

## LOCAL GOVERNMENT INCENTIVES

Below is a report prepared for a municipal client of the Sanford Holshouser law firm. The names of the municipality and the county in which it is located have been deleted.

This report gives an overview of the history of local government incentives in North Carolina; a summary of the legal authority for local government incentives; and a discussion of what Sanford Holshouser believes to be relevant policy considerations in adopting any local government economic development incentive program. Also attached to this report are N.C.G.S. §158-7.1, the Local Development Act, which gives local governments the authority to provide incentives to recruit or retain industry, and a proposed incentive.

Although this was prepared for a particular local government, almost all of the contents are equally applicable to an incentive policy being considered or adopted by any local government.

The information being provided herein is adequate for general background knowledge about recruitment/retention incentives. However it is strongly urged that if a local government undertakes to adopt an economic development incentive policy, it should engage the services of qualified legal counsel and an experienced economic development professional.

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**REPORT TO \_\_\_\_\_ CITY COUNCIL**

**REGARDING**

**LOCAL INCENTIVE POLICY FOR**

**BUSINESS RECRUITMENT/EXPANSION**

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## **INTRODUCTION**

This report is being provided as a joint effort of The Sanford Holshouser Business Development Group in partnership with the law firm of Sanford Holshouser LLP.

This advice is legally well founded based upon the long experience of Sanford Holshouser LLP in local government incentive matters. Any advice regarding legal implications of matters concerning local government incentive policies are provide solely by Ernest Pearson in his role as an attorney and partner of Sanford Holshouser LLP.

In addition, this advice is based upon a very broad awareness of local government incentive practices in North Carolina. Sanford Holshouser LLP has developed incentive policies for, negotiated incentive agreements on behalf of, or provided guidance and advice on incentive matters for over 50 local governments, and some on multiple occasions. Partners in the Sanford Holshouser Business Development Group have all dealt with local government incentive matters as leaders of recruitment efforts. The advice contained herein draws on that range of experience and insight.

This report outlines:

- A history of local government incentives in North Carolina
- A review of the legal status of and support for incentives at the local level
- Comments on the competitive necessity for incentives
- Recommendations regarding items to include in incentives policies

For ease of reference, attachments include a copy of the primary statutory authority for local government incentives, N.C.G.S. 158-7.1. Also, a sample incentive policy is attached.

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## **GROWTH IN USE OF LOCAL GOVERNMENT INCENTIVES**

During my service as Assistant Secretary for Economic Development at the N.C. Department of Commerce, from 1989 to 1993, local government incentives were used very infrequently. For example, Lenoir County very cleverly used the offer of free land to make their County stand out from all others, and was very successful in attracting industry.

There are several reasons why local government incentives were used so infrequently in that time frame. One very practical reason such inducements were sparingly used is that prior to 1993, the controlling statute, N.C.G.S. 158-7.1 did not apply to all local governments. For a local government to have authority to utilize local government incentives that government would have to obtain passage of a local bill in the General Assembly opting under the statute. Few local governments sought that authority.

Of greater importance is that local government incentives were not often competitively necessary in that era. That is, few other local governments in North Carolina and competing states were offering recruitment /retention incentives except for massive mega projects, so few local governments sought authority to utilize incentives. Also, obviously, relatively few companies had as one of their siting criteria incentive grants which are common today.

But as alluded to above, in 1993, the General Assembly amended N.C.G.S. 158-71 to have it apply to all local governments, without the necessity of passing a local bill to opt under the statute.

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Immediately following this change in the relevant statute, there was a short burst of activity as more and more local government leaders were faced with the necessity to use incentives to successfully attract new and expansion projects.

The use of local government incentives declined during the pendency of the lawsuit, *Maready v. City of Winston-Salem*, filed in 1994. This case challenged local government incentives as being unconstitutional on the basis that they constituted using public money for a private business endeavor and benefit. Concern regarding this issue caused a sharp pull back in the use of incentives for industrial recruitment /retention purposes.

