

Negotiating the Ideal Deal

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February 13, 2004

*Written for the Competing for Capital Conference,
The Humphrey Institute of Public Affairs, University of Minnesota*

Abstract:

Redevelopment agreements, state statutes, and municipal ordinances can be written to formalize the *quid pro quo* of public-private development deals, provide synergistic gains, and create monitoring and incentive structures to minimize transaction costs and shirking. Despite their appeal, many states and cities resist the use of contractual mechanisms and enter into deals where they accept the bulk of project risks for few public benefits. What is a good deal, and why do some local governments craft better deals than others? This paper will identify the different sources of bargaining leverage on which local governments and business draw and offer explanations for the variation in deal structure observed across jurisdictions.

Introduction:

It is relatively easy to criticize local governments' use of financial incentives for business retention and attraction. Critics can point to empirical evidence that incentives cost more than the public benefits they create and redirect monies from other important public goods like infrastructure and education. They can find anecdotal support for arguments that incentives poison inter-jurisdictional relations, contribute to sprawl, favor large businesses over small, strain the planning capacity of local government, and are subject to the worst kinds of cronyism and abuse.

But calls for federal legislation that would eliminate the practice of incentives have been largely ignored (see, for example, Burstein and Rolnick 1994). Public official and fiscal watchdog alike admit that, despite their general distaste for incentives and the competitive inter-jurisdictional relations they have created, such programs are difficult to condemn across the board. Incentives, along with zoning and land use regulations, are one of the few sources of bargaining leverage that local governments have over developers and businesses. In some cases, local governments have used incentives strategically to influence both the site-location decision as well as the magnitude of private investment. Whereas some jurisdictions are held hostage to demands of businesses and sign off on expensive long-term commitments, other states and cities negotiate better agreements. These dealmakers absorb relatively little risk and commit relatively little up-front investment in relation to the public benefits created.

What is a good deal, and why do some states and cities craft better deals than others¹? This paper provides some insight into the context in which the public sector and private business negotiate agreements and describes the elements of a well-designed deal from the public sector's perspective. The final section identifies the different sources of bargaining leverage on which local governments and business draw and offers explanations for the variation in deal structure.

Bargaining context:

Interests

Development incentives and regulatory environments matter less to firms when deciding between distinct regions of the country. Proximity to key markets and suppliers, labor and transportation costs, and the whims of corporate executives are more important at this stage. Once a firm has narrowed its choice of location to a particular region, however, it begins to consider the tax burden and physical characteristics of potential sites. The site location decision could be a relatively private affair, whereby the business purchases land, hires a developer and employees, and pays whatever taxes it is determined to owe. Aside from obtaining the requisite building permits and complying with existing zoning and environmental regulations, the business could have little contact with the public sector.

Negotiations ensue only if expectations are raised; i.e., either the business wants something more from local government, or the local government wants something more from business. What exactly comprises *more* is contested because public and private responsibilities in economic development are not fixed and unchanging. The principle, for example, that a city should not be responsible for the development costs of individual businesses (because this falls squarely within a private realm) is difficult to support given the historical reality of public assistance for business. Two hundred years of incentive use has blurred the boundaries of public and private roles making it impossible to defer to principle or precedent. Every case, therefore, must be negotiated on its own merits.

Businesses and governments are not likely to agree about what constitutes the "ideal deal" due to the conflicting nature of their interests. Business wants to maximize profits, and can best do so when local governments agree to absorb risks and pay for costs that the business would otherwise shoulder (taxes, infrastructure, training). Public interests are more complex and diffuse -- improving the general welfare of citizens through the

¹ This paper focuses on those incentives that are negotiated on a case-by-case basis at the discretion of the local government. Other kinds of programs, sometimes called "statutory" incentives, are offered "as a right" if the firm meets certain pre-set eligibility requirements. An example of the latter case is an investment tax credit program that allows any business that meets eligibility requirements to deduct a certain amount from its annual income tax bill. In such a case, no negotiation is necessary.

provision of tax-funded services.² Public officials can achieve this objective if they strengthen their economic base (retaining and attracting business) with minimal expenditure.

