

Using Economic Development Incentives: For Better or for Worse

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State and local incentives to stimulate economic development have increased in North Carolina, as they have across the United States. State and local governments continue to deal with the realities of economic transition created by globalization and technological advances. The quest for private investment and jobs in an increasingly competitive global economy is raising the stakes of economic development. The jurisdictions that aggressively use incentives to succeed in the “job wars” can potentially win big—but at what cost and toward what end?

Some recent large deals in North Carolina illustrate how the immediate thrill of victory in the incentives game must be tempered by questions about the actual net benefit to the state and its communities. For example, assuming that Winston-Salem and Forsyth County had to promise about \$280 million in state and local incentives to attract a Dell computer-assembly plant, was doing so worth it? What about the \$262 million offered to land a Google data center/server farm in Lenoir and Caldwell County? A new state grant program to encourage Bridgestone/ Firestone and Goodyear to expand and upgrade facilities at locations in eastern North Carolina could cost as much as \$60 million. State incentives alone totaled \$3.7 billion from fiscal years 2005–6 through 2007–8. Some observers have a nagging sense that the state and its local governments might be paying large corporations too much for jobs and investment while overlooking the needs of existing industries and small businesses.¹

The proliferation of business incentives for economic development is con-



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troverial, in part because public officials often fail to assess adequately the net return on the public investment in incentive deals. Other concerns about the growing use of incentives center on whether they work and what the rationale is for using them.² The strongest argument offered by proponents for the continued and expanded use of incentives is that incentives actually influence business location decisions. Although some evidence supports this claim, skeptics cite numerous studies that show incentives having little to no positive direct effect on investment decisions.³

This article provides public officials with a roadmap for navigating the debate on economic development incentives. The intent is not to take a position for or against incentives, but to discuss the enduring arguments from both sides and the latest research findings on incentives so that readers can make informed decisions. Many jurisdictions probably will offer business incentives into the foreseeable future. The article may help them be more strategic and judicious in using incentives to bring about desired economic development outcomes.

The Evolution of Incentives in North Carolina

The State of North Carolina had no comprehensive incentive policy until the General Assembly passed the William S. Lee Quality Jobs and Business Expansion Act (Lee Act) in 1996. Before that, the state had relied mostly on other sources of relative advantage, such as its low labor costs, well-developed transportation infrastructure, and responsive community college system. A limited tax credit for job creation and the Industrial Recruitment Competitiveness Fund (now the One North Carolina Fund) had been established in 1993, but economic developers and policy makers did not deem them sufficient.⁴ A spate of losses of industrial projects, including Mercedes-Benz to Alabama and BMW to South Carolina, prompted state officials to take a more assertive stance with economic development incentives.

The Lee Act created an expanded set of tax credits targeted at new and growing industries, with the aim of strengthening North Carolina's competitive position. An important feature of the Lee Act is that it provides the greatest aid to the state's most disadvantaged areas. The amount of tax credits available to companies in a particular county is based on the county's level of eco-

nomical distress. Counties are grouped into tiers on the basis of an index of economic performance indicators. Higher amounts of incentive dollars are available in Tier 1 (poorer) counties.

The Lee Act signaled that North Carolina was "open for business" and serious about securing its share of industrial projects. The act also sparked strategic thinking and ongoing debate

Losing some big manufacturing plants to other states in the mid-1990s prompted North Carolina to become more assertive in offering direct financial and tax incentives.



Milestones in Policy on Economic Development Incentives in North Carolina

State Incentives

Year	Event
1993	Industrial Recruitment Competitiveness Fund created by N.C. General Assembly (now One North Carolina Fund)
1996	William S. Lee Quality Jobs and Business Expansion Act (Lee Act) enacted by N.C. General Assembly
2002	Job Development Investment Grant (JDIG) program created by N.C. General Assembly
2006	Article 3J tax credits enacted by N.C. General Assembly to replace Lee Act
2007	Job Maintenance and Capital Development Fund created by N.C. General Assembly

Local Incentives

Year	Event
1925	Local Development Act enacted by N.C. General Assembly
1996	<i>Maready v. City of Winston-Salem</i> decided by N.C. Supreme Court

that have resulted in the creation of additional incentives, like the Job Development Investment Grant in 2002 (discussed later).

In the first few years after enactment of the Lee Act, the governor's office and the North Carolina Department of Commerce announced the decisions of several major companies to locate operations in the state. In 1998, FedEx decided to build a regional sorting hub at the Piedmont Triad International Airport, and steel producer Nucor agreed to construct a new plant in Hertford County. The state offered reductions in sales taxes and enhanced tax credits for capital investment to help close these deals. In 1999, North Carolina scored wins by using incentives to land a QVC distribution center in Edgecombe County, a DuPont plant in Bladen County, and TIAA-CREF in Mecklenburg County.

These and subsequent projects raise an important and largely unresolved question: To what extent can the state's success in locating these facilities be attributed to the Lee Act tax credits and other incentives? That a string of significant recruitment and expansion projects occurred in the post-Lee Act period is not in doubt. At issue is whether the

projects would have happened without the incentives. Most economic developers and many public officials will say, "Absolutely not." I come back to this question later in the article.

Over the years, the General Assembly amended the Lee Act several times to address apparent deficiencies. In 2006 the General Assembly replaced it with a new program (see the later section headed Types of Incentives).

The most recent shift in state policy on economic development incentives is evident in the General Assembly's creation of the Job Maintenance and Capital Development Fund.⁵ This program emerged out of an extra session in 2007 when lawmakers worked out a deal with the governor's office to aid major employers in some of the state's Tier 1 counties. Lawmakers designed the program primarily to benefit two tire manufacturers with locations in eastern North Carolina. The program authorizes up to \$60 million for Goodyear to upgrade a plant in Fayetteville and for Bridgestone/Firestone to modernize a

facility in Wilson. Businesses located in the most economically distressed areas of the state that invest at least \$200 million in property and capital improvements and maintain at least 2,000 workers are eligible to receive annual grant payments of up to \$4 million over ten years under the program.