On March 8, 1996, the North Carolina Supreme Court in a split decision ruled that local government incentives to recruit or retain jobs and tax base was a proper use of government funds. A concise statement of the Supreme Court's ruling follows:

The public advantages are not indirect, remote, or incidental; rather, they are directly aimed at furthering the general economic welfare of the people of the communities affected. While private actors will necessarily benefit from the expenditures authorized, such benefit is merely incidental. It results from the local government's efforts to better serve the interests of its people.

Once this cloud over local government incentives was removed, the use of incentives to recruit and retain investments began to increase rapidly.

During early work in the area of incentives, it seemed as if every time the firm was involved in working with a local government to adopt an incentive policy or negotiate an incentive agreement it was the first time that entity had dealt with this matter.

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That is not the case anymore

Now virtually all local governments engage in the use of local government incentives. Even major metropolitan areas, that for years attracted businesses by virtue of all the benefits in their area offered, now offer incentives to recruit new industry and to retain expansions of existing companies.

Local government incentives have become an essential competitive tool for local governments which want to be successful in their economic development efforts.

### **LEGAL AUTHORITY FOR INCENTIVES**

A number of statutes give some level of authority for local governments to enter into and support economic development efforts. N.C.G.S. 160A-209(c)(10b) allows municipalities to appropriate money for matters related to economic development. N.C.G.S. 158-12 allows local governments to make appropriations for regional economic development efforts. Consequently as a very basic matter, the primary leadership role local governments play in promoting economic development has been recognized and authorized for quite some time.

The statute which allows local governments to engage in providing incentive support for new and expansion projects is N.C.G.S. 158-7.1. A copy of this statute is at Attachment A for ease of reference.

Subsection (a) of this statute provides very broad authorization for local governments to utilize public funds to promote economic growth. Subsection (a) seems to have no limit on the discretion of local governments to use funds for these purposes.

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Subsection (b) of this statute goes on to list some examples of specific actions that be undertaken with local public funds to promote economic growth. But this section, even in delineating certain permissible transactions contains a very interesting parenthetical phrase, which reads, “(This listing is not intended to limit by implication or otherwise the grant of authority set out in subsection (a) of this section.)”

References to the above statute are for one reason; that is to emphasize that it seems crystal clear that the General Assembly’s legislative intent has been to give broad, strong affirmation of the authority of local governments to utilize public funds for incentives.

This statutory authority has only been challenged in one case that has gone all of the way to a final decision. That case is the Maready case referred to above. As noted, the Supreme Court made clear that using public money at the local level to promote economic development (job growth and tax base growth) is for a public purpose, regardless of whether a private company is coincidentally benefited.

Of course, as of the writing of this report, most are well aware of the lawsuit filed in the Dell Computer project by the N.C. Institute for Constitutional Law. That lawsuit raises a laundry list of challenges, including trying to get the N.C. Supreme Court to reverse itself on its finding in the Maready case. This case is in the trial stage and is quite some time away from a final decision. Until there is a ruling from the N.C. Supreme Court to the contrary, local government incentives are legal and constitutional in North Carolina. Consequently, it seems that when a local government is convinced that it is a competitive necessity to utilize incentives in a project, the judicious,

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fiduciarilly sound utilization of this authority is justified, despite pending, undecided challenges.

However, what the pending challenge and potential other challenges call for is that local governments use an extra degree of precaution in offering incentives and in promulgating incentive policies. Care should be given to assure that incentive policies and incentive agreements are drafted and utilized in a way that gives the highest potential that a challenge can be overcome.

As an example of this, local government incentives have never been challenged on a tax abatement basis. Tax abatements are unconstitutional in North Carolina. Incentive grants being negotiated or incentive policies being promulgated must avoid terminology that leaves an opening for the challenge that incentive support in a project is a tax abatement. For this reason the use of language in an incentive policy that refers to a “percentage of property taxes collected” or “tax rebates” should be avoided. Instead, levels of incentives should be stated as dollar amounts in incentive agreements. Incentive grants should be tied to jobs created and capital investment, making them truly different from a percentage of taxes.