While it may initially appear that one party's benefit is always the other's burden, a gray area exists where mutual gains may be had. This is because public and private interests are interdependent: both parties need the other in order to attain their objectives. Businesses rely on a public service infrastructure, property security, and a stable business environment whereas governments depend on tax revenues, employment, indirect and induced spending, and the physical development businesses provide. A deal that allows a firm to add more staff will help it to grow to meet increasing demand for its products while a municipality in need of jobs for its un- or underemployed population also values these jobs. Deal structure, in many ways, depends on both parties' ability to persuade the other that their interests are symbiotic and served equally by the agreement. If business is able to convince local governments that their interests overlap entirely ("what's good for General Motors is good for Detroit"), governments may be excessively accommodating and assume many of the costs of private land development and infrastructure

Power

Despite their interdependence, local governments and businesses do not always negotiate on equal footing. Local governments are handicapped by the fact that they are embedded in space and not footloose like business. Because they are constrained by inter-jurisdictional competition for private investment, public entities are dependent on private business to pay for basic services and infrastructure. They may be more likely to offer compromises so that deals end closer to the business' initial proposal.

Businesses are also better able to control critical information flows during negotiations. The financial gap companies seek to fill to make a project feasible may be much smaller than they would have the public sector believe. Business tries to assure local governments that the deal would not take place without public assistance (the "but for" condition). However, they can also bluff about the other sites they are considering and demand more than is really necessary because management has access to relevant information about the firm's own cost structure and hurdle rates to which local governments are not privy (Weber 2002). The interested government never knows the extent to which the business is serious about selecting a location; even if the business has made up its mind, it does better to keep the local government nervously anticipating a change of heart.

Business starts from an organizational advantage. Local governments often lack flexibility; in order for public administrators to change their initial offers of infrastructure provision, for example, they often have to go back to their city councils or legislatures and engage in a time-consuming process of backroom lobbying. In contrast, most

² Public agencies must often be reminded of their responsibility to serve wider, public interests – a role that interest groups, fiscal watchdogs, and community organizations take on.

corporate officials are trained to control information and negotiate in a bare-knuckled manner, hire consultants and lawyers to help them do so, and decision internal decision-making structures for expedited action.

Local governments have only recently learned how important negotiation is to protecting their interests. They are subjecting their spending on economic development to more scrutiny and relying on more accountable forms of assistance by looking to the legal framework that governs the performance of private sector contracts for guidance. This changed behavior is not the result of some enlightened attitude -- with fewer own-source funds, fewer inter-governmental transfers, and increased community outrage at and organizing around “corporate welfare,” cities have to be more selective about the business and the project expenses they finance.

What’s a good deal for the public sector?³

In many ways the quality of a deal can only be evaluated *post facto*. Did the local government get what it wanted (business retention, jobs, tax revenues) without paying too much? At a minimum, the marginal benefits should equal or exceed the marginal costs (including any foregone revenues and additional costs associated with the development) after a reasonable period of time. Even before deals are cut, however, there are certain kinds of deal structures and incentive designs that are likely to lead to better outcomes for the public sector. In such deals, the benefits and burdens are fairly calibrated, contractual safeguards (such as performance requirements) help governments to manage risks, and relevant private information is disclosed.

Ex ante decision analysis

Local governments should have some idea of what they want before negotiations begin. Contracts that rely on very loose parameters of fulfillment are considered “incomplete” and provide parties with opportunities to exploit gaps. The state of Minnesota, for example, requires all state agencies and municipalities to develop explicit benchmarks for awarding subsidies. These public purpose benchmarks include standards for job creation as well as for the wages of any new jobs.

With a better sense of their bargaining goals, local governments can better evaluate the costs and benefits of their subsidy programs. Few cities and states actually know the real cost of what they are giving away or what they are getting in return. In a survey of local economic development practitioners, only 24 percent reported any systematic or quantitative means of analyzing deals (Reese 1993). By comparing the present value of anticipated public costs (e.g., foregone revenues and additional expenditures on services, such as schools and infrastructure) to the present value of expected benefits (e.g., increased jobs, revenues generated by salaries of new employees and multiplier effects)

³ This section is based on a handbook for state and local officials commissioned but not yet released by the Illinois Department of Commerce and Economic Opportunity (Weber, Santacrose and Nolan 2003).

ex ante, cost-benefit analysis can provide a ballpark estimate of how much the public benefits will cost.⁷ Design amenities, real estate improvements, and environmental mitigation can be valued by comparing them to their market equivalents.

Performance standards

Local government can make their assistance conditional by including legally binding provisions in the contracts that specify public benefit projections (for example, creating a certain number of jobs, long-term commitments to place, and compliance with higher environmental or design standards. Many state statutes now require contracts to specify a particular wage rate, often based on a percentage of the federal minimum wage. Contracts may also stipulate that businesses provide healthcare benefits to the new or retained employees.

