Senate Finance Committee

Economic Development Incentives

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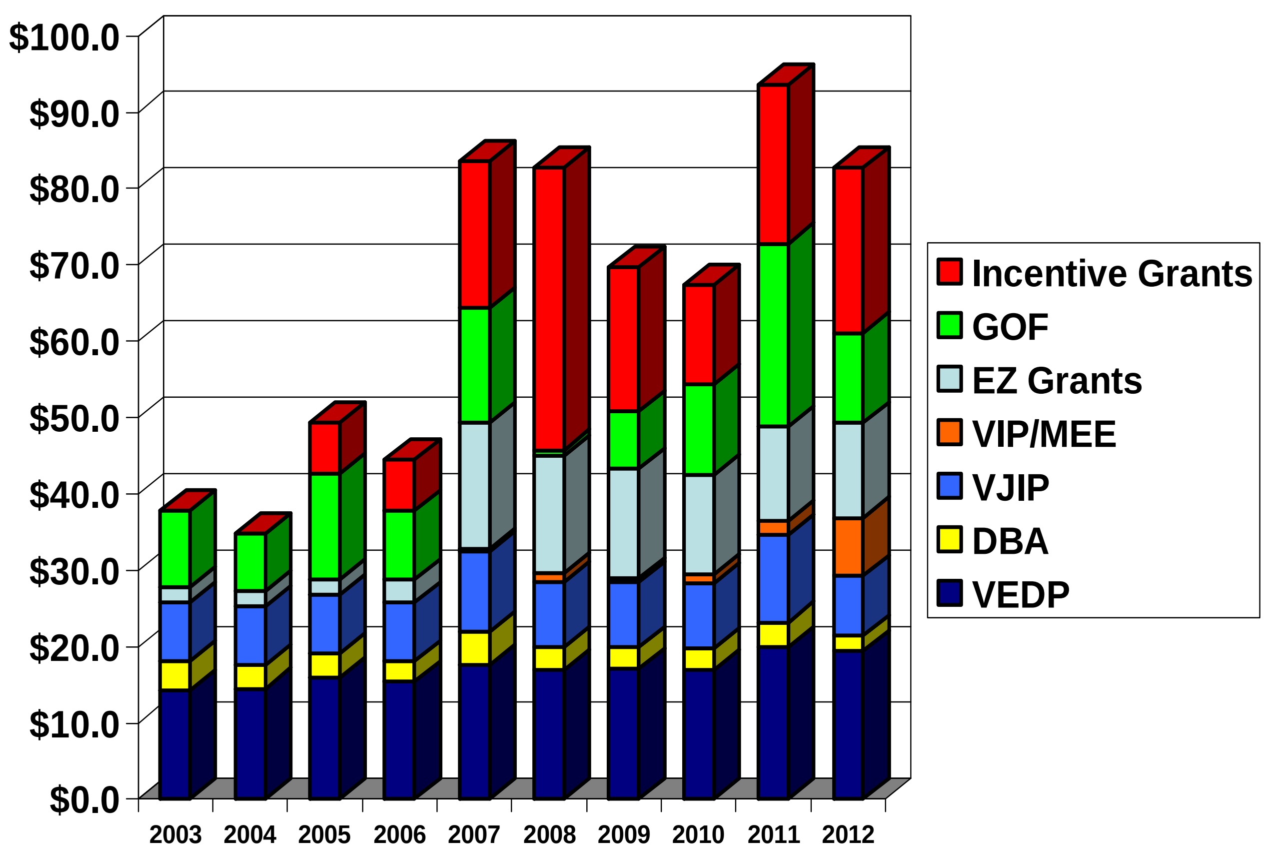
Staunton, Virginia

The Economics of Economic Development Incentives

- The number of programs and amount of funding for economic development incentives in Virginia has expanded significantly in the past decade.
  - Incentives include an array of grants, loans, tax credits and tax exemptions.
- While these incentives can influence the final decision of a company to move to or expand in Virginia, many other important factors guide the location of a business.
- Virginia faces stiff competition from other states, which in turn leads to the need for additional programs and funding to stay competitive.
- The Virginia Economic Development Partnership (VEDP) uses a Return on Investment (ROI) model to ensure that the cost of incentives does not exceed expected returns.
  - An ongoing VEDP study reports a positive return on Virginia's economic development investments.
- However, there is very limited research available specific to Virginia's economic development programs to evaluate the <u>effectiveness</u> of these programs.
  - Several states have adopted policies requiring periodic evaluations of their incentive programs.
  - A review of available literature provides mixed opinions as to the effectiveness of economic development programs in other states.