Other issues should be avoided as well, but the tax abatement issue is the big one hanging out there.

The sample incentive policy proposed in Attachment B is designed to lessen the potential of a successful legal challenge.

### **COMPETITIVE NECESSITY FOR INCENTIVES**

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Here, relatively little will be said on this topic. There are treatises and studies that go on ad infinitum arguing both sides of the issue of whether incentives are competitively necessary in recruitment/retention efforts. Instead at this point, the following relevant observations of verifiable facts regarding the current status of economic development incentives in site selection projects are offered:

- In the late 1980s and early 1990s, only a few of and the very largest projects worked through the NC Department of Commerce even raised the question of incentives, now virtually all recruitment and retention projects have as one of their initial criteria the provision of incentive support. Every company now expects this type of support.
- A national site selection magazine does a survey each year of corporate officials as to leading factors as to why sites for facilities were chosen. In the December 2004 report, incentives were listed as the number one criteria on choosing a location for a facility. It seems a bit illogical that roads, labor force, water, sewer, etc would rank below incentives, but this survey shows how predominant this matter is in the thinking of corporate America.
- Whereas in the late 1980's and early 1990's relatively few local governments in North Carolina and other states were using incentives, just about all local governments do now. If a company can get everything else it needs (labor, infrastructure, etc.) in two or more nearby localities, why wouldn't the company pick the location that offered the most financial advantages?
- One other point should be noted for any local government proximate to either the South Carolina or Virginia borders of our State. Such local governments are not only competing with nearby North Carolina localities, but with localities in other states –

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states which traditionally have had the statutory authority to do more, and be more aggressive with the use of incentives.

It is understood that public officials receiving this report have come to an understanding of the competitive necessity for incentives.

Based upon the long and broad experience of Sanford Holshouser LLP and The Sanford Holshouser Business Development Group, it can be stated conclusively that incentives for recruitment and retention have to be a tool for a local government to use if it is to be competitive.

### **ELEMENTS OF EFFECTIVE INCENTIVE POLICY**

As an initial point, the question of whether an economic development incentive policy is necessary to permit a local government to engage in industrial recruitment/retention incentive grants may be asked. The answer is no. A local government may make incentive grants whether or not a previously adopted incentive policy is in place.

However, it is recommended that a written incentive policy be adopted for several reasons:

- An incentive policy such as the one attached bolsters the defense against a judicial challenge to an incentive grant. For example, the portion at the start of the document, which lists economic hardships, would be useful evidence at such a trial to show the public purpose being served by incentive grants.

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- The policy gives the governing body guidelines as to how it will deal with incentive issues. In such important matters “the rules of the game” should not be made up as one goes along.
  - A community wants to make companies, site selection consultants and referral sources aware of the availability of incentives. Many companies have this on their initial criteria sheet so a locality that hides the fact that incentives are a possibility will lose out on projects which will just not come to look. The written incentive policy addresses this.
  - The incentive policy should be a public relations tool. The attached policy addresses this legitimate need.
  - Even though the attached incentive policy does not set forth specific levels of incentives for certain size projects, the local official should clearly, on a confidential basis, establish for the Economic Development Director what levels of incentives are authorized without further authority from the governing board. This gives a greater degree of stability of negotiations from the local government point of view, just as a person going to an auction is encouraged to have established predetermined bidding levels.

Consequently, the adoption of incentive policies is strongly encouraged. There are two primary directions that can be taken when establishing incentives policies.

First, a local government could adopt a policy which is very specific as to the amount of incentive grants which will be provided for certain levels of jobs, capital investment or both. In fact, for a period of time, quite a few local governments had incentive policies which referred to “percentage tax rebates.” In early involvement in

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helping local governments to prepare incentive policies, assistance was provided in developing policies which were specific as to incentive levels.