This new incentive program represents somewhat of a policy shift because it does not require a company to create jobs in order to receive a grant. Job creation has been central to the state's economic development policy for obvious reasons. However, the Job Maintenance and Capital Development Fund recognizes that job creation is not the only goal of economic development. Retaining jobs can be particularly important in poorer areas, and large amounts of capital investment can have significant economic and fiscal impacts.

Still, the idea of awarding grants to companies that only maintain existing employment levels, or even reduce them (for example, from 2,500 to 2,200),

makes some uneasy.⁶

This shift in state policy underscores the irony of the tension between business investments in labor and capital: as companies modernize and automate, they often can pro-

duce more with fewer workers.

The statutory authority for local economic development incentives exists in the Local Development Act of 1925.⁷ The statute authorizes cities and counties to provide a number of incentives in support of business recruitment, retention, and expansion (specific incentives are discussed later). Further, it grants broad authority for local governments to undertake a wide range of economic development activities—authority so broad that starting with what the act prohibits is easier than specifying what it allows. At least three incentives provided by local governments that often are permitted in other states are not allowed in North Carolina: property tax abatements, loan guarantees to a private company, and promises not to annex a certain parcel of property.⁸ Except for the incentives that state law forbids, coun-

A shift in the state's economic development policy recognizes that job retention may be as important as job creation, especially in areas of high poverty.

ties and cities routinely use the various tools discussed in the next section.

A significant milestone for local government incentives in North Carolina occurred in 1996 with the state supreme court ruling in *Maready v. City of Winston-Salem*.⁹ This decision reversed a lower court ruling that had declared the business incentives used by Winston-Salem and Forsyth County to be unconstitutional because they did not serve a public purpose. At issue were twenty-four incentive deals offered by the city and the county between 1990 and 1995 that totaled more than \$13 million.¹⁰ By affirming that local incentives serve a public purpose, the state supreme court cleared the way for cities and counties to continue offering incentives to lure, keep, and expand industry.

In the wake of the 1996 *Maready* decision, local governments moved quickly to ramp up their incentive programs. Later that year, Cabarrus County was one of the first to adopt an aggressive incentive policy that would essentially

grant new or expanding industries a rebate of up to 85 percent of property taxes paid over five years.¹¹ This idea of paying companies back a portion of their property taxes mimics tax abatement to some extent. However, it can be distinguished from prohibited tax abatement when such payments are contingent on the company creating a certain number of jobs or investing a minimum amount in real property and equipment. Indeed, such arrangements can help a local government avoid paying out more in incentives than it receives in tax revenue from the company. This type of incentive is thought to be more legally defensible when it is in the form of a cash grant that is not an explicit refund of property taxes paid by a company (see the later section headed Legality).¹² The courts have not yet weighed in on the constitutionality of this practice.

(For a summary of state and local milestones in policy on economic development incentives, see the sidebar on page 18.)

Types of Incentives

State governments offer both tax and nontax incentives to companies. North Carolina's state-level tax incentives consist primarily of corporate income and franchise tax credits and sales tax exemptions and refunds.¹³ The Article 3J Program, which replaced the Lee Act effective January 1, 2007, provides state tax credits to eligible businesses that create jobs, invest in business property (machinery and equipment), or invest in real property (buildings and land).¹⁴ The credit for investing in real property is available only to companies that invest at least \$10 million and create at least 200 jobs in Tier 1 counties. Article 3J tax credits are nondiscretionary, meaning that any taxpayer that meets the eligibility criteria is entitled to claim the credits.

By contrast, certain nontax incentives are discretionary grant programs in which funds are awarded on a case-by-case basis. Examples are the Job Development Investment Grant (JDIG) pro-



Table 1. Incentive Tools Used by Local Governments in North Carolina

	Percent Reporting (n = 217)
Zoning and permit assistance	59.0
Infrastructure improvements	56.2
Cash-grant incentives	42.4
One-stop permitting	30.0
State development zone	24.0
Land or building acquisition	23.0
Site preparation	19.4
Subsidized land or buildings	17.5
Subsidized worker training	16.1
Low-interest loans	11.1
Relocation assistance	9.2
Employee screening	9.2
Regulatory flexibility	7.8
Incentives for retail projects	7.4

Source: Jonathan Q. Morgan, “2006 Survey of Local Government Economic Development Activities” (Chapel Hill, NC: School of Government, University of North Carolina at Chapel Hill).

gram and the One North Carolina Fund. Companies must apply to receive JDIG grants. A five-member Economic Investment Committee makes funding decisions and awards grants on the basis of a percentage of the state income tax withholdings generated from eligible positions. The One North Carolina Fund receives a nonrecurring appropriation from the General Assembly to enable the governor to close deals that are strategically important.¹⁵ Other state-level nontax incentives in North Carolina most often come in the form of low-interest loans through industrial revenue bonds, job training, and infrastructure assistance.