Funding for Economic Development in Virginia

- Over the past decade, annual funding for economic development activities has more than doubled.
  - Most of this increase can be accounted for by the enhanced use of performance-based incentive grants, the addition of new programs, doubling of the GOF in FY 2011, and the policy decision to make the Enterprise Zone Program a grant instead of a tax credit.



Funding for Economic Development
Fiscal Years 2003-2012
($ in millions)

Virginia's Major Incentive Programs

- Governor's Development Opportunity Fund (1992)
  - The "GOF" provides **deal closing** grants and loans to localities to assist in the creation of new jobs and capital investment. Requires local dollar-for-dollar match.
- Virginia Investment Partnership Grants (1999)
  - "VIP" is used to encourage **existing** manufacturers or research and development services to add production capacity, update technology or modernize assembly processes.
- Major Eligible Employer Grants (2000)
  - "MEE" is used to encourage **major employers** to invest in Virginia through expansion of existing operations or construction of new facilities.
- Virginia Economic Development Incentive Grants (2005)
  - "VEDIG" is used to encourage companies to locate significant **headquarters**, administrative or research and development operations in Virginia.
- Virginia Jobs Investment Program (Formerly ITP, 1965)
  - "VJIP" provides for **training or retraining** of individuals for specific employment opportunities at new or expanding business facilities in Virginia.
- Performance Grants (started in 1996 with Motorola)
  - **Customized** grants awarded based on specific performance criteria.

Future Obligations

- Virginia is obligated for performance-based incentive payments and grants into future biennia, assuming projects meet investment and job creation criteria:

Program ($ in millions)	**FY 2013**	**FY 2014**	**FY 2015**	**FY 2016**
VIP/MEE	$8.1	$10.3	$12.2	$11.9
VEDIG	1.6	2.5	4.7	6.1
Rolls Royce	9.3	12.9	10.8	3.3
Semiconductor Grants	5.4	5.4	5.4	3.8
Advanced Shipbuilding	5.0	5.0	5.0	5.0
Biofuels Production Grants	6.5	6.5	6.5	6.5
SRI	1.0	0	0	0
Annual Total	**$36.9**	**$42.6**	**$44.6**	**$36.6**

- The 2009 General Assembly created the Major Employment and Investment (MEI) Project Approval Commission to increase legislative involvement in the decision-making process for large incentive packages with future funding obligations.
  - The Commission consists of the chairman and two members from the Senate Finance Committee and the chairman and four members from the House Appropriations Committee.
  - An MEI project must have a capital investment of at least $250 million and create at least 400 jobs.
  - The Commission has considered only one project to date.

Enterprise Zone Program Grants

- The Enterprise Zone (EZ) Program, administered by the Department of Housing and Community Development (DHCD), is designed as an **economic revitalization tool** (versus a deal closing incentive) in designated economically distressed areas.
  - Created in 1982 as an income tax credit and real property improvement tax credit.
- In 2005, the program was restructured into a grant-based program, although businesses can still claim tax credits for investments and jobs created prior to FY 2005.
  - Real Property Investment Grants are provided for of up to 20 percent of qualified construction costs made to a building or facility located in an EZ.
  - Job Creation Grants are provided for permanent full-time positions earning at least 175 percent of minimum wage.
- The Code requires DHCD to prorate grants equitably if eligible grant requests exceed available funding.
  - Since 2005, the program has been consistently over-subscribed. Most recently, grants have been prorated at 62 cents for each dollar of qualified projects.
  - DHCD projects funding would need to increase by $7.4 million each year to fully fund the EZ Program.

Virginia Has a Variety of Other Tools to Attract Businesses

- Industrial Development Bonds
  - The Virginia Small Business Financing Authority issues bonds to provide businesses with access to long-term, fixed asset financing.
- Economic Development Loan Fund
  - Assists businesses with capital investment in eligible communities through direct loans to fill the gap of needs not met by conventional financing.
- Loan Guaranty Program and Capital Access Program
  - Increases the availability of loans for small businesses by reducing risk to lenders.
- Economic Development Related Tax Credits
  - Green Job Creation Tax Credit - A credit against personal or corporate income tax of $500 per year through 2014 for each qualifying "green job" for up to 350 jobs.
  - Major Business Facility Tax Credit – Qualified companies locating or expanding in Virginia can receive a $1,000 corporate income tax credit for each new job created.
  - Recycling Equipment Tax Credit – A credit to manufacturers for machinery and equipment for processing recyclable materials.
  - Day Care Facility Investment Tax Credit – A credit of up to $25,000 for construction of company-provided day care facilities.
  - Worker Retraining Tax Credit – A credit of 30 percent of expenditures for eligible worker retraining costs, subject to an aggregate cap of $2.5 million in any tax year.

