Economic Development Incentives Must Be "Necessary": A Framework for Evaluating the Constitutionality of Public Aid for Private Development Projects

C. Tyler Mulligan[*]

A familiar scene unfolds in communities across the country. A for-profit company approaches a local government and seeks a discretionary[1] economic development incentive—often in the form of a direct subsidy such as a cash grant—for the company's proposed development project in the community. The project may involve redevelopment of a historic building on Main Street; perhaps construction of a new retail center off the highway; or maybe job creation at a manufacturing facility. When the company requests a direct public subsidy for the project, a crucial constitutional question must be answered: Would the subsidy be an unlawful gift under the state constitution?

A potentially overlooked factor in determining whether a public subsidy for private enterprise amounts to an unconstitutional gift is the concept of "necessity."[2] In other words, is the subsidy "necessary" to achieve the desired public end? If the subsidy is not necessary to achieve the public's objective, then the public is probably not receiving valid consideration for its subsidy payment.[3] In that case, the subsidy essentially amounts to an unconstitutional gift to the recipient. But how can courts and legislative bodies determine whether "necessity" exists when a private enterprise requests public aid, in the form of an economic development incentive or subsidy, for construction of a facility?

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[*] Albert and Gladys Hall Coates Distinguished Term Associate Professor of Public Law and Government, School of Government at the University of North Carolina at Chapel Hill. *See C. Tyler Mulligan*, UNC SCHOOL OF GOVERNMENT (2016), https://www.sog.unc.edu/about/faculty-and-staff/c-tyler-mulligan [https://perma.cc/Y4UK-WJ4Y] (providing a biography of the author).

[1] The incentive is discretionary because it must be approved as an exclusive benefit to that company alone, as opposed to an incentive that is provided automatically to all companies within a certain class. As examples of the latter, a local government might provide small business counseling services to all small businesses in the community, or a reduced water rate might be available to all business customers that use a certain volume of water. Those benefits are offered on a general basis, not exclusively to one company on a discretionary basis. General benefits available to all businesses are not the focus of this article.

[2] *See infra* Part II; *see also* C. Tyler Mulligan, *Economic Development Incentives and North Carolina Local Governments: A Framework for Analysis*, 91 N.C. L. REV. 2021, 2050–52 (2013) (describing the "necessity" or "but for" determination undertaken for economic development subsidies in North Carolina).

[3] *Id.*

A threshold determination is whether jurisdictions are competing with each other over the location of the facility. Businesses have become proficient in using competitive facility location decisions to extract subsidies from state and local governments.[4] In these competitive situations, necessity is a foregone conclusion. Governments find themselves in a "prisoner's dilemma" in which they have little choice but to offer a subsidy to the requesting business, and the causation between the provision of public aid and the resultant location decision is easily demonstrated.[5] In such *competitive* scenarios, the presence of "necessity" or "but for" causation cannot seriously be questioned. Case law pertaining to business location subsidies has, for the most part, involved competitive situations like these; thus courts have generally assumed necessity exists and have deferred to legislative decisions about the appropriateness of subsidies.[6] In this permissive legal environment, business location subsidies have proliferated. Nationwide, state and local governments pour upwards of $70 billion annually into this effort.[7]

However, business location subsidies have become so ubiquitous that businesses are requesting subsidies even when location competition is absent and the subsidies arguably are not "necessary." Examples of these *noncompetitive* scenarios include commercial and residential development projects in which the financial feasibility of a project is based upon local market demand and other local conditions.[8] When local conditions are important to feasibility, the project owner cannot reasonably claim that

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[4] Richard Briffault, *Foreword: The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 RUTGERS L.J. 907, 947 (2003) ("Moreover, corporations have proven adept at playing competing localities against each other in order to extract government payments or tax exemptions."); *see, e.g.*, Jeff Bennett & Cameron McWhirter, *Volvo to Build First U.S. Car Plant in South Carolina,* WALL ST. J., May 11, 2015, http://www.wsj.com/articles/volvo-car-corp-to-build-plant-in-berkeley-county-sc-1431340237 [https://perma.cc/GBG7-UF75].