Many local governments outside North Carolina frequently use property tax abatements as a discretionary tax incentive to promote economic development.¹⁶ As mentioned earlier, property tax abatement by local governments is not legal in North Carolina.¹⁷ So local governments provide discretionary cash grants to businesses instead. A recent analysis of cash-grant incentive packages approved by counties during 2004–6 found that most were supporting new facility locations rather than existing business expansions.¹⁸ Cash grants

Table 2. Incentives for Dell and Google

	Dell (in millions)	Google (in millions)
State Incentives		
Computer-manufacturing tax credit*	\$200.0	NA
Tax credits (Lee Act and Art. 3J)	21.4	\$ 2.6
Job Development Investment Grant (JDIG)	8.8	4.8
Job training	8.3	NA
Infrastructure	3.0	0.7
Sales tax refund	1.0	NA
Sales tax exemption	NA	89.0
Total state package	\$242.5	\$97.1
Local Incentives (City and County)		
Cash grants†	17.2†	165.0
Site preparation and improvements	13.0	NA
Land	7.0	NA
Total local package	\$ 37.2	\$165.0
Total State and Local Incentives	\$279.7	\$262.1

Source: The figures are my compilations from various news reports and data from the North Carolina Department of Commerce. NA = not applicable.

* Paid out over 15 years.

† Includes \$3.3 million from the Golden LEAF Foundation.

‡ Paid out over 30 years.

are typically paid out over a number of years, though some amount often is provided up front. They are usually “performance based,” which means that they are tied to the number of jobs and the level of capital investment that the business creates. A company may be required to forfeit some or all of a grant if it fails to meet certain performance thresholds in a given year. Some cities and counties base the amount of the grant on a percentage of property taxes paid by the company.

According to a recent survey of North Carolina local governments that I conducted, only zoning and infrastructure improvements are used more widely than cash-grant incentives (see Table 1). Other common local incentives include one-stop permitting, state development zones, low-interest loans, subsidized worker training, and relocation assistance. (For definitions of tools used by local governments that are not self-explanatory, see the sidebar on page 21.) A relatively new economic development tool available to local governments in North Carolina, tax increment financing, has not been widely used to date.¹⁹

Two Cases in Point: Recruitment of Dell and Google

Although not typical of the scale and the scope of routine incentive offers, two recent projects to recruit major businesses illustrate how public officials in North Carolina combine various state and local incentives to create a winning package. Dell and Google are two household names connected to the knowledge-based economy. Any state or community would want to land projects of theirs. North Carolina public officials and economic developers aggressively pursued these projects to bring jobs and investment to areas of the state that badly needed them and to mitigate the loss of textile and furniture industries. (For estimates of the state and local incentive packages offered to lure the new facilities of these two major corporations, see Table 2.)

The largest part of the state package for Dell is a tax credit tied to the number of computers produced at the new North Carolina facility. The General Assembly enacted this special tax credit in 2004 during an extra legislative ses-

sion to ensure that Dell would locate somewhere in the Piedmont Triad region of the state.²⁰ Once Dell chose North Carolina, local governments in the Triad region—Davidson County, the City of Greensboro and Guilford County, and the City of Winston-Salem and Forsyth County—proposed separate local packages to lure the facility to their respective jurisdictions.²¹ Winston-Salem/Forsyth had been rumored to be the favorite and offered the largest package, which consisted of cash grants, land costs, and funds for surveying, grading, paving, road construction, public utilities, and other site improvements. It is not entirely clear how influential the local incentives were, but Dell decided

on the Winston-Salem site in Forsyth County. The state and local incentives for Dell largely depend on the company meeting certain performance targets with respect to employment (1,500 jobs) and capital investment (\$100 million). Most of the incentive dollars will be paid out annually over time. Dell did not receive a check up front for \$279.7 million.

By contrast, Google's state incentives are mostly in the form of a full exemption from the sales taxes that it would pay to purchase electricity and certain equipment for up to thirty years. The sales tax exemption on electricity is important for Google because a server farm uses an enormous amount of electricity to keep its many computers running

around the clock. The exemption also matters because the company apparently would not have had to pay this tax in many other states that were under consideration. The local incentives offered by the City of Lenoir and Caldwell County are thirty-year cash grants based on 100 percent of business property taxes and on 80 percent of real property taxes paid by Google. These incentive grants are estimated to total as much as \$165 million over thirty years, which prompts some to think that Lenoir and Caldwell County "gave away the farm," so to speak, to get a server farm.²²

The amount of public dollars put on the table for Dell and Google is significant. However, the cost of each incentive package must be considered in relation to the economic and fiscal benefits that the companies will generate (see Table 3). To receive the full amount of incentives, Dell must employ at least 1,500 workers at the facility in Winston-Salem. The jobs are expected to pay an average annual salary of \$28,000. Critics point out that this is lower than the average annual salary of all workers in Forsyth County. Proponents contend that the project will have a strong multiplier effect on the state and the region because of its ability to attract supplier firms to locate nearby. The North Carolina Department of Commerce estimates that Dell's initial direct capital investment of \$100 million and ongoing operations will contribute more than \$24 billion to the gross state product and net the state \$743 million in revenue over twenty years. Dell's ripple effect within the region is projected to generate an additional 6,000 indirect jobs at suppliers, service companies, retailers, hotels, restaurants, and so forth.

Google expects to employ 210 workers directly in Lenoir with an average annual salary of \$48,300—significantly higher than the average annual salary of workers in Caldwell County. Yet there is concern that the company will not hire local residents and will bring in workers from elsewhere because much of the local workforce lacks the education and the skills required for the jobs at the Google facility. Although Google will employ far fewer workers than Dell, its level of capital investment—\$600 million—is much higher. The state

Selected Business Incentive Tools Defined

Clawbacks: penalty provisions in incentive contracts that require companies to pay back some or all of the incentive monies they received if they fail to meet performance expectations within a certain period.

Employee screening: assistance to new or expanding companies in hiring workers—preemployment services, job fairs, connections to employment agencies, and the like.

Infrastructure assistance: help in providing, paying for, or offsetting the costs of improvements to utilities such as water and sewer systems, roads, power lines, and telecommunications on behalf of a company.