Virginia Has Numerous Economic Development Related Sales and Use Tax Exemptions

- The following has been exempted from Virginia's sales and use tax (estimated FY 2010 fiscal impact):
  - Purchases for machinery, tools, spare parts, industrial fuels and raw materials used directly in production by manufacturers ($445.7 million);
  - Items purchased for resale by distributors (unknown);
  - Certified pollution control equipment and facilities ($3.8 million);
  - Custom computer software ($89.8 million);
  - Utilities delivered through lines, pipes or mains ($346.1 million);
  - Purchases used directly and exclusively in research and development ($16.2 million);
  - Most film, video and audio production-related purchases ($0.4 million);
  - Charges for Internet access, related communications services and sales of software via the Internet (unknown);
  - Purchases used directly and exclusively in activities performed in cooperation with the Virginia Commercial Space Flight Authority ($0.4 million);
  - Semiconductor clean rooms or equipment and other tangible personal property used primarily in the integrated process of designing, developing, manufacturing or testing a semiconductor product (unknown); and,
  - Computer equipment purchased or leased for the processing, storage, retrieval, or communication of data in certain circumstances ($1.3 million).

Factors Important to Business Location

- While incentive programs and tax credits may be helpful in luring companies to locate and invest in a state, there are many factors that are critical to the business decision of where to locate.
- Forbes.com measures six "vital categories" with a total of 33 data points in awarding its annual "Best for Business" state rankings:
  - Business Costs (labor, energy and taxes);
  - Labor Supply (educational attainment, net migration and projected population growth);
  - Regulatory Environment (tort climate, incentives, transportation and bond ratings);
  - Current Economic Climate (job, income, gross state product, unemployment, and presence of big companies);
  - Growth Prospects (projected growth in jobs, income, gross state product, business openings/closings, and venture capital investments); and,
  - Quality of Life (Index of schools, health, crime, cost of living, and poverty rates).
- In 2009, Forbes.com ranked Virginia first among the 50 states in <u>overall</u> best business climate for the fourth year in a row.
- However, in 2010, Virginia ranked second behind Utah:
  - Virginia fell from 1st to 6th in Quality of Life, from 12th to 14th in Growth Prospects and from 20th to 24th in Business Costs; remained 2nd in Regulatory Environment and 3rd in Labor Supply; and, improved from 18th to 4th in Economic Climate, as compared to 2009 rankings.

And the Winner is…

- In CNBC's "Top States for Business 2010", Virginia moved from first in 2009 to second place, behind Texas, but remained ahead of No. 3 Colorado, No. 4 North Carolina, and No. 5 Massachusetts.

- CNBC uses publicly available data in ten weighted categories for a total of 2,500 possible points:
  - Cost of Doing Business (450 points);
  - Workforce (350 points);
  - Quality of Life (350 points);
  - Economy (314 points);
  - Transportation & Infrastructure (300 points);
  - Technology and Innovation (250 points);
  - Education (175 points);
  - Business Friendliness (175 points);
  - Access to Capital (50 points); and,
  - Cost of Living (25 points).

- Virginia's 2010 rankings, as compared to other states, fell from 2009 in the following areas: Education (from 7^{th} to 13^{th}), Transportation & Infrastructure (from 10^{th} to 12^{th}), Economy (from 7^{th} to 11^{th}), and Workforce (from 8^{th} to 9^{th}).

- According to CNBC, "In runner-up Virginia, which has a built-in cushion of technology and government jobs, particularly in the northern part of the state, the employment picture statewide is somewhat shaky."

What Matters Most?

- According to Area Development Magazine's 24th Annual Corporate Survey (2008), the following is how industry and manufacturing firms ranked the top 20 factors important to business location decisions:

<u>90-100%</u>
1. Labor costs
2. Highway accessibility
<u>80-89%</u>
3. Tax exemptions
4. Energy availability and costs
5. Corporate tax rate
6. Availability of skilled labor
7. Occupancy and construction costs
8. **State and local incentives**
9. Availability of advanced information, communication and technology services
10. Inbound/outbound shipping costs
<u>70-79%</u>
11. Low union profile
12. Available land
13. Availability of buildings
14. Right-to-work state
15. Proximity to major markets
16. Expedited or "fast-track" permitting
17. Environmental regulations
<u>60-69%</u>
18. Availability of long-term financing
19. Proximity to suppliers
20. Training programs

- The survey found that only 52 percent of the companies responding had previously accepted incentives.