However, at a fairly early stage, the conclusion was reached that continues to the present. Incentive policies which set forth specific levels of incentives should not be used. Serving as a town board member and legal counsel for many local governments in the state, experience has shown that many elected officials like to have incentives set out specifically what will be provided, because it is comforting to not have to decide the amount of incentives on a project by project basis. However, this approach has three major problems. One problem is legal in nature, and the other two are a problem in the economic development arena:

- It is very hard to write incentive policies that are specific as to amounts of incentives without making reference to percentages of taxes or tax base. This just invites a legal challenge based on the tax abatement argument.
- An incentive policy becomes a public document. Why in the world would one want every competing locality to be able to see the local government's incentive levels?
- Also, given the point raised in the above paragraph, why would a local government engaged in negotiations with a company want that company to know the local government's bidding level?

For these reasons, recommending incentive policies which are specific as to the levels of incentives was abandoned long ago.

The second option is attached as a recommended beginning point for the City of \_\_\_\_\_ to develop an incentive policy. This provides broad guidelines on the provision of incentive support, and does not set forth specific levels of incentives.

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However it is wise, if not essential, that the Economic Development Director has guidelines by which to go. Consequently, it is recommended that aside from the attached policy and on a confidential basis, that the Director be given input on the level of incentives which would be supported.

The attached draft of a starting point on an incentive policy is written in part from a public relations point of view. However, the language is also important from a legal point of view. Throughout the attached policy terms and portions which may seem to be casual language have significant legal meaning.

Some of the key elements of the attached incentive policy include:

- The Preamble certainly has public relation benefits, but from a legal point of view, it is desirable to start to lay out a clear case on why incentive grants are necessary from a public purpose point of view and the legal basis for incentives. This portion, particularly the recitation of economic hardships, establishes the public need being addressed by this policy.
- The portion on “Policy Principles” also could provide good evidence in a legal challenge. This portion shows a carefully thought through basis for any incentive support. Also, in the intense emotional process of negotiating for a significant economic development project, having policy considerations to guide the decision makers keeps “things on track.”
- The portion on incentive “Program Parameters” will guide the City as to relevant criteria to weigh in considering incentive support for a company. This guides staff and company representatives as to relevant information to be provided, and helps to guide the thinking of elected officials. How high a project “scores” on these criteria

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gives some guidance as to incentive amounts. Also, this level of due diligence and the summary of public purposes considered in this section could be good information to use at any trial over a challenge to an incentive grant.

- “Minimum Project Qualifications” should be in any incentive policy. Some projects are just too small to merit going through the incentive process, hence the project size requirements in the attached policy. Recruitment incentives are largely irrelevant for certain types of businesses (e.g. law offices), so the attached policy lists only certain types of prospects which would qualify for incentives. It is essential to weed out projects which are of low impact for the community or for which incentives play no part in their location decisions.
- The “Exclusionary Factors” portion states that projects which might meet all “Minimum Project Qualifications” will still not be considered for incentives if one or more exclusionary factors apply.
- The portion regarding use of grant funds only list certain cases which will leave value in the community if a company closes early or curtails its operations. This is the best position to be in to be able to point to value added measures that continue to be of benefit to the community. This will not deter a company. A savings on one line item of a budget just allows the company to move money to another line item.
- The “Procedure for Grant Consideration” sets forth a simple but very adequate process for incentive grants to be considered. This allows for everyone from elected officials to senior staff to have a clear process to go through in these matters.
- These guidelines are only guidelines. Throughout, this policy emphasizes that the governing board retains discretion as to incentives on a project-by-project basis.

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An incentive policy which has the above characteristics would be most effective from a marketing point of view and most defensible if called into question either in a legal court or the court of public opinion.

As can be seen, some information needs to be inserted into the attached incentive policy. Any assistance needed to help determine what should be included in these places will be provided.

