The Future of Economic Incentives

Although state and local budgets have been strained by the current economic crisis, incentive funds are still available in many places for the most viable projects.

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New national leadership, market uncertainty, recession, and low consumer confidence have combined to create a very different landscape from that of a year ago. When the fundamentals behind corporate decisions have changed this much, it's time to pause and consider the fundamentals. Rules of thumb and familiar behavior patterns break down, but the building blocks of location selection, economic incentives, and negotiation remain unchanged.

So what does this mean for the future of economic incentives? Change is already evident in the programs offered, the companies seeking them, and the environment in which they are negotiated. Patterns are beginning to emerge, but the field is still full of conflicting information. To make sense of it, we've surveyed economic development agencies and real estate professionals to identify what's changed and what hasn't. We'll look at local, state, and federal programs, and at recent experience from across the country.

The Legislative Environment

This year will mark the clash of budget realities with the dire need for economic development. A down economy is precisely the situation that makes communities work harder to bring in jobs and investment. But 2009 will also be a time of revenue shortfalls and shrinking budgets, and the balance between them will not be even across all markets.

The Center for Budget and Policy Priorities reports 44 states face budget deficits in either fiscal year 2009 or 2010. The only states expected to be in the black are Texas, West Virginia, Montana, Alaska, Wyoming, and North Dakota.

Some states are facing mid-year shortfalls. Florida, for example, is faced with a $2.3 billion deficit for FY 2009. As a result, state lawmakers are eliminating $24 million from Florida's Quick Action Closing Fund, a grant program used to bolster business attraction and retention efforts. Other states may squeak through 2009, but be faced with reduced budgets in July, when most begin a new fiscal year.

Yet it would be wrong to assume that 2009 will be a bad year for incentives, even in states facing a shortfall. First, by all economic forecasts, we should expect fewer companies to be investing in new locations. There will still be movement, but the "new development pie" will be smaller. This reduces the candidate pool for incentive programs. Less money will chase fewer projects, so winners may end up better off.

Second, many states are holding the line in the face of widespread budget woes, and even expanding economic development incentive programs. Jay Nixon, Missouri's new governor, is already working to expand benefits under the State's Quality Jobs Program, citing the need to "get Missourians back to work and support small-business growth during these challenging economic times." Under the Quality Jobs Program, eligible companies are able to retain the state withholding tax of new jobs and/or claim state tax credits, which are refundable, transferable, and/or saleable. Governor Nixon also proposes the creation of a low-cost, direct-loan program for small businesses and the use of tax credits to offset pre-employment training expenses.

In Virginia, Governor Tim Kaine is pursuing a $5 million increase in the Governor's Opportunity Fund, and legislation is being considered that would raise the cap on the Virginia Investment Partnership Program. And other states, like South Carolina and Utah, aren't expecting large increases to their incentive funds, but report continued strong support for economic development programs despite budget issues.

Last summer the Commonwealth of Puerto Rico established very aggressive incentive programs through its Economic Incentives for the Development of Puerto Rico Act, including a reduced income tax rate of zero to 1 percent for target industries, a $5,000 per job tax credit for employment created in target municipalities, and a credit of up to 10 percent of industrial energy cost.

The Local Level

To identify trends at the local level, we surveyed senior Grubb & Ellis transaction professionals. In general, it seems local incentives are not falling off:

Minneapolis, MN: Bruce Maus notes that recessionary pains are felt most intensely at the local level and so it is the local organizations that are frequently the most creative. "Cash will be short, but free land, tax abatement, tax increment financing, and other programs that don't require a city or county to write a check to start the project will still be available," he says.

Oklahoma City, OK: Mark Beffort expects to see continued aggressive pursuit of economic development projects in his area. "Oklahoma City is very aggressive. They see the benefit if it means jobs. This is very visible in the recent establishment of a new TIF district to support Devon Energy's proposed new 1.9-million-square-foot corporate headquarters. In addition, in '08 we (the public) passed an incentive to relocate the Seattle Sonics (now Thunder) to Oklahoma City. We have raised well in excess of $1 billion to improve infrastructure and entertainment."

Lee County, FL: In an effort to turn the economic tide, Lee County, Florida, recently established an unprecedented $25 million Financial Incentives for Recruiting Strategic Targets (FIRST) Initiative. The new incentive offers cash to companies in high-impact industries, such as life sciences.

Washington, D.C.: "We believe that economic development officials are more intent than ever to retain existing/remaining jobs and to promote emerging areas where they have made significant investments," reports Grubb &Ellis' Bruce McNair. He reports securing $15 million in real estate tax waivers to motivate a non-profit client to relocate into an emerging market in the District of Columbia. He does note, "This position may change as the economy continues to deteriorate and local budget pressures grow."

Incentive Structure: Self-Funding Makes a Difference

Some incentives are easier on the budget than others. Incentives funding directly tied to new tax revenues generated by the project are easier to stomach when the economy is down because they don't divert money from existing funding priorities.

EDGE — Economic Development for a Growing Economy (EDGE) programs in Indiana and Illinois let companies retain part of income tax withheld from new employees instead of sending it on to the state. This payment vehicle short cuts the administration process, while leaving employees unaffected, but it also assures that the state only gives up money that is directly attributable to those new jobs.

Property tax abatement and tax increment financing (TIF) districts are similarly self-adjusting, in that incentives are based on new revenue to the taxing entity. Reports from local economic developers indicate continued willingness to offer these programs in 2009.

