Coates' Canons Blog: When May NC Local Governments Pay an Economic Development Incentive?

By Tyler Mulligan

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News outlets regularly report about the latest company that was lured to North Carolina through the payment of a cash economic development incentive by a local government and the state. Local government cash incentives often take the form of an annual cash payment to a company that is contingent on the company's creation of jobs, investment in taxable property in the jurisdiction, and timely payment of property taxes, among other conditions. The statutory authority for making the incentive payment is supplied by G.S. 158-7.1, and the local government is required to approve and account for how the incentive payment is expended by the recipient company pursuant to G.S. 158-7.2. The accounting of payments is accomplished through an incentive agreement in which the recipient company agrees, typically, to create jobs at a facility that involves leasing or purchasing land, constructing a building, and/or installing equipment in the jurisdiction.

For most of the last century, however, North Carolina local governments were not permitted to make such incentive payments. It wasn't until 1996, following the loss of economic development projects to other states, that the North Carolina Supreme Court finally decided that economic development incentives serve a constitutionally-permitted public purpose—*under certain conditions*. These conditions continue to impose limitations on incentives today, so this post reviews the relevant limitations and summarizes the conclusions of a 2013 North Carolina Law Review article entitled, *Economic Development Incentives and North Carolina Local Governments: A Framework for Analysis*.

NC Constitution: Exclusive Emoluments and Public Purpose

As a threshold matter, local governments are not permitted to provide "exclusive emoluments"—in other words, gifts of public property—to private entities (Section 32 of Article I of the North Carolina Constitution). Exclusive emoluments are permitted only "in consideration of public services." That is, the public must get something in return—known as "consideration" in contract law—for a payment to a private entity. A separate set of constitutional provisions requires that expenditures by local governments and contractual payments to private entities must serve a public purpose (Section 2 of Article V of the North Carolina Constitution). As long as a payment or expenditure serves a valid public purpose, it not only satisfies the constitutional provisions regarding public purpose, but also the exclusive emoluments provision as well. The courts alone—not the legislature, not statutes—decide what is a valid public purpose under the constitution.

G.S. 158-7.1: Broad Statutory Language and Procedural Requirements

Local governments may act only pursuant to statutory authority. In the economic development context, statutory authority for offering incentive payments to companies is found within the remarkably broad language of the Local Development Act of 1925 (G.S. 158-7.1 et seq.). When local governments make economic development expenditures involving the purchase or improvement of property (G.S. 158-7.1(b)), strict procedural requirements are imposed by statute, such as notice and hearing requirements (G.S. 158-7.1(c)). When a local government turns funds over to a company for expenditure (such as an incentive payment), those same procedural requirements are imposed. Additionally, the expenditures must be approved and accounted by the local government (G.S. 158-7.2) and the funds made subject to recapture in an incentive agreement in the event the company fails to create the required jobs and tax revenue and fails to maintain operations (G.S. 158-7.1(h)). If the local government turns funds over to a company for the purchase or improvement of property, and the company keeps the property rather than returning the local government's interest, then this is the economic equivalent of transferring the local government's interest in property to the company, and additional requirements are imposed regarding job creation and wages (G.S. 158-7.1(d)-(d2)). Professor David Lawrence makes this "economic equivalent" argument on p. 107 of his text on economic development law.

The restrictions imposed by statute, however, are not the final word. Economic development incentives involve payments of *public* funds to *private* entities in service of a mix of public and private purposes, thereby colliding with the constitutional provisions regarding exclusive emoluments and public purpose. This makes economic development different from other *purely public* activities of local governments and results in far more constitutional scrutiny from the courts. For this reason, the statute alone cannot be our guide—it is necessary to look closely at case law to determine the extent of a local government's authority to offer economic development incentives.