It is significant to note that in the review of \_\_\_\_\_ County's proposed incentive policy and incentive contract, it appears that many of the above principles have been carried forward. Consequently with some minor calibrations, it seems that the \_\_\_\_\_ policy can be quite consistent with the \_\_\_\_\_ County policy.

### **CONCLUSION**

Thank you for allowing Sanford Holshouser LLP and The Sanford Holshouser Business Development Group to work on this matter.

If any expansion upon the above comments or further assistance is needed, it would be our privilege to be of service.

**§ 158-7.1. Local development.**

(a) 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. These appropriations may be funded by the levy of property taxes pursuant to G.S. 153A-149 and 160A-209 and by the allocation of other revenues whose use is not otherwise restricted by law.

(b) A county or city may undertake the following specific economic development activities. (This listing is not intended to limit by implication or otherwise the grant of authority set out in subsection (a) of this section). The activities listed in this subsection may be funded by the levy of property taxes pursuant to G.S. 153A-149 and G.S. 160A-209 and by the allocation of other revenues whose use is not otherwise restricted by law.

(1) A county or city may acquire and develop land for an industrial park, to be used for manufacturing, assembly, fabrication, processing, warehousing, research and development, office use, or similar industrial or commercial purposes. A county may acquire land anywhere in the county, including inside of cities, for an industrial park, while a city may acquire land anywhere in the county or counties in which it is located. A county or city may develop the land by installing utilities, drainage facilities, street and transportation facilities, street lighting, and similar facilities; may demolish or rehabilitate existing structures; and may prepare the site for industrial or commercial uses. A county or city may convey property located in an industrial park pursuant to subsection (d) of this section.

(2) A county or city may acquire, assemble, and hold for resale property that is suitable for industrial or commercial use. A county may acquire such property anywhere in the county, including inside of cities, while a city may acquire such property inside the city or, if the property will be used by a business that will provide jobs to city residents, anywhere in the county or counties in which it is located. A county or city may convey property acquired or assembled under this subdivision pursuant to subsection (d) of this section.

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(3) A county or city may acquire options for the acquisition of property that is suitable for industrial or commercial use. The county or city may assign such an option, following such procedures, for such consideration, and subject to such terms and conditions as the county or city deems desirable.

(4) A county or city may acquire or construct one or more "shell buildings", which are structures of flexible design adaptable for use by a variety of industrial or commercial businesses. A county or city may convey or lease a shell building or space in a shell building pursuant to subsection (c) of this section.

(5) A county or city may construct, extend or own utility facilities or may Page 1 of 3 G.S. 158-7.1 2/6/2006 provide for or assist in the extension of utility services to be furnished to an industrial facility, whether the utility is publicly or privately owned.

(6) A county or city may extend or may provide for or assist in the extension of water and sewer lines to industrial properties or facilities, whether the industrial property or facility is publicly or privately owned.

(7) A county or city may engage in site preparation for industrial properties or facilities, whether the industrial property or facility is publicly or privately owned.

(c) Any appropriation or expenditure pursuant to subsection (b) of this section must be approved by the county or city governing body after a public hearing. The county or city shall publish notice of the public hearing at least 10 days before the hearing is held. If the appropriation or expenditure is for the acquisition of an interest in real property, the notice shall describe the interest to be acquired, the proposed acquisition cost of such interest, the governing body's intention to approve the acquisition, the source of funding for the acquisition and such other information needed to reasonably describe the acquisition. If the appropriation or expenditure is for the improvement of privately owned property by site preparation or by the extension of water and sewer lines to the property, the notice shall describe the improvements to be made, the proposed cost of making the improvements, the source of funding for the improvements, the public benefit to be derived from making the improvements, and any other information needed to reasonably describe the improvements and their purpose.