[5] Matthew Schaefer, *State Investment Attraction Subsidy Wars Resulting from a Prisoner's Dilemma: The Inadequacy of State Constitutional Solutions and the Appropriateness of a Federal Legislative Response*, 28 N.M. L. REV. 303, 311–12 (1998) ("The prisoner's dilemma is typically described as follows: Two prisoners are separately interrogated by the authorities, who attempt to extract confessions from each implicating the other. If both are silent, each will go free. If both confess, each will get a moderate sentence. If one confesses and the other does not, the former will get a light sentence and the latter a heavy sentence. Accordingly, both prisoners would be best off if each remains silent, but each fears the other will confess. To avoid the danger of the heavy sentence that would follow from the other's confession, each confesses and incurs a moderate sentence. The prisoners are unable to reach their preferred outcome (total silence) because they are unable to communicate and reach a binding agreement. How does the prisoner's dilemma apply to the situation of state subsidy wars? . . . A state that idly sits by while other states offer investment attraction subsidies will have a heavy sentence placed upon it as mobile capital and tax revenues accompanying the capital flow to those other states."); *see also* Mulligan, *supra* note 2, at 2090 (comparing competitive incentives to a "prisoner's dilemma").

[6] *See infra* Part I.

[7] Marcia Clemmit, *Attracting Jobs: Do Tax Breaks for Business Spur Employment?*, CQ RESEARCHER, Mar. 2, 2012, http://library.cqpress.com/cqresearcher/document.php?id=cqresrre2012030200&type=hitlist&num=0 [https://perma.cc/KP4X-NC4U].

[8] Bert Caldwell, *Cabela's Baits the Hook, and States Are Biting*, THE SPOKESMAN REV., Sept. 10, 2006, http://www.spokesman.com/stories/2006/sep/10/cabelas-baits-the-hook-and-states-are-biting/ [https://perma.cc/2GSA-98TG] ("What sets Cabela's apart from other businesses is the way it has wrapped its whole approach to brick-and-mortar retailing around its ability to get site concessions.").

locations are interchangeable such that the project could be relocated to any one of several jurisdictions without altering feasibility. In these noncompetitive situations, any court that takes constitutional gift analysis seriously should scrutinize the necessity of the requested subsidy.

To that end, this article proposes an analytical framework for conducting an evaluation of necessity as a component of constitutional gift analysis. Part I provides an overview of state constitutional law pertaining to gifts and public aid to private enterprises. It highlights the distinction in case law between competitive and noncompetitive scenarios and concludes that more robust judicial scrutiny of necessity is required in noncompetitive situations.

Part II proposes an analytical framework that divides subsidy-seeking projects into two categories, competitive and noncompetitive, and treats each category differently. Section A of Part II deals with competitive scenarios and acknowledges that, in case law, the necessity of a subsidy is taken for granted when competition is present. In other words, necessity for public aid to a project can be assumed when the project involves a legitimate location competition.[9] However, competition should be verified, so a disclosure rule is recommended that would compel subsidy-seeking businesses to make disclosures about project financials and reveal all competing locations under consideration. Section B addresses noncompetitive contexts where the necessity of public aid cannot be presumed. It proposes a simple framework, based on principles found in real estate development literature, for courts to employ in determining necessity in noncompetitive situations.

The article concludes by describing how the proposed framework has already been applied by the author for development projects and has proven to be both practical and effective. Courts are advised to enforce constitutional public aid provisions by implementing the proposed necessity framework when evaluating the constitutionality of public aid in noncompetitive situations.

Part I: A Distinction in Gift Clause Case Law—Competitive versus Noncompetitive

Most state gift clauses (also referred to as public purpose clauses and aid limitation clauses) across the nation are over a century old and tend to be variations on a theme.[10] In general, these constitutional clauses require government "spending or lending

[9] *See, e.g.*, Common Cause v. State, 455 A.2d 1, 19 n.23 (Me. 1983) ("Getting [the company] to locate … in Portland was a prime objective of the state and city in the negotiations. We cannot say that provision for a subsidy was unnecessary in order to achieve that objective.").

[10] David E. Pinsky, *State Constitutional Limitations on Public Industrial Financing: An Historical and Economic Approach*, 111 U. PA. L. REV. 265, 280 (1963) ("At the turn of the century, some form of public aid limitation had been incorporated in the constitutions of a large majority of the states. For better or for worse, they are still with us, virtually unchanged . . . . The constitutional movement of the nineteenth century was an extremely pragmatic one; each change in each state was a direct reaction to the specific evils which had manifested themselves in that and perhaps neighboring jurisdictions. Some constitutions therefore contain only a credit clause, others join to it a stock clause, and still others have all three. The potential for diversity is further intensified by the fact that any or all of these restrictions may apply only to

[to] be for a public purpose"; "bar the gift or loan of state credit except for a public purpose"; and "ban direct state investment in business corporation obligations."[11] The clauses were designed to prohibit governments from assuming financial risks flowing from private decision making—in other words, from placing public funds under private control.[12]

However, over the past century, courts have chipped away at these gift clauses by allowing exceptions when public aid to private enterprise promotes certain public purposes.[13] Court-approved public purpose exceptions include redevelopment in blighted areas, affordable housing for low-income persons, and incentives for competitive business location decisions.[14] When a public purpose exception applies, courts have generally deferred to legislative determinations about whether sufficient public benefit is obtained in consideration for public aid.

