



Municipal Economic Development Incentives



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Faced with the realities of the financial crisis, many municipalities want to establish or revamp existing economic development policies, procedures or programs. This paper will recommend strategies and provide examples of programs that allow municipalities to engage aggressively in economic development while limiting their financial exposure and legal risks.

In the simplest terms, a municipality's economic development objectives are to increase its tax base, create jobs, and stimulate the local economy by encouraging new business activities or expansion of existing business activities. These business activities result in an infusion of construction capital, the inflow of money from the purchase of goods and services, increased payroll dollars circulating in the local economy, and an expanded tax and fee base for the community. The added diversity of the business mix also makes the community more attractive to residential and economic development prospects.

What motivates a business to consider locating or expanding in a community? The business wants a place that offers strategic business advantages relative to its peers, a high quality of life for its employees and the lowest possible financial exposure. The bottom line is the business wants to use or put at risk as little of its own money as possible to expand business activity and maximize profits.

Incentivizing Economic Development

Many economic development projects that may have been viable in the past without public sector assistance are no longer possible. The result of the financial crisis of 2008 and 2009 is a dramatic decline in credit availability and tightening of underwriting criteria. This decrease in available credit and a weak overall economic climate have severely reduced the level of economic development activity at a time when it is most needed by municipalities.

The same economic conditions have severely limited discretionary spending by local governments. More than ever, local governments want to minimize the money spent or put at risk through incentives to land a new economic development activity. At the same time, the local government wants to maximize the benefits associated with the limited incentive investments. Without creative solutions to balance financial risk, significant new economic development is unlikely or will occur very slowly. This makes viable public-private partnerships that balance the risk among the participants, the preferred method for municipalities wanting to be actively engaged in promoting economic development.

In the current economic environment, a municipality's objective should be to use local public funding as judiciously as possible. The municipality must balance this objective with an understanding that some assistance could spur development activity and land the limited number of available prospects.

The first objective should be to use outside money, non-municipal money, wherever possible. Someone on your staff or a municipal consultant associated with your organization needs to have a high level of knowledge of available private sector, state and federal resources including funding cycles, eligibility and allowable uses of the grant or loan resources. To be most effective in using outside resources, your city should have the ability to creatively and effectively combine or package resources from various sources, including the business' equity contribution.

Once outside resources have been exhausted, the municipality may want to consider limited municipal participation in the project through incentives. When evaluating how to effectively promote recruiting and expanding new and existing businesses, property tax and business license abatements often rise to the top as a preferred incentive approaches. While these approaches are the easiest to identify and undertake as part of an economic development strategy, there are very serious issues that must be considered before implementing this approach.

In South Carolina, the state constitution and statutes limit a municipality's flexibility for offering incentives based on tax and fee abatements.. The legality of waiving or abating all or part of business license fee and/or tax revenue is questionable due to public purpose and equal protection constraints.

The expenditure of public funds in South Carolina must be for a "public purpose" which has been defined by the state Supreme Court as a purpose that "has for its objective the promotion of the public health, safety, morals, general welfare, security, prosperity, and contentment of all the inhabitants or residents, or at least a substantial part thereof." See Anderson v. Baehr, 265 S.C. 153, 217 S.E.2d 43, 47-48 (1975).

The court later established "a four-part test in the analysis of whether the public purpose doctrine is being violated," See Nichols v. South Carolina Research Authority, 290 S.C. 415, 351 S.E.2d 155 (1986) and WDW Properties v. City of Sumter, 342 S.C. 6, 535 S.E.2d 631(2000).

- (1) What is the intended ultimate goal or benefit to the public?
- (2) Are public parties or private parties the primary beneficiaries?
- (3) Is the benefit to the public speculative?
- (4) What is the probability that the public interest will be ultimately served and to what degree?

"Public funds" must be used for "public purposes" which have a high probability of resulting in public benefit equal to or exceeding the value of the public funds invested. There must also be "a reasonable relationship between the public purpose to be achieved and the means chosen to effectuate that purpose..." 246 S.E.2d at 875.

In addition to analyzing the public purpose of assistance, another major concern is equal protection considerations. To comply with the equal protection clauses of the state and federal constitutions, the classification of properties and businesses for the purpose of taxation and application of fees must not be arbitrary. All members of each class must be treated alike under similar circumstances, and the tax or fee must be fair and nondiscriminatory in its application.