The contractual agreement can specify a reasonable time period for which the business must maintain operations in the locality or create a certain amount of jobs in exchange for its assistance. Connecticut statute governing a below-market rate loan program states that “Business is prohibited from relocating during the term the loan is outstanding or for ten years after receiving assistance, whichever is longer.”⁴ Without a so-called “benefit period”, a subsidized company will have an indefinite amount of time in which to fulfill its promises.

At the same time, savvy governments are not excessively rigid in their attempts to embed capital; they understand that it difficult to hold firms to their promises about the future given the vagaries of the global economy (Weber 2002). Corporate managers make location decisions in the context of great uncertainties and attempt to rein in the factors they *can* control: debt levels, capital spending, overhead, and staffing – all of which influence the places where they locate.

Local administrators are left with the challenge of protecting their assets while anticipating the uncertainties inherent in turbulent markets. They do this by designing incentives that calibrate the number of jobs or investment to a subsidy *ex post* and by making investments in places, as opposed to individual firms. Unlike an outright grant of funds, performance-based programs provide no assistance to the company *until* it meets specified levels of performance -- for example a firm receives an income tax benefit once it has hired a certain number of workers at a designated minimum wage. The incentive can increase as the number of employees hired grows.⁵ This kind of payment clause protects the jurisdiction’s investment in case the company encounters setbacks or falls

⁴Connecticut Development Authority, Master Guarantee Agreement 1995

⁵ The \$2.5 million incentive package negotiated between Bismarck, North Dakota and Coventry Healthcare contained a provision whereby the company agreed to receive progressively larger payments for the subsequent phases or groups of employees hired. The city waited to make its largest payment until the final group had been hired. *The Bismarck Tribune*, October 31, 2002.

behind in its hiring schedule. Performance-based incentives may be less popular with businesses, as they typically prefer to receive lump sum payments to cover development and other start-up costs. With proper monitoring, however, they are easier for the public sector to enforce.

Enforcement mechanisms

To spend the time and effort to write detailed contracts and then to ignore the businesses after funds have “changed hands” is not an effective economic development strategy. If companies do not comply with the terms and conditions of the agreement as stated, they may have “breached” their contract. Some contracts include a notice provision to inform the municipality of any changes in the operations of the business, such as the initiation of any lawsuits or bankruptcy proceedings, which might adversely impact the subsidized project.

In other cases, the public sector must devise monitoring requirements. Local governments typically include one of two types of monitoring techniques. The first type places the onus on the public sector but requires that specified documents be available for public inspection and audit. A more effective type of provision creates an affirmative obligation on the part of the business to provide necessary information rather than to merely allow local governments to ask for the right of inspection. Kansas City, for example, double checks self-reported data from firms against information derived from the city's employee earnings tax (Weber 2002). Companies are given a grace period of about two to three years to meet the specified standards.

Penalties are less important when municipalities use performance-based incentives from the start. If a state or city withholds funds until the recipient company has demonstrated that it has lived up to its obligation, there is no need to recapture funds because of nonperformance further down the road.

If public funds change hands up front, however, nonperformance provisions, remedies, and damages should be written into the contract. These provisions generally fall into five categories:

- Recisions: canceling a subsidy agreement if job and revenue projections are not met;
- Clawbacks: recovery of all or part of subsidy costs if performance goals are not met;
- Recalibrations: adjustment of subsidy to reflect changing business conditions;
- Penalties: additional charges (e.g., the interest accrued on the public's investment) for nonperformance or relocation
- Debarment and suspension: prohibiting the noncompliant company from receiving incentives in the future (Ledebur and Woodward 1990).

It goes without saying that a written contract should represent the complete understanding between parties because informal promises do not hold up in courts. If accountability

mechanisms are clear, reasonable, and obvious from the start of negotiations, firms may voluntarily repay the incentive if they renege on their promises, obviating the need for any formal legal enforcement.⁶ Accountability mechanisms reduce the uncertainty and potential for arbitrary behavior that plagues incentives on both sides. In 2003, for example, Philips Semiconductor honored its clawback agreement by paying back \$13.1 million in tax breaks to the City of Albuquerque, New Mexico after it closed its plant.

What kinds of governments negotiate good deals?