Many commentators have focused on the public purpose exception for business location decisions, claiming that it exemplifies the hollowing out of gift clause provisions to the point that gift clauses no longer impose meaningful limits on public purpose.[15] Such critiques of the exception for business location incentives tend to focus on one particular component of gift analysis that courts have ceded to legislative bodies: the evaluation of whether the public benefit received in consideration for a subsidy is adequate.[16] Some courts have set a startlingly low bar, verifying only that the legislature's articulated public benefit rationale is not irrational.[17] These permissive courts may be hesitant to wade into "arcane" agreements[18] and to review economic

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the state, to counties, to cities and towns, or to a specified combination of these."); Briffault, *supra* note 4, at 912 ("Initially, these provisions applied only to the activities of state governments. As a result, they were sometimes circumvented by state legislation authorizing local governments to provide assistance to private firms . . . and in the late nineteenth century, many states amended their constitutions to apply the public purpose and aid limitations to local governments.").

[11] Briffault, *supra* note 4, at 911–12.

[12] Pinsky, *supra* note 10, at 283–84.

[13] Briffault, *supra* note 4, at 914–15 ("Today, state constitutional 'public purpose' requirements are largely rhetorical. State legislatures define what public purposes are and receive great deference when they determine that a particular program promotes the public purpose. State constitutional provisions articulate the truism that public spending must be for a public purpose. But they do not provide a judicially enforceable constraint on state or local government.").

[14] *See, e.g.*, Mulligan, *supra* note 2, at 2104–05.

[15] *See supra* note 13.

[16] Briffault, *supra* note 4, at 946 ("With many economic development programs little more than giveaways of tax breaks or low-interest loans to private firms, courts could more strictly scrutinize the fit between the public end and the means chosen, or the balance between the public and private benefits, particularly for measures that provide significant private gains but only speculative public ones. But this would involve difficult empirical questions of assessing the benefits from a program and calculating how likely they are to occur. In many cases a more difficult question would be deciding whether to classify a particular benefit as public or private, or what is the proper balance between public and private benefits.").

[17] *Id.* at 914 (characterizing some courts as deferring to legislative determinations "that a spending, loan, or tax incentive program will promote the public purpose are to be accepted as long as they are 'not . . . irrational.'")

[18] *Id.* at 940.

analysis[19] that is "often misunderstood and used inappropriately."[20] With such complexity and subjectivity involved in determinations of public benefit, it is perhaps understandable why some state courts have concluded that such public benefit review is "beyond their capacity, and that the means for pursuing economic development as well as the determination that economic development is a legitimate public end is a political question, not a judicial one."[21]

However, there are countervailing considerations that suggest courts should take a more active role in public benefit analysis. Courts may be better than legislative bodies at conducting evaluations of public benefit considering the "weakness of the state legislative institution."[22] At least one commentator has articulated a more active role for courts in weighing public benefits.[23] The Arizona Supreme Court, en banc, asserted its authority in this area by forbidding legislative bodies from considering one particular form of public benefit. The court explicitly rejected the notion that paying taxes to a jurisdiction is sufficient consideration for receiving a subsidy from that jurisdiction, thereby altering the calculus for future legislative determinations of public benefit.[24] Although public benefit determinations are not the focus of this article, it is helpful to understand that assessment of public benefit—rather than assessment of necessity—has been a central theme in the debate over public aid for private enterprise.[25]

Arguments over the judiciary's role in assessing the public benefit of location subsidies reflect a general pessimism about the ability of either legislative or judicial institutions to undertake the evaluation. However, that pessimism rests on an assumption that is true only in a limited subset of cases. That is, it assumes that the difficulty in

[19] One commentator discussed the application of economic multipliers and suggested that a reasonable distinction could be made by courts between basic activities that produce "an inflow of income from the export of goods to other areas," such as manufacturing, and derivative activities that result in "a net flow of income away from the area." Pinsky, *supra* note 10, at 308–09.

[20] Jonathan Q. Morgan, *Analyzing the Benefits and Costs of Economic Development Projects*, 7 COMMUNITY & ECON. DEV. BULL. 6 (2010), http://sogpubs.unc.edu//electronicversions/pdfs/cedb7.pdf [https://perma.cc/6ZXQ-JHQ9] ("One of the major concerns about economic impact analysis is that multipliers are often misunderstood and used inappropriately.").