In response to inquiries for an opinion on the constitutionality of a partial abatement or full waiver of business license fees for businesses meeting defined criteria, the state attorney general's office responded that "an ordinance is a legislative enactment and is presumed to be constitutional" and that "only a court may declare an ordinance void as unconstitutional or preempted by or in conflict with state statutes" See S.C. Attorney General Opinion of April 9, 2010, at www.scattorneygeneral.org/opinions/pdf/2010/gaines%20k%20e%20os-9030%204-9-10%20business%20license%20tax.PDF. The opinion provides no direction as to potential constitutional

problems or conflicts with state law regarding business license abatement ordinances. This opinion leaves such ordinances open to potential challenge and interpretation by the court.

Due to the uncertainty of the legal issues associated with tax and business license abatements, the Municipal Association of South Carolina recommends cities and towns pursue alternative strategies such as grant or loan programs rather than waivers and abatements. However, the municipality must carefully construct even these programs to meet constitutional muster and compliance with state law.

Incentive Programs

All incentive programs should be established by ordinance. The ordinance or enabling legislation should address equal protection, statutory and public purpose issues. The preamble should clearly define the ordinance's legislative intent by establishing findings that describe why public assistance is needed and what public benefits are to be derived from economic development incentives.

To minimize equal protection challenges, the ordinance should also define who is eligible for assistance. The municipality should base eligibility on objective criteria such as public purpose standards defined in the ordinance. Preferably these standards should be measurable. Examples of measurable public purposes include:

The degree to which the development may potentially stimulate other desirable economic development and/or redevelopment activity (catalytic effect).

The contribution that the development will make toward increased employment and earnings within the city, including the number and quality of jobs created.

The increase in property tax revenues that may result from the development.

The increase in sales tax/fee revenues that may result from the development.

The potential of the development for further business activity expansion and additional job creation.

The preservation of key historical or architecturally significant buildings or sites.

The extent to which additional direct or indirect public costs to the city and to other local governmental units would be necessary, such as the cost of extending public infrastructure facilities and/or municipal services.

Other public benefits, for which performance standards are not as easily measured, may include:

The likelihood that the proposed development would not occur in the absence of economic development incentives (government intervention).

The extent to which the proposed development satisfies a desired or unique niche in the marketplace and helps diversify the economy of the city.

The beneficial economic impacts the development may have on a particular area of the city identified by the municipality as needing special assistance, including areas needing revitalization or redevelopment.

The compatibility of the location of the development with land use and development plans as described by city goals and/or the comprehensive plan, including considering availability of existing infrastructure facilities and essential public services.

If the ordinance contains additional limitations related to the geographic location, business type or any other qualification for participation in the incentive program, the ordinance should establish very clear justification for why such limitations are necessary. Being able to demonstrate that incentive eligibility is not arbitrary and that all members of the class of eligible business activities are being treated alike under similar circumstances is extremely important.

Additionally, municipalities must design the incentives to ensure the public purpose will materialize and be realized by the public. Likewise, the ordinance should provide for written agreements to be executed by the participants to formalize the incentive arrangement.

In the case of upfront grants or loans, the written incentive agreement should be backed by supplemental written documents to reasonably guarantee developer performance and to collateralize the financial participation by the municipality if the project defaults or fails to meet the public purpose standards. The remaining portion of the enabling ordinance should define the maximum level of public participation in the project. The objective is to ensure the ratio of municipal financial participation relative to the level of other source financing/participation is low and that the value to the general public relative to the investment is greater than the value of benefit to private parties.

Structuring Incentives

The municipality may structure incentives granted to eligible projects in two ways, as upfront loans or grants or as grants paid after certain conditions are met. The "after-the fact" method is preferred and easier to structure. Compliance with the defined performance standards is verified before payment. Under this method, payment is made after the public purpose has been met. This approach does not require security mechanisms because the public benefit is not speculative. Often this form of incentive is structured as a payment to the development based on a percentage of the municipal revenue derived and collected from the project that would not otherwise have been collected if the economic development project had not been completed. The revenues included in the "after-the-fact grant" payment and the levels of payment vary substantially among municipalities. These terms are defined in the municipality's incentive ordinance and agreement with the developer.

One of the most often used incentives is an infrastructure reimbursement. Municipalities regularly require developers to bear the cost of installing public infrastructure necessary to support the proposed project. This infrastructure may include water lines, sewer lines, roads, storm drains and sidewalk improvements. Infrastructure reimbursement incentives generally provide that a defined portion of the revenue generated from the development and any subsequent development along or supported by the developer-installed infrastructure will be shared with the initial developer. This is done through an annual grant payment until

the cost of the infrastructure is fully reimbursed or a time period defined in the terms of the incentive ordinance expires (see sample ordinance attachment # 1).