One-stop permitting: co-locating, streamlining, and fast-tracking of government inspection, licensing, and permitting services to make it easier for businesses to apply for and obtain various permits.

Regulatory flexibility: taking of steps to clarify and streamline rules, and otherwise ease the burden of government regulations on businesses.

Relocation assistance: provision of help to new or expanding companies in relocating executives by paying relocation costs, assisting with spousal employment, aiding in sociocultural acclimation, providing housing and child care referrals, and the like.

Site preparation: provision of funds to cover the costs of specialized infrastructure, engineering or survey work, clearing, grading, demolition, paving, environmental assessments, and so forth, for a company to locate at a particular site.

State development zone: a designated area of high poverty within a North Carolina municipality where higher state tax credits are available to companies that invest and create jobs.

Tax increment financing: a mechanism by which local governments issue bonds, without a voter referendum, to make public improvements that are necessary to spur private investment in a designated area. This tool relies on the incremental tax revenues that result from increases in assessed property values. The bonds are considered to be self-financing because, if successful, the public improvements they finance will stimulate new private investment and generate tax revenues that will be used to pay off the bond debt.

commerce department estimates that Google will contribute about \$1 billion to the state's economy and net the state \$37 million in revenue over twelve years. At the local level, Google will purchase a substantial amount of electricity from Duke Energy, help increase revenues from the utility franchise tax, and become Lenoir's second-largest water customer.²³ The company might end up as the city's third-largest taxpayer, even after accounting for the incentive grants it will receive.²⁴

Issues in the Incentives Debate

The Dell and Google projects raise important questions about the role of incentives in economic development. These and other recent incentive offers, including the new grant program aimed at Bridgestone/Firestone and Goodyear, underscore why the debate over incentives rages on. At least five points of contention fuel the debate: the extent to which economic development incentives are (1) legal, (2) fair, (3) efficient, and (4) effective, and the extent to which both the process for awarding incentives and the recipients are (5) accountable. To use incentives more wisely in fueling growth and prosperity, state and local officials must understand them in terms of these issues.

Legality

In the *Maready* decision, mentioned earlier, the North Carolina Supreme Court made it clear that local business incentives serve a public purpose and therefore do not violate the state constitution. According to the ruling, incentives meet the public-purpose test because they help create jobs and expand the tax base. Citizens benefit through increased economic opportunity and better public services. However, certain legal questions remain unresolved and continue to be pressed in the judicial system.

The North Carolina Institute for Constitutional Law, a group generally opposed to incentives, filed lawsuits challenging the constitutionality of the Dell, Google, and Bridgestone/Firestone–Goodyear deals. The lawsuit challenging the Dell incentives claimed that they primarily benefited the company, failed to serve a public purpose, and violated

Table 3. **Estimated Economic and Fiscal Impacts of Dell and Google on North Carolina**

	Dell	Google
Jobs (direct)	1,500	210
Average salary	\$28,000	\$48,300
Capital investment (in millions)	\$100	\$600
Jobs (indirect)	6,000	372
Contribution to gross state product (in billions)	\$24.50	\$1.06
State revenue (net) (in millions)	\$743	\$37

Source: Data compiled from newspaper articles and conversations with staff of the North Carolina Department of Commerce, Division of Policy, Research, and Strategic Planning.

the Commerce Clause of the U.S. Constitution. The North Carolina Court of Appeals upheld the constitutionality of the Dell incentives, and the North Carolina Supreme Court refused to hear the case.²⁵ The lawsuit against the Google deal, based on similar constitutional grounds, was dismissed by a superior court judge in November 2008.²⁶ An appeal is possible. The lawsuit filed over Bridgestone/Firestone–Goodyear and the Job Maintenance and Capital Development Fund might reveal if the courts will view incentives that are not tied to job creation as sufficiently serving a public purpose.²⁷ Also, as mentioned earlier, whether the courts will deem cash grants as being, in effect, the same as tax abatement is not entirely clear.

U.S. federal courts also have considered challenges to the legality of economic development incentives. A lawsuit filed in a federal district court claimed that two particular incentives in Ohio—a local property tax exemption and an investment tax credit—violated the Commerce Clause of the U.S. Constitution. DaimlerChrysler received these incentives to expand a Jeep plant in the state.²⁸ The district court ruled that both incentives were constitutional. On appeal, the Sixth Circuit Court of Appeals upheld the local property tax exemption but declared Ohio's investment tax credit in violation of the Commerce Clause.²⁹

The Sixth Circuit Court ruling got the attention of economic developers and policy makers and created uncertainty about similar tax credits offered in other states. The case, *DaimlerChrysler Corporation v. Cuno*, eventually made its way to the U.S. Supreme Court,

which dismissed it on the basis that the plaintiffs lacked standing in the federal courts.³⁰ By not ruling on the constitutionality of the tax credit in question, the Supreme Court has left open the possibility of future lawsuits.

Fairness

The concern about the fairness of incentives has to do with who reaps the benefits and who bears the costs of economic development policies. With incentives, some businesses clearly benefit, but others may lose. When government provides tax concessions, grants, and other assistance to certain businesses and not others, its doing so has the appearance, if not the effect, of treating comparable taxpayers unequally.³¹ The perception that incentives mostly go to new companies locating in a community can breed resentment among existing firms, particularly if they are direct competitors with the companies receiving aid. Moreover, the requirements of most incentive programs that a certain minimum number of jobs be created and a certain minimum investment be made typically make small businesses ineligible to participate.