[21] Briffault, *supra* note 4, at 946–47.

[22] *See* Pinsky, *supra* note 10, at 309; *see also* Dale A. Oesterle, *Lessons on the Limits of Constitutional Language from Colorado: The Erosion of the Constitution's Ban on Business Subsidies*, 73 U. COLO. L. REV. 587, 617 (2002) ("One can doubt the financial expertise and judgment of elected officials to make risk/return calculations.").

[23] Briffault, *supra* note 4, at 946 ("Even with judicial deference to the legislative definition of economic development as public purpose, courts could in theory play a role in determining whether a particular economic development program actually advances its stated public purpose . . . [and] could strictly scrutinize the fit between the public end and the means chosen, or the balance between the public and private benefits, particularly for measures that provide significant private gains but only speculative public ones.").

[24] Turken v. Gordon, 224 P.3d 158, 166 (Ariz. 2010) (opining that the duty "to pay taxes arises from law applicable to all, not out of contract," and therefore tax payments could not serve as consideration flowing to the City under a parking agreement with developer).

[25] Even if one rejects the notion that courts should take a more active role in assessing public benefit, that conclusion has no bearing on whether courts should nonetheless evaluate the *necessity* of business subsidies, as this article proposes.

evaluating the public benefit of location subsidies is due to the presence of interstate competition.[26] Indeed, in case law where courts have deferred to the legislature on public aid to private enterprise, opinions have pointed to interstate competition as an important reason for carving out a business location exception and giving legislatures more latitude.[27]

Thus, the assumed context for deferring to the legislature is one of competition between governments, in which the "but for" causation or "necessity" of the public aid can readily be assumed because governments find themselves in a "prisoner's dilemma."[28] In these competitive situations, it is unlikely that a location subsidy is wholly unnecessary or reliant on invalid past consideration[29] (an example of the latter is a business that seeks a subsidy but has already decided where it will locate).[30] It may therefore be rational for courts to defer to legislative bodies in a competitive context,

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[26] *See* Pinsky, *supra* note 10, at 275 ("However, since state programs are initiated and implemented in a context of interstate competition to attract new industries, it is difficult for any state to objectively draw a line between adequate and excessive allocation of public funds and credit for industrial financing.").

[27] In a leading state supreme court case, the majority expressed concern about capturing economic development "which might otherwise be lost to other states." Maready v. City of Winston-Salem, 467 S.E.2d 615, 627 (N.C. 1996). A lower court picked up on the treatment of interstate competition and addressed it as a factual determination—it is either present or it is not. *See* Haugh v. Cty. of Durham, 702 S.E.2d 814, 823 (N.C. Ct. App. 2010); *see also* Linscott v. Orange Cty. Indus. Dev. Auth., 443 So. 2d 97, 99–100 (Fla. 1983) (noting that the state's posture on revenue bonds placed it "at a competitive disadvantage with other states"); Hayes v. State Prop. & Bldgs. Comm'n, 731 S.W.2d 797, 798 (Ky. 1987) (noting that "Kentucky was involved in a fierce competition with many of the other states of this nation regarding the location of a major automotive manufacturing plant"); Basehore v. Hampden Indus. Dev. Auth., 248 A.2d 212, 218 (Pa. 1968) ("There is another important factor to consider. Industrial development authorities are so prevelant [sic] throughout the country that Pennsylvania is at a competitive disadvantage in attracting industry to this state should we declare this act unconstitutional."); Mayor & Members of City Council v. Indus. Dev. Auth., 275 S.E.2d 888, 890 (Va. 1981) ("The General Assembly has rejected these arguments and determined that this type [of] authority is necessary to promote the economy of the Commonwealth, and enable it to compete with other states which utilize this 'tool' to attract industry and promote their economic growth."); State *ex rel.* Hammermill Paper Co. v. La Plante, 205 N.W.2d 784, 798–99 (Wis. 1973) ("The development of such programs will also place Wisconsin upon a competitive basis with neighboring states that heretofore have approved similar legislation." (footnotes omitted)).

[28] *See supra* notes 2–5 and accompanying text.

[29] The generally accepted rule in contract law is that past consideration is not valid consideration. *See, e.g.*, Lantec, Inc. v. Novell, Inc., 306 F.3d 1003, 1012 (10th Cir. 2002) (applying Utah law, which says that "[g]enerally, past services cannot serve as consideration for a subsequent promise"); Smith v. Recrion Corp., 541 P.2d 663, 665 (Nev. 1975) ("Past consideration is the legal equivalent to no consideration."); *see also* ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 9.1 ("Happenings of the past, not bargained for by a promisor, are far less likely to be held to make an informal promise enforceable than are those for which the promisor bargains.").