Nonetheless many local governments continue to fear that these contractual mechanisms will lower the value of the incentive for the business if the business perceives future tussles with the law, a lack of flexibility on the part of the public sector, and additional reporting requirements and compliance costs. Many states and cities resist the use of the contractual protections mentioned above and enter into deals where they accept the bulk of project risks for little return. When the state of West Virginia loaned over \$64 million to Anchor Hocking to help the company keep its plant open and provide jobs to its employees. Unfortunately it failed to state these purposes in the actual loan documents. The absence of a specific goal, coupled with a contractual provision allowing prepayment of the loan without penalty, led the court to conclude that the firm satisfied its obligations by paying off the loan.⁷

Conversely, some governments take a rigid bargaining position, refusing to negotiate altogether or make any concessions. The assumption of fundamental interest conflict (i.e., zero-sum bargaining) underpins the notion that firms seek only to extract wealth from the locale and that cities try to extract as much as they can from the firm. Such adversarial assumptions lead cities to adopt protective and often rigid regulatory strategies: for example, exactions on corporations disproportionate to the costs associated with new development. Such behavior may discourage business activity. Some remember the Cleveland investment “strike” following then-Mayor Dennis Kucinich’s refusal to subsidize a large retail redevelopment in the absence of a living wage guarantee.

Why do some states and cities negotiate safeguards to manage risks and assure performance while others potentially jeopardize their fiscal health? This last section seeks to generalize about the features of local governments that may influence their bargaining leverage.

⁶ In a recent interview in *Site Selection Magazine*, a Vice President of Toyota denied that states and cities with accountability mechanisms were “crossed off” from the list of possible plant locations (Bruns 2004). He advised, “If you're going to use clawbacks, put them in up front. Don't put them in at the last minute, when you think you have a deal and all of a sudden the lawyers get involved with all these clawbacks nobody talked about. The problem with clawbacks is ... (i)t's just another bureaucracy to deal with. But I understand why states sometimes use them – with some companies you're not sure of their history and can't test their track record.”

⁷ *West Virginia v. Anchor Hocking*, No 87-C-759-1 (N.D.W.V. filed 6/3/88)

Leverage implies some situational advantage – those who have it have less to lose if the deal falls through. Although space-bound governments start off from a bargaining disadvantage, any locality that has discretionary powers to grant or deny requests for changes in density, tax burdens, and zoning has a modicum of bargaining leverage. If municipalities had no leverage, businesses would have no need to negotiate with them.

However, the more assets particular places possess, the more leverage and decisional independence they are likely to acquire. This is why most assume that those governments with better market positions (relative to their competition as potential business locations) have the ability to be better negotiators. If the private sector needs the municipality more than the municipality needs the business, many of the risks of development can be migrated back to the private sector. For example, the attractiveness of Chicago as a location for retail development has allowed the City to require that developers receive Tax Increment Financing (TIF) incentives on a “pay-as-you go” basis (Weber 2003). Structuring the deal this way means that the developer initially pays for the costs of the project and is only reimbursed as the municipality collects the incremental property taxes. This places the onus on the developer (to generate new property tax revenues) instead of on the municipality (to float bonds secured with the incremental tax revenues).

Moreover, in higher income locations with strong tax bases, residents may prefer slower growth, choosing less congestion over more development. These jurisdictions can afford to be selective, either refraining from the practice of offering incentives or including extensive public benefits requirements in their incentive contracts. They can devalue the threats of businesses in favor of other political objectives. In contrast, poorer places may have to offer more to induce much-needed development and help private investors overcome development risks (Rubin and Rubin 1987).

The desirability of a locale is reflected in the value of its land. Indeed, those municipalities with a valuable land inventory (i.e., publicly owned properties) are able to extract benefits from potential developers (Elkins 1995). With the Yerba Buena development in San Francisco and California Plaza in Los Angeles, the respective cities took on more risks than a strictly regulatory approach but were able to secure from private developers expensive new cultural facilities and public spaces (Sagalyn 1997). They leveraged the power of rising land values and a scarcity of developable sites to negotiate for additional developer contributions to their ambitious mixed-use projects. Because of the desirability of these sites, they did so in a way where the developers were able to achieve their anticipated rates of return. Expensive homes may provide the tax base needed to pay for the bulk of city services so that the overall tax burden on businesses is not considered so high as to require abatements.