Comparison to Other States

- Virginia faces stiff competition from other states in its efforts to attract major economic development projects.
- In aggregate, Virginia offers a broader array of incentives, tax credits and tax exemptions, as well as competitive corporate and sales and use tax rates.

State	Corporate Tax Rate	Sales & Use Tax Rate	Bonds	Loans	Incentive Grants	Tax Credits	Tax Exemptions	Deal Closing Fund (most recent appropriation)
VA	6.0%	5.0%	✓	✓	✓	✓	✓	GOF ($23.9 million)
MD	8.25%	6.0%		✓	✓	✓		Sunny Day Fund ($5.0 million)
NC	6.9%	7.75+%	✓	✓	✓	✓	✓	One North Carolina Fund ($28 million)
SC	5.0%	6.0%			✓	✓		No Equivalent
GA	6.0%	4.0+%		✓	✓	✓	✓	Edge Fund ($47.1 million)
FL	5.5%	6.0+%		✓	✓	✓	✓	Quick Action Closing Fund ($13.46 million)
TX	Franchise Tax	6.25+%	✓		✓			TX Enterprise Fund ($217.0 million fund balance)
TN	6.5%	7.0%	✓	✓	✓	✓	✓	No Equivalent
PA	9.99%	6.0+%		✓	✓	✓		Opportunity Grant Fund ($25 million)

(Appendix A contains more details on competing state programs.)

Predicting Return on Investment

- The Virginia Economic Development Partnership (VEDP) uses a Virginia-specific Return on Investment (ROI) model to assess what level of incentive funding should be offered to a specific project.
  - Developed in 1990's with input from economists from UVA, W&M, VEC and DPB.
  - Utilizes companies' promised number of new jobs, average salary, and capital investment.
  - Calculates return by comparing value of incentives to projected state revenue from income and sales taxes based on direct and indirect employment.
  - The model includes:
    - Income and sales taxes paid by direct workers;
    - Income and sales taxes paid by indirect workers using an industry specific multiplier from the projected number of direct jobs;
    - Taxable equipment and personal property;
    - Construction materials (if applicable); and,
    - Direct and indirect construction employment.
- VEDP will adjust proposed incentive packages based on the outputs of the model to ensure that total state costs do not exceed expected returns in projected state revenues.

Return on Investment Analysis

- VEDP is conducting an ongoing state benefit-cost analysis of 201 incentive projects funded since FY 2002:
  - This analysis includes eight years of actual project data on 187 GOF projects and 14 additional projects that received VIP, MEE or VEDIG grants.
  - These projects include total announced private capital investment of $10.6 billion and the creation of 52,548 jobs.
  - According to VEDP, these projects have produced gross state revenue of $1.5 billion since FY 2002, with a cost to the state of $207 million, resulting in net state revenue of about $1.3 billion.
    - The resulting benefit-cost ratio is $7.00 in return for each $1.00 spent based on results-to-date.
    - VEDP projects this ratio will increase to $11.00 for each $1.00 spent with 10 full years of data.
- When possible, VEDP verifies actual direct employment data, which is then used to project the assumed indirect employment generated:
  - Seventy percent of the observations on the <u>direct</u> impact of these projects are derived from VEC's Quarterly Census of Employment and Wages.
  - Twenty percent comes from surveys of grantees as they approach the end of their performance.
  - Ten percent of the data is based on the original ROI assumptions.
  - <u>Indirect</u> impacts cannot be verified but are calculated using industry specific multipliers used in the ROI model.

Why Companies Do Not Choose Virginia

- VEDP produces a "Reasons Lost Summary Report" based on exit interviews with businesses that decide to locate elsewhere.
- From 2005 to 2009, a total of 178 projects being pursued by VEDP did not come to fruition. The reasons cited by the companies have been grouped into five categories:
  - **Business Model**: financing, market proximity and logistical concerns.
  - **Real Estate:** availability of facilities, infrastructure (utilities, rail, highway access) and unmet megasite requirements.
  - **Labor Force:** job readiness, comprehensive training programs and wage costs.
  - **Incentives:** tax policy, other states' specific grant programs, interest-free loans and deals offered at existing facilities.
  - **Other:** cost-of-living, cultural issues, personal impressions, failed projects, and unknown reasons.
- Only thirteen percent of respondents indicated that incentives were a factor in their decision.

Reason given for not selecting Virginia	Number of Projects	Percentage
Business Model	61	34%
Real Estate	57	32%
Labor Force	16	9%
Incentives	23	13%
Other	21	12%
Total	178	100%

Do Incentives Really Make a Difference?