[30] Mulligan, *supra* note 2, at 2050 ("An example where consideration would be absent is a company seeking incentives to locate in a local government's jurisdiction after the company has already committed to locate there. Following such a commitment, the local government cannot accept the company's promise to locate in the jurisdiction as valid consideration for an incentive payment, because the company has already committed to locate in the jurisdiction. Such an incentive would amount to a constitutionally impermissible gift: the constitution does not allow the government to pay an entity to do something that the entity has already committed to do.").

where courts can be reasonably confident that subsidies are exchanged for valid consideration, because the business would not have located in the jurisdiction "but for" the subsidy.[31] The fact that necessity is clear in these situations may help explain why, today, virtually all state courts have upheld some form of business location subsidies.[32]

However, not all subsidy cases involve location competition, and in those noncompetitive situations, the rationale for judicial deference to legislative bodies evaporates. Noncompetitive scenarios are different from competitive scenarios in important ways and should not be treated the same under the law. A typical noncompetitive situation involves a developer (or redeveloper) of buildings designed for commercial or residential purposes (or both), with arguably no element of location competition, who nonetheless requests direct subsidies. Absent competition, necessity cannot be assumed. Indeed, as Part II demonstrates, the necessity of public aid in a noncompetitive scenario is both debatable and highly contextual. Accordingly, in noncompetitive situations, courts (and legislative bodies) should presume that necessity and "but for" causation are questionable,[33] and should proceed to undertake the necessity analysis proposed in this article.[34]

On what basis can courts raise the issue of necessity in situations in which competition is disputable or lacking? The emphasis on competition within the body of case law and legal scholarship provides courts with the opening they need. By recognizing the role of location competition in justifying public purpose exceptions to gift clauses,[35] the absence of such competition in a particular case can provide the rationale for imposing greater judicial oversight.

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[31] Mulligan, *supra* note 2, at 2098 ("The company has stated explicitly that the incentives package will be a determinative factor in its location decision. A company making [this] incentive request will have no difficulty certifying that 'but for' the incentive, the company would not have located its facility in the local government's jurisdiction.").

[32] Briffault, *supra* note 4, at 913 ("During the closing decades of the twentieth century, state courts increasingly expanded the scope of permissible public purposes, so that by the end of the century virtually every state supreme court had upheld at least some economic development programs that involved direct assistance—including cash grants, low-interest loans, and tax breaks—to individual firms.").

[33] Mulligan, *supra* note 2, at 2098–99 ("The developer has selected the location, expended resources on pre-development of the project (such as site assemblage, market research, and design, among others), and courted investors for the project based on the characteristics of the local population—not on the basis of incentives . . . . The best that the developer in [a noncompetitive] scenario could say is that 'but for' the incentive that subsidizes the purchase of land and construction of the commercial buildings, the project could not go forward *in its proposed form*. That is a weak, if not entirely ineffectual, 'but for' argument, and it is fundamentally different from the 'but for' determination [in a competitive context] where the incentives were offered to induce companies to locate in one jurisdiction rather than another."); *see also* Briffault, *supra* note 4, at 913–14 ("Some courts have continued to police economic development programs, invalidating some—such as those aimed at aiding non-industrial activities like hotels and restaurants.").

[34] *See infra* Part II.B.

[35] *See supra* note 27.

Fortunately, competition tests are not unprecedented in law.[36] Legislatively enacted business location subsidy programs have long mandated such a determination.[37] Even better, no arcane or complex tests are required in order to determine the existence of competition, though greater transparency would be helpful, as discussed in Part II.

It is reasonable to conclude that courts are capable of distinguishing between competitive and noncompetitive scenarios and establishing different analytical frameworks for each. A bifurcated approach to gift analysis is therefore possible: state courts can defer to legislative bodies in competitive situations, but take a more active role when competition is absent. In the latter noncompetitive scenarios, a different analytical framework should be applied, with necessity playing a central role as explained in the next Part.

Part II: A Bifurcated Approach – The Role of Necessity in Competitive and Noncompetitive Scenarios

Part I reviewed gift clause case law and explained that interstate competition was an important reason given by courts for creating a public purpose exception for business location subsidies. The presence of genuine competition served as a proxy for necessity, and in such competitive scenarios, courts were comfortable deferring to legislative determinations about public benefit. When competition is absent, however, the rationale for the public purpose exception is weakened, and courts can no longer assume that public aid to the enterprise is necessary. If necessity is absent, then a subsidy likely amounts to a gift. Accordingly, to give effect to constitutional gift clauses, courts should make a necessity determination for all discretionary development subsidies, but the test may look different depending on whether the context is competitive or noncompetitive.