The counterargument is that it is sensible to discriminate among taxpayers and provide special treatment to those who create large numbers of jobs and make significant investments in a community, because doing so benefits the greater good. For example, some evidence suggests that when economic development policies stimulate local growth, they also improve the distribution of income by enhancing job opportunities for minorities and people with lower education levels.³²

If economic development incentives do indeed serve a larger public purpose, then their benefits should extend beyond private companies and industries to other taxpayers. Such an effect is more likely to occur if the companies receiving incentives hire local residents and invest in distressed areas with high unemployment.³³ The Google project in Caldwell County will certainly increase economic activity in a part of the state with above-average unemployment, but whether local residents will get many of the new jobs remains to be seen.

Google will tap into the excess water and electric power capacity created by the loss of major textile and furniture industries. This outcome will yield important public benefits. In the case of both Dell and Google, if the incentives convinced the companies to build facilities in places where they otherwise would not have done so, taxpayers will gain economic opportunities and resources that might justify the millions of dollars of incentives promised.

On the other hand, if the incentives were not the determining factor, they might be an inequitable transfer of business costs from selected corporations to other taxpayers. Is it fair for taxpayers in one jurisdiction to subsidize a business for creating jobs that go to the residents of other jurisdictions? This question hovers over the Dell project, given that the taxpayers in Winston-Salem and Forsyth County are on the hook for the local incentives, whereas the plant surely employs people from various other cities and counties.

Ultimately the fairness of incentives is in the eye of the beholder and is a separate (though not unrelated) issue from whether they are effective, efficient, or worth the cost.

Efficiency

In one sense, interjurisdictional tax competition, including incentives, is thought

to be an efficient way to allocate public resources as firms seek the best locations to achieve the optimal balance of taxes and government services.³⁴ State and local governments offer incentives to make their jurisdictions more attractive to firms. Some argue that the efficiency effects of tax incentives are negated because incentive competition is a zero-sum game: one jurisdiction gains at the loss of another. From a national perspective, such beggar-thy-neighbor behavior produces no net economic gains because

capital merely re-locates from place to place. Others refute the zero-sum-game argument and suggest, “State and local economic development competition may increase productivity,

redistribute jobs towards the high unemployment areas that need jobs the most, and increase national employment by using previously unemployed labor.”³⁵

Sharing project costs and revenues within a region and encouraging companies to hire locals and invest in distressed areas enhance the fairness of incentives.



Table 4. **The Most Important Site-Selection Factors for Large Manufacturing Firms**

Ranking	Factor	Percent
1	Highway accessibility	96.9
2	Labor costs	92.3
3	Energy availability and costs	89.0
4	Availability of skilled labor	88.7
5	Occupancy or construction costs	88.2
6	Available land	85.4
7	Corporate tax rate	83.8
8	State and local incentives	83.4
9	Environmental regulations	83.2
10	Tax exemptions	82.8
10 (tie)	Proximity to major markets	82.8
11	Advanced ICT [information/communication technology] services	82.2
12	Low union profile	80.6
13	Availability of buildings	79.3

Source: Data from Geraldine Gambale (ed.), *The 22nd Annual Corporate Survey and the 4th Annual Consultants Survey* (Westbury, NY: Area Development Magazine, 2008), www.areadevelopment.com/annualReports/dec07/pdf/corporateSurvey.pdf.

In practice, any incentive may be zero-sum, positive-sum (benefits exceed costs), or negative-sum (costs exceed benefits), depending on how it is applied.³⁶ The important point is that any incentive amount offered that is above the absolute minimum required to attract a business is inefficient from a public-sector perspective.³⁷

When jurisdictions use incentives to compete with one another for jobs and investment, they can face a situation known in negotiation and decision-making theory as the “prisoner’s dilemma.” In this view, incentive competition becomes a counterproductive “race to the bottom” that could jeopardize the long-term fiscal capacity of states and localities. As a former mayor of Indianapolis, Stephen Goldsmith, notes, “You can’t say no, but you can’t afford to say yes” when companies request incentives.³⁸ Moreover, the intense competition among jurisdictions can ratchet up the scale of incentive packages to the point of overpayment, and result in excessive costs per job created. Additional inefficiencies arise from the high opportunity costs of incentives and potential revenue shortfalls that might cause state and local governments to provide fewer critical public services such as education and infrastructure.³⁹

The argument that incentives are inefficient because they erode the tax base and undermine the provision of essential public services ignores a key assumption about how incentives should work. Incentives are supposed to help create new tax revenues. The

revenues cannot be diverted from other uses if they never materialize in the first place. In a letter to the editor, former North Carolina Secretary of Commerce James T. Fain III correctly noted that

Google’s incentives represented a claim on tax revenues that would not be realized unless the company decided to locate in the state:

*Incentives offered by the state are dependent on future tax receipts paid by the company. They are primarily reductions of future tax revenues that we do not now receive, nor would we ever receive if Google does not locate here. Google will receive future incentive benefits only if it creates the jobs and makes the investments that generate this tax revenue for their incentives.*⁴⁰

Incentives should result in jobs and tax revenues that would not otherwise exist. But proving that incentives influence business decisions is difficult.

This logic holds up as long as it can be demonstrated that Google would not have located in North Carolina if it had not been offered the incentives. If that cannot be demonstrated, then the state is merely subsidizing a business decision that would have happened without any incentive, and it is forgoing tax revenues that it would have otherwise received. Those forgone revenues are then not available for spending on education, infrastructure, and other public services or to facilitate lower tax rates overall.

The incentive package may have made the difference with Google, but it is difficult to know for sure. That Google announced plans for a similar facility in neighboring South Carolina within weeks of its North Carolina announcement casts some doubt on how stiff the competition was and how decisive the incentives might have been.⁴¹

Effectiveness

In the debate about whether incentives work, legal justifications and theoretical arguments must pass muster with the facts from empirical research. Unfortunately, the research findings on effectiveness are not conclusive and provide ammunition for both sides of the debate.⁴² However, they offer some insights when considered

in the proper context.