We might therefore expect to see those local governments with higher initial levels and rates of growth in a superior bargaining position relative to those more desperate for private investment. Indeed, jurisdictions such as Berkeley (CA), Westchester County (NY), and Cambridge (MA) include public benefit requirements, such as job quality standards, in their incentive contracts. These jurisdictions are not as concerned about

their competition because they know their highly-educated residents and positive images are a draw.

But not all such governments play their (upper) hands. For example, New Jersey, a wealthy, high-tax state, just passed a law that would allow it to borrow to pay for incentive grants in any year when the state legislature does not appropriate the money. A recent report found that several high-profile deals between New York City and businesses like contained "employment cushions" that allowed companies to lay off employees without such actions breaching their contracts (Good Jobs First 2004).

Nor does this rationale explain why many lower-income jurisdictions are proponents of more accountable deal making. Good Jobs First lists the 43 states, 41 cities, and 5 counties that attached job quality standards to at least one development subsidy (Good Jobs First 2003). On this list, many poor, fiscally challenged jurisdictions – Detroit, St. Louis, and Rochester, to name a few – stick out. It may be that if poor municipalities experience high degrees of political activism, local officials there will be pressured into signing contracts with more job creation requirements. In the past decade, a community-based movement for corporate accountability has arisen to monitor economic development deals and expose incidents of subsidy abuse. These groups have organized an increasing number of petition drives and referenda to place subsidies and performance measures on local ballots. Their power also lies in their ability to raise community awareness of the deal terms, which may shame companies and the local governments that subsidize them into better behavior. If minorities participate to a high degree in such movements, it may explain why Reese (1998) found that the larger the minority presence in a municipality, the more likely it was to focus on the contractual requirement of community benefits.

Even if a municipality has bargaining leverage (e.g., because a scarcity of developable sites), there must be opportunities for exploiting this bargaining advantage which arise only when government and business engage in specific political processes to coordinate interests on specific matters of public policy (Kantor 2002). Wealthy residential suburbs may not craft ideal deals because they have no available land for new commercial or industrial development. Ideal deal-making is likely to arise out of what economists call "repeated games" – similar experiences that build staff's negotiation skills, spur community activism around these issues, and perhaps lead to ordinances and statutes that expressly require such mechanisms. This is one of the reasons why larger cities and states (with better-paid staff and more use of sophisticated planning and decision analysis techniques) tend to be better negotiators. One study found that the more strategic municipalities were located in close proximity to cities of similar sizes or were suburbs of a central city (Reese 1998). In contrast, depopulated, low-tax, rural areas have been known to give away the store to lure branch plants.

Local governments make up part of the distinctive civic culture of economic development, some of which are more inclined toward "good government" reforms respecting such values as transparency and accountability. Studies have found the use of accountability mechanisms more prevalent on the West Coast and in the Northeast (Elkins 1995; Reese 1998), but that their use cuts across political persuasions. Some of the most conservative, pro-business local regimes have passed the most stringent laws

requiring the use of these contractual safeguards. In Indianapolis, for example, all new jobs must pay at least 90 percent of the area average wage level in order to qualify for property tax assistance and the city has a reputation for auditing firms and enforcing clawbacks (Weber 2002). And in 1996 alone, the Indianapolis Metropolitan Development Commission cancelled tax abatements to five companies who failed to live up to their pledges of job creation (Phillips, 1996).

Conclusion:

Without empirical research it is difficult to determine which factors will predict the crafting of ideal deals between different kinds of political jurisdictions. It is also difficult to examine whether ideal deals actually lead to ideal outcomes. Although using performance standards is certainly better than giving away subsidies for free, local governments still draft contracts too loosely and enforce them too weakly to get the most from their public investment.

Often economic development practitioners give up before they start. They figure that even when they write comprehensive contracts, there is no guarantee that businesses will stick by its promises. Indeed, public officials have the power to bargain and persuade, to make concessions, provide incentives and reduce or eliminate local taxes or restrictions, but they do not have the power to compel businesses to move into or remain in the jurisdiction. Drafting contracts takes place within a larger context of suburban, regional and international competition for business and the context in which it operates has become increasingly unstable and unpredictable.

This, however, is no excuse for being a poor negotiator. Moreover, if more municipalities and states adopt these kinds of contractual provisions as normal practice, individual governments would have more leverage over the firms they subsidize. If all governments raise standards in a coordinated manner, individual governments cannot claim that accountability mechanisms hamper their ability to compete for business relative to those that do not regulate incentives.

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