In its simplest form, a necessity determination involves a public body determining whether the requested subsidy is necessary to cause the project to go forward in the community. Necessity determinations are not new to the arena of business location subsidies. These determinations have appeared in case law, legislation, and executive branch regulations.[38]

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[36] *See, e.g., Haugh*, 702 S.E.2d at 823 (finding that interstate competition was present because the company's "consideration was relocating to and outfitting a partially completed facility in Durham or moving to readily available facilities with readily available equipment in California").

[37] *See, e.g.,* NEV. REV. STAT. ANN. § 704.7876 (requiring an attestation "that but for the incentive provided pursuant to the Program, the applicant would not have located or intended to locate the business in this State").

[38] For example, in North Carolina, "necessity" determinations are found in all three: case law, statutes, and executive branch regulations. *See* Maready v. City of Winston-Salem, 467 S.E.2d 615, 619 (N.C. 1996) (describing typical procedures for approval of incentives to include a determination that "participation by local government is necessary to cause a project to go forward in the community"); N.C. GEN. STAT. § 143B-437.52(a)(4) (2011) (requiring that any grant issued through the Job Development Investment Grant program be "necessary for the completion of the project in this State"); *id.* § 143B-437.02(h)(5)(F) (requiring that site development performed using funds from the Site Infrastructure Development Fund be "necessary for the completion of the project in this State"); N.C. DEPT. OF COMMERCE, GUIDELINES AND PROCEDURES FOR COMMITMENT OF FUNDS FROM THE ONE NORTH CAROLINA

This Part explores how necessity can be evaluated depending on whether a project involves location competition. Section A addresses necessity in a competitive context and reveals the importance of transparency in conducting effective evaluations of necessity. A disclosure rule is proposed to facilitate an accurate determination. As already noted, necessity can largely be assumed in competitive situations, but a more probing approach must be used when competition is absent. To that end, Section B sets forth a framework, based on principles found in real estate development literature, for testing necessity of development subsidies in a noncompetitive context.

Section A: Testing Necessity in a Competitive Context—and a Disclosure Rule

Part I's review of constitutional gift law explored the role of necessity in the context of location competition. As Part I explained, much of the case law pertaining to public aid of private enterprises deals with competitive situations. In those cases, necessity can practically be assumed away,[39] because as courts have noted, governments have little choice but to provide the requested subsidy or lose the project "to other

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FUND § 6.1 (2004) http://www.thrivenc.com/node/985/one-north-carolina-fund-guidelines [https://perma.cc/BS3X-FWJN] (establishing the "Threshold Statutory Criteria for Awarding Funds" in Section 6.1 as being "used in connection with projects for which participation by the state government is needed for the project to go forward or be undertaken in the state"). For examples of legislation in other states, see MASS. GEN. LAWS ANN. ch. 23A, § 3C (requiring coordinating council to find, among other things, that "a duly authorized representative of the controlling business has certified to the [council] that the controlling business would not have undertaken the proposed project but for the EDIP tax credits and local tax incentives available to it pursuant to this chapter"); N.J. STAT. ANN. § 52:27D-489d (providing that in deciding whether to approve a local incentive grant agreement, the Local Finance Board shall consider, among other factors, "the need for the redevelopment incentive grant agreement to the viability of the redevelopment project"). *But cf.* Common Cause v. State, 455 A.2d 1, 19 n.23 (Me. 1983) (rejecting party's argument based in contract law that public subsidy to induce a shipbuilder to locate a new operation in the state and invest in port facility was a fictitious contract because the facility improvements would have been undertaken by any good manager; finding that locating the operation in the State was a "prime objective" of the State and therefore court "cannot say that provision for a subsidy was unnecessary in order to achieve that objective"); *see also* Delogu v. State, 720 A.2d 1153, 1155 (Me. 1998) (citing *Common Cause* for the proposition that "public purpose is not determined . . . by the economic need of the recipient of the aid"). Such "necessity" or "but for" determinations are also common preconditions for approval of tax increment financing (TIF) arrangements. *See* Craig L. Johnson & Kennith A. Kiriz, *A Review of State Tax Increment Financing Laws*, *in* TAX INCREMENT FINANCING AND ECONOMIC DEVELOPMENT: USES, STRUCTURES, AND IMPACT 39 (Craig L. Johnson & Joyce Y. Man eds., 2001) (indicating at the time of writing that 14 states had a "but for" test and that some other states had a related test for tax increment financing and stating that "determining whether development would have occurred is an extremely difficult matter"); Richard Briffault, *The Most Popular Tool: Tax Increment Financing and the Political Economy of Local Government*, 77 U. CHI. L. REV. 65, 77 (2010) (citing cases where courts have rejected TIF proposals but suggesting that "but for" test rarely presents meaningful obstacle for projects). TIF programs are legislatively enacted and provide financing for publicly owned projects (see Option 3 in the proposed framework, *infra*) but typically do not provide direct subsidy to private enterprise.