Part of the inconsistency arises from differences in measures and methods across studies. There also is the difficulty of isolating the effects of incentives on economic

outcomes, which requires controlling for many other variables. A more fundamental problem is knowing precisely what it means for a particular economic development incentive to be effective or not. The real question is, Effective at what?

A proper assessment of the effectiveness of incentives must take into account how specific tools are supposed to work and what they can realistically be expected to achieve. It also is important to distinguish between the micro-level effects on firms and the macrolevel effects on states, regions, and communities. At the firm level, incentives aim to lower the cost of doing business in a way that boosts profitability.⁴³ This is a



fairly immediate and direct effect on which there is little disagreement.

The next concern, then, is the extent to which incentives influence site selection. At the heart of this question is whether incentives actually function as incentives or inducements or whether they are mere subsidies to business. An “incentive” incites or spurs action, and an “inducement” stimulates or moves by persuasion.⁴⁴ By contrast, a “subsidy” is simply a grant or a gift of money.

If tax and other financial incentives are to be considered as economic stimulus tools rather than “corporate welfare,” they should directly sway decisions about business investment and job creation. On this matter, there is again a lack of certainty and clarity in the research findings. A study of state incentives in Ohio identified different effects on the actual employment growth of firms compared with the employment levels initially promised by the firms.⁴⁵ The researchers found that incentives had a negligible effect on actual employ-

ment growth in firms, but were positively correlated with announced job growth. These findings suggest that incentives will cause firms to overstate the number of new jobs they will create.

A recent analysis of North Carolina’s Lee Act tax credits suggests that “tax incentives go to firms without significantly influencing their decisions on investment and employment.”⁴⁶ A possible explanation for this is that taxes and incentives account for only a small portion of business operating costs and therefore do not matter all that much. In surveys, companies tend to emphasize the importance of incentives, and they have a vested interest in doing so. But according to *Area Development’s* most recent corporate survey, incentives are only one of several factors that businesses consider in site selection (for a list of the fourteen most important ones, see Table 4). In that survey, incentives ranked 8 out of a possible 25 factors.

Despite the ambiguity about whether incentives result in the creation of jobs

and investment by firms (microlevel) that would not otherwise occur, most studies conducted through the 1980s found that taxes and incentives have little to no effect on macrolevel economic growth.⁴⁷ This is counterintuitive because lower business tax burdens are thought to be more conducive to growth. Later research indicates that taxes might matter more than initially thought and particularly that higher taxes can hinder economic growth.⁴⁸ If that is true, then by easing the tax burden on firms, incentives could make a place more competitive for business investment and thereby spur economic growth.

Assuming that incentives are effective at promoting state and local economic growth, to what extent do they work for the people and the places most in need? This question is related to the fairness-equity concern discussed earlier, but also has implications for the overall effectiveness of incentives, especially those that target economically distressed areas. Some studies demonstrate that

poor people and places can experience the greatest gains from economic development incentives.⁴⁹ In North Carolina, the Lee Act tax credits attempt to steer jobs and investment to poorer communities by offering larger credits to businesses that locate in counties with higher unemployment rates and lower income levels. There is evidence that this aspect of the incentive program is “particularly effective in encouraging firms to invest more and hire more workers in economically distressed areas.”⁵⁰ In some other states, traditional incentives appear to stimulate growth only in prosperous areas, with the result that growth begets growth.⁵¹

In sum, the research to date suggests that economic development incentives do not always induce firms to create substantial jobs and investment that would not occur without the incentives. This appears to be the case despite the fact that companies say incentives are important factors in site selection. The case for using incentives to promote growth at a macrolevel and in lagging areas is more compelling.

Ultimately, the empirical research findings must be interpreted in light of the economic and political realities of the new economy. Facing intense global competition, manufacturing plants continue to close and move offshore, and people continue to lose jobs. When this happens, local governments lose revenues and are sometimes left with underused public infrastructure. The political pressure grows to do something or at least to appear to be taking action to improve economic conditions. In this context, economic development incentives might prove effective in ways that are difficult to capture in numbers.

If nothing else, incentives probably improve the competitive positions of states and localities and help them close deals. To appreciate this relationship requires an understanding of the site-selection process that businesses—often assisted by hired consultants—use in deciding where to locate or whether to expand.⁵² Incentives do not typically matter until a firm has narrowed the list of possible locations to a few that meet all its other requirements for a site or a building—infrastructure, workforce, and the like. At that point, the incentives can

tip the scale in favor of one location over another. From a competitiveness perspective, a jurisdiction has to decide whether to play to win or sit it out. Given how the game is played, incentives can help states and localities win, at least in the short run. Winning some of the time is better than always losing. In this way, incentives become a necessary evil in attracting and retaining businesses and securing the jobs and investment they create.⁵³ Against the odds, public officials might be willing to tolerate the inefficiency of incentives if they provide an edge no matter how slight:

For every 10 plants offered such an incentive, the incentive would be decisive for about 3 of them. The incentives given to the other 7 plants would have no effects on business location or employment growth. The only effect would be an extra cost to state and local governments of these unneeded 7 incentives. Unless economic developers can somehow determine which of the 10 plants “needs” the incentive to tip its location decision, this loss on 7 of the 10 plants is a necessary cost to tip the location decision of the other 3 plants.⁵⁴

To return to a question I posed at the outset, Are the incentives worth it? A good cost-benefit analysis will provide a quantitative answer to this question for a given project. Ideally the public benefits of incentive deals should exceed their costs. However, a major business location or expansion project can benefit communities in quantitative and qualitative ways. It can serve as a beacon of hope that prosperity will return to communities hard hit by job loss. It can restore self-respect to displaced manufacturing workers who need employment to support their families. For these people, the debate over the effectiveness of economic development incentives is an academic exercise. Referring to the Google project, Lenoir Mayor David Barlow said, “Psychologically, the impact of this for our community would be greater than the reality.”⁵⁵ Projects like Dell and Google also have symbolic value to the extent that they put communities on the map for future economic development opportunities.

