, the local government's interest is sold for *less* than fair market value, then the buyer must comply with G.S. 158-7.1(d2), which requires creation of a "substantial number jobs" and construction of taxable improvements that will generate tax revenue such that the local government will recoup the discount on the sale price.

As explained in Professor David Lawrence's text on economic development law and my law review article, paying a grant for rehabilitation of historic real property in this context is the "economic equivalent" (to quote Professor Lawrence) of acquiring an interest in historic property, improving the property, and then selling the local government interest for less than fair market value. The sale of the government's equity stake for less than fair market value—the grant—triggers all of the statutory requirements of G.S. 158-7.1(d2), including creation of a substantial number of jobs paying above the average wage and the requirement that the local government recoup its grant from revenue generated by improvements to the property. The jobs requirement means that a purely residential project would not qualify for an incentive payment under G.S. 158-7.1—there must be a commercial business component.

Maready constitutional requirements for grants for historic preservation under G.S. 158-7.1

In addition to complying with the statutory requirements outlined above, any incentive grant for historic rehabilitation under G.S. 158-7.1 should also comply with *Maready*'s constitutional public purpose analysis. The Court of Appeals has said that it will uphold incentives that are "parallel" to the incentives approved in the *Maready* case. An examination of the incentives approved by *Maready* reveals some additional, constitution-based procedures. For incentive appropriations to be "parallel" to *Maready*, they should adhere to the following *Maready* requirements as well.

The primary motivation for the *Maready* court to permit incentives under G.S. 158-7.1 was interstate competition—the court was particularly interested in allowing incentives that could attract companies which "might otherwise be lost to other states"—and all of the incentives approved by the court involved both substantial job creation and new tax revenues to recoup the incentives "within three to seven years." Jobs and tax base are therefore constitutionally required for any economic development incentive under G.S. 158-7.1. In addition, the court was satisfied that "strict procedural requirements" would prevent abuse of this new incentive authority. In fact, the court laid out the following incentive approval procedures as "typical," even though none of them could be found within the statutory language of G.S. 158-7.1 at the time:

- An initial necessity determination is made that the incentive is required for a project to go forward (necessity is

easily proven in a competitive situation, where a company “might otherwise be lost to other states,” but necessity is highly suspect for mixed-use development projects as explained in this post and this law review article).
- A written guideline or policy is applied to determine the maximum amount of incentive that can be given to the receiving company.
- Expenditures take the form of reimbursements, not unrestricted cash payments.
- Final approval is made at a public meeting, properly noticed.
- A written agreement governs implementation.

The above-listed procedures are now imbued with constitutional significance, as explained in this law review article and in several blog posts (e.g., here and here). Even if the General Assembly were to attempt to eliminate these procedures through legislation, local governments would still be advised to follow the procedures, as they are now an integral part of the constitutional public purpose rationale for incentives. Any local government failing to adhere to the above standards for economic development incentives, regardless of the language in the statute, would no longer be “parallel” to *Maready* and would therefore invite the courts to reassess the constitutionality of those incentives.

Links

- www.ncga.state.nc.us/Sessions/2015/Bills/Senate/PDF/S472v3.pdf
- www.ncga.state.nc.us/EnactedLegislation/Statutes/HTML/ByChapter/Chapter_158.html
- www.nclawreview.org/2013/09/economic-development-incentives-and-north-carolina-local-governments-a-framework-for-analysis/
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