[39] *See supra* notes 27–29 and accompanying text.

states."[40] As a result, the chance that a competitive location subsidy is unnecessary or relies on invalid past consideration is low.[41]

Courts make the final determination on whether competition is present,[42] but they are informed by initial determinations by executive or legislative bodies. One court, for example, referred to determinations made by local governments that subsidies were necessary to make the projects at issue go forward in the community[43]—an uncontroversial presumption in the face of interstate competition.[44]

However, courts should not defer to determinations by other public bodies about the presence or absence of competition unless there is a reasonable basis for the conclusion. In order to accurately assess whether a business subsidy involves a competitive situation or not—and ultimately, whether a subsidy is necessary—courts (and executive or legislative bodies making initial determinations) need information about the project to be subsidized. The need for this information forms the basis for implementing a disclosure rule.

As an example of a possible disclosure rule, any company requesting a discretionary subsidy could be required to provide pertinent information publicly to every solicited government unit in advance of approval of any incentive, including: (a) important details about the amount of the company's proposed investment in the facility and how the project will be financed, (b) the anticipated timing of the company's investment in the facility and associated job creation, (c) the company's internal location selection process and criteria, and (d) the specific location of every site under consideration for the project.[45]

Disclosure of this kind would allow a court (or executive or legislative body) to check the validity of the location competition. For example, officials could review the different locations being considered by a subsidy-seeking business and could compare those locations with the business' internal selection process and criteria to determine whether the other locations were legitimate competitors. Due to the fact that business location decisions often involve interstate competition, an effective disclosure rule would need to be enacted at the federal level and enforced nationwide. Legal standing could be granted to affected governments and taxpayers to file suit in federal court to ensure that disclosure occurs.

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[40] *Maready*, 467 S.E.2d at 627.

[41] This conclusions assumes, as case law does, that a promise by a business to locate its jobs and capital investment in one state rather than another is valid consideration for payment of a location subsidy. *See supra* notes 16–21 and accompanying text.

[42] *See supra* note 36.

[43] *Maready*, 467 S.E.2d at 619 ("[a] determination is made that participation by local government is necessary to cause a project to go forward in the community").

[44] *Id.* at 627.

[45] The name of the company is one piece of information that would not be necessary to reveal and has been intentionally omitted from this listing. The company could remain anonymous and communicate to governments through a third party.

This would, of course, represent a significant shift in practice, since most incentive negotiations today occur under a cloak of secrecy.[46] Establishing a disclosure requirement is justified on the basis that a company seeking public resources should accept a public process. If a company wants its site-selection process to remain proprietary and confidential (not public), then it should forego publicly funded incentives. In addition, transparency would enable each government unit to assess competitor governments and contemplate intergovernmental cooperative arrangements, which would be enforceable thanks to the disclosure requirement.

Importantly for this article's framework, a disclosure rule would help governments distinguish between competitive and noncompetitive situations. Faced with a questionable claim that a project involves location competition, a disclosure rule would ensure that governments receive information to support (or refute) the claim. Courts, likewise, should delve into evidence about competition and establish a precedent for extensive discovery as part of any constitutional review by the judiciary, regardless of whether a disclosure rule is enacted legislatively.[47]

Section B: Testing the Necessity of Public Aid in a Noncompetitive Context

Recall that noncompetitive scenarios involve developers (or redevelopers) of buildings designed for commercial or residential purposes that are seeking incentives for development projects, even though no reasonable claim can be made about location competition. In the absence of competition, as explained in this Section, a subsidy probably is not "necessary"—and to the extent that a subsidy for private enterprise is unnecessary, it amounts to an unconstitutional gift regardless of the public benefit.[48] This Section provides a framework for evaluating the necessity of public aid for private enterprise in noncompetitive situations.

To set the stage for this Section, an example is helpful. Suppose a developer proposes to construct a mixed use project that will include residential and commercial components. Assume that, *without* a subsidy, the developer can obtain sufficient financing to construct the project one half mile away from the town's most central and desirable location, Main Street. However, *with* a subsidy, the developer could afford to construct the project directly on Main Street by acquiring more desirable and expensive land and applying interior and exterior finishes that would make the project more appealing as compared to other residential and commercial space in the community. In this scenario, the project can go forward in the community without subsidy, but it cannot

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[46] Jonathan Q. Morgan, *Using Economic Development Incentives: For Better or for Worse*, POPULAR GOV'T, Winter 2009, at 16 (noting the "secretive nature" of incentive negotiations and explaining that companies require confidentiality "to protect trade secrets and avoid tipping their hand to competitors").