Accountability

One of the most common criticisms of incentives is that they are frequently provided without the recipients being sufficiently accountable to taxpayers and the broader public interest. Corporate mergers, changing economic conditions, and intense global competition can lead companies to change their investment plans drastically over time. This can create the possibility that companies will fail to deliver on their promises to create a certain number of jobs and make a certain amount of capital investment.

For example, in 1999 the state offered \$35 million in incentives to Wisconsin Tissue to build a \$180 million tissue mill and paper-recycling plant in Halifax County with 150 employees. But a few months after the deal was announced, the company was bought by Georgia-Pacific and scrapped plans for the facility, so it received no incentives.⁵⁶

In the same year, Corning opened a \$600 million production facility for fiber-optic cable in the Cabarrus County town of Midland after being offered state and local incentives. The facility expanded to employ as many as 800 workers at one point and had 550 when it shut down in 2002 in the face of a steep downturn in the telecommunications industry. In 2007, Corning decided to gradually restore a limited amount of production at the Cabarrus facility in response to improved market demand.⁵⁷

In an interesting twist of fate, Dell is reportedly seeking to sell all its plants, including the one in Winston-Salem, in response to shifting corporate strategy. How this might affect its incentive deal or operations in North Carolina is unclear.⁵⁸ Also, in December 2008, Google notified state officials that the slowing economy would inhibit its ability to add jobs and investment in Lenoir according to the timeline for the JDIG funds it was offered. Therefore, it would forgo receiving the funds.⁵⁹

Even when companies fulfill employment and investment expectations, the estimates of the ripple effect on a community are mere forecasts based on imperfect economic models. For example, a recent report suggests that the model used by the state commerce department

to assess incentive packages tends to overstate the economic benefits that firms will provide and leads to over-bidding.⁶⁰ Using more conservative assumptions, the authors show the Dell project having a much smaller effect on the state's economy and a negative fiscal impact on state revenues. This demonstrates that economic and fiscal impact analysis is imprecise and must be used with care and interpreted with caution.

Another accountability concern is the secretive nature of early incentive negotiations. Companies require that their investment plans be kept confidential to protect trade secrets and avoid tipping their hand to competitors. State law allows for confidentiality, withholding of public records, and protection of trade secrets on economic development projects under certain conditions.⁶¹ As a result, state and local officials often commit public dollars before the details of a deal are widely known. Companies also demand confidentiality because they do not want information on pending plant closures elsewhere to leak out and they want to avoid excessive real estate speculation that might drive up the costs of land acquisition.⁶² Public officials face the dilemma of balancing the company's need for confidentiality and anonymity against the public's right to know.

Public officials are at a disadvantage in incentive negotiations because companies have access to much more information than public officials do on what other jurisdictions are offering and which alternative locations are viable. Only the companies know for sure the amount of incentives that will tip the decision in favor of one place over another. Google is alleged to have exploited this information imbalance in the negotiations with state and local officials over its incentive package.⁶³

Several mechanisms exist that might help jurisdictions win with incentives but avoid the "winner's curse" of paying too much for too little in return.⁶⁴ These include some safeguards already adopted in North Carolina according to a survey that I conducted recently—such

as using clawback provisions, tying incentives to company performance, requiring performance contracts, and conducting cost-benefit analyses (see Table 5)—plus others that I didn't include in my survey because they are more commonly used at the state level—targeting distressed areas and establishing standards for wages and job quality.

Safeguards like performance-based contracts with clawback provisions can help governments avoid paying too much for too little.

Better Use of Incentives

Despite the ongoing controversy over economic development incentives, no end is in sight to the escalating competition among jurisdictions that has been likened to an arms race. It is foolhardy to think that state and local governments will unilaterally disarm and stop using incentives in the near future. National legislation calling for a



Table 5. Accountability Mechanisms Used by North Carolina Local Governments

	Percent Reporting
Clawback provisions	60.7
Cost-benefit analysis	59.5
Performance agreement always required	51.2
Formal policy for eligibility	51.1
Provision for hiring local residents	18.3

Source: Jonathan Q. Morgan, “2006 Survey of Local Government Economic Development Activities” (Chapel Hill, NC: School of Government, University of North Carolina at Chapel Hill).

ceasefire in the economic war among the states has been introduced periodically in the U.S. Congress, but it is unlikely to be enacted anytime soon. Where does this leave public officials in North Carolina?

As others have aptly noted, incentives are not inherently good or evil, right or wrong, wise or foolish. They are tools that public officials can use more prudently—or less so—depending on the application. Economic development incentives should be consistent with the letter and the spirit of the law to avoid potential legal challenges. Beyond legality, public officials should clearly understand the tradeoffs among fairness, efficiency, effectiveness, and accountability in using incentives to promote job creation and private investment. Current practice in North Carolina incorporates many good reforms in the use of incentives. Additional ones are possible:⁶⁵

- More enforceable contracts
- Greater transparency and disclosure
- More rigorous cost-benefit analysis
- Better state-local and regional collaboration
- Improved opportunities and support for hiring local residents and the unemployed
- A greater focus on small businesses, existing industry, and job training

Taken together, these enhancements in incentive policy will help jurisdictions strengthen their negotiating position with companies, maximize public benefits, and protect the public investment in incentive deals.