(d) A county or city may lease or convey interests in real property held or acquired pursuant to subsection (b) of this section in accordance with the procedures of this subsection. A county or city may convey or lease interests in property by private negotiation and may subject the property to such covenants,

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conditions, and restrictions as the county or city deems to be in the public interest or necessary to carry out the purposes of this section. Any such conveyance or lease must be approved by the county or city governing body, after a public hearing. The county or city shall publish notice of the public hearing at least 10 days before the hearing is held; the notice shall describe the interest to be conveyed or leased, the value of the interest, the proposed consideration for the conveyance or lease, and the governing body's intention to approve the conveyance or lease. Before such an interest may be conveyed, the county or city governing body shall determine the probable average hourly wage to be paid to workers by the business to be located at the property to be conveyed and the fair market value of the interest, subject to whatever covenants, conditions, and restrictions the county or city proposes to subject it to. The consideration for the conveyance may not be less than the value so determined.

(d1) Repealed by Session Laws 1993, c. 497, s. 22.

(d2) In arriving at the amount of consideration that it receives, the Board may take into account prospective tax revenues from improvements to be constructed on the property, prospective sales tax revenues to be generated in the area, as well as any other prospective tax revenues or income coming to the county or city over the next 10 years as a result of the conveyance or lease provided the following conditions are met:

(1) The governing board of the county or city shall determine that the conveyance of the property will stimulate the local economy, promote business, and result in the creation of a substantial number of jobs in the county or city that pay at or above the median average wage in the county or, for a city, in the county where the city is located. A city that spans more than one county is considered to be located in the county where the greatest population of the city resides. For the purpose of this subdivision, the median average wage in a county is the median average wage for all insured industries in the county as computed by the Employment Security Commission for the most recent period for which data is available.

(2) The governing board of the county or city shall contractually bind the purchaser of the property to construct, within a specified period of time not to exceed five years, improvements on the property that will generate the tax revenue taken into account in arriving at the consideration. Upon failure to construct the improvements specified in the contract, the purchaser shall reconvey the property back to the county or city.

(e) All appropriations and expenditures pursuant to subsections (b) and (c) of this section shall be subject to the provisions of the Local Government Budget

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and Fiscal Control Acts of the North Carolina General Statutes, respectively, for cities and counties and shall be listed in the annual financial report the county or city submits to the Local Government Commission. The budget format for each such governing body shall make such disclosures in such detail as the Local Government Commission may by rule and regulation direct.

(f) At the end of each fiscal year, the total of the following for each county and city may not exceed one-half of one percent (0.5%) of the outstanding assessed property tax valuation for the county or city as of January 1 preceding the beginning of the fiscal year:

- (1) The investment in property acquired at any time under subdivisions (b) (1) through (b)(4) of this section and owned at the end of the fiscal year.
- (2) The amount expended during the fiscal year under subdivisions (b)(5) and (b)(7) of this section.
- (3) The amount of tax revenue that was taken into account under subsection (d2) of this section and was expected to be received during the fiscal year.

The Local Government Commission shall review the annual financial reports filed by counties and cities to determine if any county or city has exceeded the limit set by this subsection. If the Commission finds that a county or city has exceeded this limit, it shall notify the county or city. A county or city that receives a notice from the Commission under this subsection must submit to the Commission for its review and approval any appropriation or expenditure the county or city proposes to make under this section during the next three fiscal years. The Commission shall not approve an appropriation or expenditure that would cause a county or city to exceed the limit set by this subsection.

(g) Repealed by Session Laws 1989, c. 374. (1973, c. 803, s. 37; 1985, c. 639, s. 1; 1985 (Reg. Sess., 1986), c. 846, s. 1, c. 848, s. 1, c. 858, s. 1, c. 911, s. 1, c. 921, s. 1; 1987, c. 577, s. 1.1; 1989, c. 374, s. 1; 1991, c. 598, s. 6, c. 659, ss. 1, 2; 1991 (Reg. Sess., 1992), c. 793, s. 1, c. 799, s. 1, c. 938, s. 1; 1993, c. 31, s. 1, c. 42, s. 1, c. 246, ss. 1 (a), 1(b), c. 275, s. 2, c. 358, s. 13, c. 497, ss. 22, 24, c. 536, ss. 1, 4.)

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Attachment B