Infrastructure investment remains in favor with all levels of government, because of the immediate, reliable impact coming from construction salaries and purchase of building material. Economic development organizations have shown a preference for these "safe" investments, which lend greater weight to the long-term projections of companies with significant capital investment. President Obama's budget is also expected to include funds for infrastructure. Companies that pursue construction projects in 2009 will likely find communities willing to help with needed infrastructure improvements.

Tax credits — Annual budgetary debates often gloss over tax credits, which are typically established by state statute. We expect these programs to remain largely untouched, with a few exceptions. California will "limit use of research and enterprise zone tax credits in the 2008 and 2009 tax year" by reducing the percentage of the franchise or income tax due

that can be offset. However, this incentive structure is only relevant to the extent that companies have taxable income.

Discretionary grants — The toughest battles involve programs that rely on grant monies awarded during budgetary processes. These include the discretionary "deal-closing funds" that many states use to cinch projects, as well as training incentives that rely on annual appropriations. While drastic cuts have not yet appeared across the board, heated discussions will be a feature of the current legislative sessions.

Financing — Financing-driven incentives show a mixed outlook. The credit crunch makes these incentives more important than in the past. Local and state financing assistance that relies on federal programs like Community Development Block Grants or the Small Business Administration (SBA) may see an increase, especially under the Obama administration. However, private-sector participation requirements are making it tougher to put together a successful package. In Carlsbad, Calif., Grubb &Ellis' Mark Randall reports, "The secondary market for SBA loans has become quite slow, which will affect the extent to which the SBA can leverage its funds."

Foreign investment — In Greenville, N.C., Steve Navarro, president of Grubb & Ellis | The Furman Company, expects more emphasis on federally assisted programs to cover the gap left by the banking community. One potential source is the federal investor visa (or EB5) program, which awards a U.S. visa to foreign individuals who create U.S. jobs through investment in target geographies. Navarro and colleague Allen Ballew see this program as a way to bring foreign capital and American jobs to South Carolina. They have become one of 17 designated regional centers nationwide to sponsor EB5 immigration investment. Half of the 10,000 visas available under this program will be awarded through these regional centers. Other entities, including economic development organizations, have taken a similar approach.

Clawback funds — The dark side of incentive implementation has also revealed one bright spot. Clawback agreements, which kick in when companies fail to meet agreed-upon investment and job-creation targets, may require them to repay monies received. The good news in this bad situation is that these monies are frequently being added back to the "pot" above and beyond budgetary appropriations. Likewise, monies earmarked — even if not paid out — may become available when companies find themselves unable to proceed with earlier plans.

New Negotiating Environment

In 2009, remember that all incentive applications will receive greater scrutiny than in the past. Governments are under extreme pressure to make ends meet and will need to be convinced that the project is a safe investment (i.e., the company has the financial resources to carry through and stay liquid) and that the return on investment (job creation, job quality, and tax revenue) warrants the expenditure of funds.

Those that survive the review process will face a sharper pencil during negotiations. Even markets with money and the political will to spend it will be very focused on good stewardship of scarce funds. "Whereas before we might have thrown in an extra $50,000 just to make sure we won the project, now we're more likely to put out a lower number and keep our fingers crossed," noted one state official. "Companies will need to explicitly tell us what bridge we need to cross."

This year, far fewer companies are pulling the trigger on new investments, so governments show increased interest in smaller projects. We were surprised by the warm response to a recent incentives assignment — a small (two-person, 35,000-square-foot) distribution facility was offered significant up-front cash grants. This was a big change from the environment of two years ago, with one community noting, "In today's economy, all jobs are good jobs."

Sorting Out Retention Incentives

As corporations struggle with reduced demand for service and products, they naturally consider consolidations, reductions, and closings. Requests for proposal (for corporate real estate services) arriving in our offices show a pronounced shift in emphasis, from "strategic planning for future expansion" to "cost reduction and identification of consolidation opportunities." This is at odds with the traditional motivations for granting economic development incentives, namely the expansion of a local economy. In a stalled or shrinking economy, retention is the equivalent of growth, but it presents several challenges.

First, who is eligible for retention incentives? Spending to create new growth is easy to defend, but awards to companies that are already in place are grounds for grumbling among other companies. Successful arguments for retention incentives are usually based on a handful of arguments, consisting of the following:

- *We have to make a choice.* — Companies considering consolidation across multiple markets have a legitimate argument that the consolidation could be here, or it could be elsewhere.
- *We'll be adding jobs somewhere.* — The combined entity often ends up larger than the existing facility, when out-of-town components are included.
- *This is a big commitment.* — Companies may be shifting from a short-term relationship (a leased facility or non-crucial company functions) to capital investment, long-term job training, or development of a specialized facility.

Better Odds, Smaller Wins, More Accountability

The tug-of-war between budget shortfalls and a greater need for economic development continues. A lot is riding on current legislative sessions. While outcomes will vary based on geography, project type, and form of incentive, two principles remain as valid as ever:

1. Good projects will still see active recruitment. Look no further than IBM's 1,300-person technology service center in Dubuque, Iowa, which was accompanied by a $55 million incentive package. Or consider Michigan's approval of $335 million in tax credits for battery manufacturing plants.

2. Incentives do not make a bad location good. Companies consider the entire operating picture when making a location decision. Economic incentives are something they consider very late in the location selection process, when they've created a list of locations that work.

The mechanisms that fund incentives are strained by the current economic crisis, but their justification is stronger than ever, and strong incentive programs endure. They are characterized by increased accountability, tougher scrutiny of projects, and built-in self-funding. For a strong project in genuine need, the world has not changed that much.

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