Notes

1. See Dan Zehr, “Some Believe Incentives Wasted on Big Business,” *Greensboro News-Record*, November 30, 2004, www.theboydcompany.com/Archived%20Sites/Greensboro%20News%20&%20Record%2011-30-2004.htm. See also William Schweke, “Do Better Job Creation Subsidies Hold Real Promise for Business Incentive Reformers?” in *Reining in the Competition for Capital*, ed. Ann Markusen (Kalamazoo, MI: W. E. Upjohn Institute for Employment Research, 2007), 161–81.

2. A legislative study committee of the North Carolina General Assembly (the Joint Select Committee on Economic Development Incentives) is considering these and other questions about incentives. UNC at Chapel Hill’s Center for Competitive Economies is doing extensive research to inform the committee’s work.

3. For a review of the studies, see Alan Peters and Peter Fisher, “The Failures of Economic Development Incentives,” *Journal of the American Planning Association* 70 (2004): 27–37.

4. John Manuel, “North Carolina Economic Development Incentives—A Necessary Tool or Messing with the Market?” *North Carolina Insight* 17 (1997): 23–49.

5. S.L. 2007-552.

6. See Elaine Mejia, *Risky Business: NC Poised to Take a Giant Step in the Wrong Direction in Economic Development Policy*, BTC Brief (North Carolina Budget and Tax Center) (Raleigh, NC: North Carolina Justice Center, August 2007), www.ncjustice.org/assets/library/1014_btcbriefcorpsub13aug2007.pdf.

7. N.C. GEN. STAT. § 158-7.1(b) [hereinafter G.S.].

8. David M. Lawrence, *Economic Development Law for North Carolina Local Governments* (Chapel Hill, NC: Institute of Government, University of North Carolina at Chapel Hill, 2000).

9. *Maready v. City of Winston-Salem*, 342 N.C. 708, 467 S.E. 2d 615 (1996).

10. Lawrence, *Economic Development Law*.

11. Manuel, “North Carolina Economic Development Incentives.”

12. Lawrence, *Economic Development Law*.

13. Jonathan Q. Morgan and David M. Lawrence, “Economic Development,” in *County and Municipal Government in North Carolina*, ed. David M. Lawrence (Chapel Hill, NC: School of Government, University of North Carolina at Chapel Hill, 2006), art. 26.

14. For an explanation of the Article 3J tax credit, see the North Carolina Department of Commerce website, www.nccommerce.com/en/BusinessServices/LocateYourBusiness/WhyNC/Incentives/3J.htm.

15. Units of local government must provide a match to the One North Carolina Fund grant.

16. Steven G. Koven and Thomas S. Lyons, *Economic Development: What Local Governments Do*, ICMA Special Data Issue 2 (Washington, DC: ICMA Press, 2006).

17. Article V, Section 2(2), of the North Carolina Constitution states, “Only the General Assembly shall have the power to classify property for taxation, which power shall be exercised only on a State-wide basis and shall not be delegated.”

18. North Carolina Institute for Constitutional Law, *The Incentives Game: North Carolina Local Economic Development Incentives* (Raleigh, NC: North Carolina Institute for Constitutional Law, 2007).

19. Joseph Blocher and Jonathan Q. Morgan, “Questions about Tax Increment Financing in North Carolina,” *Community and Economic Development Bulletin* no. 5 (Chapel Hill, NC: School of Government, University of North Carolina at Chapel Hill, 2008).

20. S.L. 2004-204.

21. See Matt Harrington, “Regional Plan Won’t Happen for Dell Deal,” *Business Journal Serving the Greater Triad Area*, November 29, 2004, www.bizjournals.com/triad/stories/2004/11/29/story6.html; Matt Harrington, “With Dell Confirmed for the Triad, Economic Developers Must Now Compete with Each Other,” *Business Journal Serving the Greater Triad Area*, November 9, 2004, <http://triad.bizjournals.com/triad/stories/2004/11/08/daily12.html>.

22. Jonathan B. Cox, “Lenoir Gets Google, at a Cost,” *Raleigh News & Observer*, January 20, 2007, www.newsobserver.com/102/story/534390.html.

23. W. Lane Bailey (Lenoir city manager), “Economic Development Incentives” (presentation at the annual conference of the North Carolina City/County Managers Association, January 2008).

24. *Ibid.*

25. *Blinson et al. v. State of North Carolina*, No. 05 CVS 8378 (Wake County Super. Ct. filed June 23, 2005); *rev. denied*, 186 N.C. App. 328, 651 S.E.2d 268 (2007); *appeal dismissed*, 362 N.C. 355, 661 S.E.2d 240 (2008). For a history of the case, see www.ncicl.org/litigation/2.

26. Munger et al. v. State of North Carolina, No. 07 CVS 11756 (Wake County Super. Ct. filed August 16, 2007). For a history of the case, see www.ncicl.org/litigation/6. See also Chris Coletta, "Wake County Judge Throws Out Google Incentives Suit," *Triangle Business Journal*, November 14, 2008, www.triangle.bizjournals.com/triangle/stories/2008/11/10/daily46.html.
27. Richards et al. v. State of North Carolina, No. 07 CVS 20487 (Wake County Super. Ct. filed December 20, 2007). For a history of the case, see www.ncicl.org/litigation/10.
28. The State of Ohio and the City of Toledo agreed to provide a 13.5 percent credit against the state corporate franchise tax for investments in machinery and equipment and a 100 percent local property tax exemption over ten years.
29. Cuno v. DaimlerChrysler, No. 01-3960 (6th Cir., Sept. 2, 2004).
30. DaimlerChrysler Corp. v. Cuno, 547 U.S. 332 (2006). For a copy of the opinion, see <http://supreme.justia.com/us/547/04-1704/concur.html>.
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