- JLARC conducted an analysis in 2002 of the long-term costs and benefits of the major incentive programs and funding available in Virginia at that time.

- JLARC concluded that "if the State were to eliminate funding of its…business incentive programs in a given fiscal year, there would be longer-term consequences."

  – Fewer new jobs and private capital investment would occur in Virginia.

  – Less corporate income and sales tax revenues as well as less indirect economic activity related to investment in Virginia would result.

  – In two to three years, the State's loss of tax revenues likely would be more than the amount that could be saved by cutting these programs.

- JLARC also noted that some companies had been promised sizeable grants in future years, which would require new appropriations from future General Assemblies.

  – VEDP staff expressed the concern that not fully funding future commitments would undercut Virginia's economic development efforts.

Are Virginia's Incentives Effective?

- There appears to be little other independent analysis of the effectiveness of Virginia's economic development incentives in influencing the outcome of business location and expansion decisions.
- A 2001 study conducted at Virginia Tech concluded that GOF funding appeared to be "randomly scattered" across Virginia.
  - The study suggested that the ROI criteria used by VEDP did not take into account the costs of services provided to the business or the unintended negative consequences on other existing businesses.
- A 2001 study by the Environmental Law Institute examined only the impact on land-use related to GOF activities, and not the effectiveness of the program.
- Similarly, a 2006 study conducted at Old Dominion University examined mainly the spatial distribution of GOF awards.
- The General Assembly may wish to consider having JLARC update its analysis as the amount of funding and number of programs has expanded since 2002.
  - Additional focus should be given to the effectiveness of incentives rather than just the outcome of funding incentive programs.
  - JLARC is currently working on an assessment of the effectiveness of corporate and individual tax preferences, which would complement this analysis.

Several States Have Reporting Requirements

- Georgia, Minnesota, Maine and North Carolina all require some type of periodic evaluation of their incentive programs, so there is more independent research specific to these states' economic development programs.
  - Results of the various studies are mixed as to conclusions about effectiveness, but these findings are useful in adjusting policies and targets.
- Minnesota passed an economic disclosure law in 1995, which has since been amended to include:
  - Demonstration of public purpose of each subsidy.
  - Higher standards for awarding business subsidies, including specific wage floors.
  - Measurable, specific and tangible goals of each agreement.
  - Payback requirements, if commitments are not reached.
  - Accountability procedures, including reporting requirements for companies and local governments to be included in an annual report to the legislature.
- The 2007 North Carolina General Assembly appointed a Joint Select Committee on Economic Development.
  - A 2008 evaluation of three primary incentive tools found that while the programs have helped increase investment and generated new jobs, their effect in the most distressed areas of the state has been "disappointing".
  - A 2009 report concluded that the effectiveness of incentives is mixed while the cost is expensive. (Copy attached as Appendix B.)
  - Based on these findings, the NC General Assembly just passed legislation to increase reporting requirements and restructure some of these programs.

Issues for Future Policy Decisions

- A 2009 report by a University of North Carolina professor examined questions raised by recent large incentive packages:
  - Are state and local governments paying large corporations "too much" for jobs and investment?
  - Are the needs of existing industries and small businesses being overlooked?
  - Are public officials at a disadvantage in incentive negotiations because companies know what other jurisdictions are offering and know what level of incentives will tip the scale?
  - Are public officials failing to adequately assess the net return on the public investment?
- In order to address these questions, the report offers suggestions to guide future policy decisions:
  - Recognize that job retention may be as important as job creation, especially in areas of high poverty.
  - Share project costs and revenues within a region and encourage companies to hire locals and invest in distressed areas to enhance fairness of incentives.
  - Pursue performance-based contracts and clawback provisions that help governments avoid paying too much for too little.
  - Ensure that incentives result in jobs and tax revenues that would not otherwise exist.

Summary and Conclusions

- Virginia is a leader in the nation in recruiting new and expanding businesses, thanks to a wide assortment of economic development tools, combined with favorable tax policies and regulatory environment, an educated workforce and a high quality of life.
  - Maintaining a strong educational system and transportation infrastructure is critical to future economic growth.
- Funding for economic development programs has increased substantially over the past decade.
  - Funding commitments in future biennia are significant and will likely continue to grow.
- Virginia utilizes a good system of “clawbacks” and performance-based incentives to ensure that funds are not wasted on failed projects.
- VEDP’s in-house analysis of Virginia’s return on its economic development investment appears favorable.
  - Further efforts to verify all assumptions and to factor out costs of government services could enhance this analysis.
- Additional independent evaluation of the effectiveness of incentive programs could drive future funding and policy decisions and help to better target programs.