As a result of the effectiveness of this type of grant program, municipalities have expanded this approach by providing annual grant payments to qualified business activities that meet or exceed an expanded set of public purpose standards, such as job creation, capital investment, property tax and/or fee generation defined in the incentive enabling ordinance and incentive agreement (see attachment # 2 Anderson Ordinance).

If carefully and properly defined in the incentive ordinance, the same grant concept and structure may be expanded to a broad range of other public purposes. These could include, but are not limited to, high priority municipal objectives such as the preservation and adaptive reuse of historical or architectural significant buildings or sites, development of business activities that will serve as a major anchor tenant, or catalytic activity to encourage additional economic development activity and job creation.

This approach has some challenges that restrict its use. "After-the-fact" financial incentives cannot be counted, in most cases, as equity in a project. Therefore, this does little to address gap financing challenges which often plague economic development projects. However, this incentive approach does improve project cash flow by infusing cash payments to the developer during the early years of a project. The increased cash flow may strengthen the developer's pro forma financial statements, reducing the risk associated with the project. The reduced risk may allow a developer to qualify for a higher initial investment or loan(s) proceeds which may eliminate the need for gap financing.

When a gap in financing cannot be avoided and prevents an essential project from moving forward, municipalities may want to consider upfront grants or loans to developers. With this approach, there is a need for a more complex arrangement between the municipality and the developer. To ensure compliance with constitutional and statutory provisions, the municipality needs to reasonably guarantee, that if the loan or grant is made to the developer, the public benefit for which the incentive is based will (1) materialize, (2) be proportional to the level of public investment and (3) remain in place for a reasonable time period relative to the level of initial public investment.

Additionally, security mechanisms should accompany such grants/loans to provide reasonable assurance that, if the publicly assisted project does not produce the anticipated public benefit, the municipality has recourse to recover its investment in the project. The upfront incentive assistance is often structured as a deferred forgivable loan from the city. If the developer meets defined performance standards related to the intended public purpose, (i.e. job creation and/or taxable investment), the city will defer the annual principal and interest of the loan. If the developer continues to meet the public purpose standards for the cumulative period defined in the loan agreement, the city forgives the outstanding principal and interest. A deferred forgivable loan is usually accompanied by a loan agreement, promissory note and mortgage to ensure that the public investment is recoverable if the developer fails to meet the defined public purpose(s) associated with the assistance.

In the case of projects that involve the renovation and/or adaptive reuse of historic buildings or property, an alternative revenue source to incentivize a project may be the purchase of a historic preservation easement. A historic preservation easement is a voluntary legal agreement between a property owner and

a qualified easement holding organization to protect a significant historic property by restricting future changes to and/or development on the site.

Façade easements are commonly used to require the preservation of historic and architecturally significant exterior features of a property. Easements are granted in perpetuity. Once recorded in the county records office, an easement becomes part of the property's chain of title and usually "runs with the land" in perpetuity. An easement granted in perpetuity means it lasts forever. It binds not only the owner who grants the easement but also all future owners.. Clearly the public benefit associated with this form of incentive is the permanent preservation of historic and architecturally significant resources for future generations.

Because the easement is legally binding and the payment of the easement fee can be structured such that the money is exchanged as the preservation work is completed on the building, there is very little concern that the public benefit for which the incentive is granted will not materialize or will be temporary in nature. In this case, a well-written incentive agreement and façade easement may be all the documentation that may be necessary.

Summary

Economic development incentives can be an effective tool for municipalities if carefully developed, structured and implemented. Incentives should be used prudently after thorough due diligence by the municipality granting the incentive. Publicly funded incentives may be granted either in the form of grants or loans provided that the funds are used for a public purpose which has a high probability of resulting in public benefit proportional to the level of investment of public funds.

Eligibility for incentive participation must not be arbitrary and must treat all members of the class of eligible business activities in a similar manner under similar circumstances. Carefully defined and applied eligibility criteria based on public purpose standards can assist municipalities in avoiding public purpose and equal protection challenges. The municipality may grant incentives to developers upfront or after certain performance standards have been met. Security mechanisms should accompany upfront incentives to ensure developer performance and to collateralize the public incentive investment.