Case Law on Economic Development Incentives:*Maready* and Progeny

If we assume that a local government has adequate statutory authority for offering a particular incentive (an assumption that in practice should not be taken lightly), how do we determine whether it also serves a public purpose and avoids running afoul of the state constitution? The answer is found in the seminal case on economic development incentives, *Maready v. City of Winston-Salem*, 342 N.C. 708, 467 S.E.2d 615 (1996), and in subsequent cases decided by the North Carolina Court of Appeals. Those cases examined dozens of economic development incentives provided by local governments to private companies pursuant to G.S. 158-7.1. In *Maready*, the court opined that economic development incentives authorized by G.S. 158-7.1 are constitutional "so long as they primarily benefit the public and not a private party." The requisite "net public benefit," according to the court, is generated by providing jobs, increasing the tax base, and diversifying the economy. Furthermore, the court was comforted by the "strict procedural requirements" of G.S. 158-7.1. As pointed out in the law review article, the court essentially assumed that cash payments to companies for the purchase or improvement of property were subject to the same procedural requirements as if the local government engaged in those activities directly (supporting the economic equivalent argument).

Additionally, the incentives in *Maready* are particularly important, because in subsequent cases at the North Carolina Court of Appeals, the court has refused to strike down incentives that are "parallel" to those approved in *Maready.* As described in the law review article, the key characteristics of the *Maready* incentives can be summarized as follows:

Consideration Obtained by Local Government in Exchange for Incentive

- *Job creation*: Every incentive approved by *Maready* and subsequent cases involved the creation of a substantial number of permanent jobs. Additionally, cases outside of North Carolina, on which the *Maready* court explicitly relied, referred to job creation more than any other factor as a basis for finding that incentives serve a public purpose.
- *Increasing the tax base*: Every incentive in *Maready* was designed such that the increase in the tax base and resultant tax revenue would pay for the incentive within three to seven years.

Procedural Requirements for Approval of Incentives

- An initial "but for" or necessity determination is made that the incentive is required for a project to go forward, typically in a competitive situation.
- 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.

Secondary Characteristics

- *Competition with other states*: A driving force behind the *Maready* decision was the sense that, without incentives, job-creating facilities "might otherwise be lost to other states." The court openly fretted about "the actions of other states" and "inducements … offered in other jurisdictions." There was, therefore, an underlying assumption that all of the incentives in *Maready* involved interstate competition. A requirement for out-of-state competition is not unique to North Carolina. *See, e.g. State ex rel. Ohio Cty. Comm'n v. Samol*, 165 W. Va. 714 (1980) (revenue bonds, which are a form of debt financing, authorized for private facility due to competition with another state). The

North Carolina Court of Appeals was asked to assess the importance of interstate competition directly in the 2010 case, *Haugh v. County of Durham*, but the court was not forced to decide the issue for reasons explained in my law review article and this blog post about interstate competition.
- *Diversifying the economy*: The *Maready* court listed diversification of the economy alongside job creation and increasing the tax base as an indicator of "net public benefit" arising from an incentive, and subsequent case law has included this factor in its public purpose analysis, but no further elaboration of the term's meaning has been supplied. The absence of further explanation makes it difficult to determine the relative importance of this factor. In cases outside of North Carolina on which the *Maready* court explicitly relied, "diversification of the economy" has referred to significant impacts on sectors of the economy, such as locating an advanced automobile manufacturing plant, or improving the state's aviation system, or making a port more attractive to seaborne commerce.

Conclusion

We know that the North Carolina Court of Appeals will uphold incentives that are "parallel" to the incentives approved in *Maready.* At a minimum, this involves following the strict procedural requirements described above and ensuring that incentives attain adequate jobs and increase the tax base. A conservative approach would also ensure that the secondary characteristics—diversification of the economy and interstate competition—are present. The *Maready* case represents an expansion of public purpose into an area that has long been off-limits in North Carolina, so incentives venturing beyond the boundaries of *Maready* would invite a new assessment by the courts as to public purpose.

For projects that do not offer sufficient jobs or other forms of consideration mentioned above, there may be alternative sources of statutory authority in pursuit of different public purposes. Alternatives are explored in the law review article and in blog posts here and here.

Links

- canons.sog.unc.edu/wp-content/uploads/2012/09/Shell-building-under-construction-cropped.jpg
- www.ncga.state.nc.us/EnactedLegislation/Statutes/HTML/ByChapter/Chapter_158.html
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