[47] *See, e.g.*, *Haugh*, 702 S.E.2d at 821–23 (N.C. Ct. App. 2010) (closely examining the factual circumstances pertaining to competition and then upholding the location incentives at bar because they were consistent with case law on interstate competition); *see also* Mulligan, *supra* note 2, at 2068.

[48] *See* Turken v. Gordon*,* 224 P.3d 158, 164 (Ariz. 2010) ("When government payment is grossly disproportionate to what is received in return, the payment violates the Gift Clause.").

go forward in the more exceptional form proposed by the developer unless some subsidy is provided. As described, the project does not involve location competition (between jurisdictions) nor is it being pursued for some other public purpose, so the rationale for public aid is weak or nonexistent.[49]

Recall, however, that a project in a noncompetitive context might still be eligible for public aid in pursuit of public purposes such as elimination of blight or construction of affordable housing for low-income persons.[50] In these situations, even though the project context is not competitive, a subsidy may nonetheless be necessary and permissible in order to accomplish the desired public purpose. Taking the example of the mixed use project described above, a public subsidy might be necessary to induce the developer to locate the project in a government-designated blighted area (where lower rents strain the project's feasibility) rather than on a prime piece of real estate on Main Street (where rents are higher). Or a subsidy may be required to enable the developer to construct residential units that are affordable to low-income members of the community. The constitutional question is whether the subsidy provided is unnecessary and therefore amounts to an unconstitutional gift.

An effective necessity test will help governments to minimize the amount of public subsidy required to accomplish the desired end. In the case of a development project in a noncompetitive context, basic methods of real estate development finance can be applied to determine the effect of a subsidy on the project's financial feasibility. A project achieves financial feasibility, as that term is used by development professionals, when the project earns adequate returns to support the minimum investment of private capital needed to finance construction of the project.[51] As a financial and practical matter, feasibility—and therefore necessity—is knowable.

Exactly how might a court employ principles of real estate development finance to test an assertion that a subsidy is "necessary" in a noncompetitive context? Trial courts would need to ask probing questions about the financial feasibility of the project, and

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[49] In this situation, a determination that a subsidy is unconstitutional would be expected in a state such as North Carolina where competition and necessity are incorporated into the constitutional rationale for business subsidies. *See supra* notes 27 and 47. However, the subsidy might survive a challenge in a state where the judiciary has largely abdicated its role in enforcing public aid clauses. *See, e.g.*, State *ex rel.* Brown v. City of Warr Acres, 946 P.2d 1140, 1145 (1997) (applying public purpose exception to public aid clauses without questioning legislative determination of public benefit and without requiring competitive conditions or necessity).

[50] *See supra* note 14 and accompanying text. Even in the context of affordable housing, necessity plays a role. *See In re* Housing Bonds, 296 S.E.2d 281, 285–87 (N.C. 1982) (finding a public purpose in issuance of bonds for affordable housing that occurs "*only*" when decent housing is not otherwise available because "private enterprise is unable to meet the need").

[51] To attract sufficient private investment to allow a project to proceed, a development project's pro forma financials must demonstrate that the project can achieve a minimum rate of return. RICHARD B. PEISER & DAVID HAMILTON, PROFESSIONAL REAL ESTATE DEVELOPMENT: THE ULI GUIDE TO THE BUSINESS 168 (3d ed. 2012) (describing feasibility analysis as "the one lenders require to ensure that the project will live up to its performance expectations"). Typical return expectations for private real estate development projects are regularly reported in publications such as the quarterly Real Estate Research Corporation (RERC) Report.

appellate courts would require detailed findings from lower courts to substantiate any determination of necessity. The disclosure rule proposed earlier should be helpful in this regard. Fortunately, there is no need to invent a new analytical framework—courts should simply mirror the analysis that would be conducted by a reasonable development professional faced with the same question.[52]

What does that analysis look like? Some public officials employ a crude "gap" analysis. This method makes basic assumptions about the availability of private debt and equity to finance a development project and then calculates the difference between the total project costs and the assumed availability of private capital. The difference is then presented as a static financing "gap" that must be filled by a public sector contribution.[53]

There are at least two problems with utilizing a static "gap" to evaluate necessity. First, it fails to capture what is actually a dynamic and fluid analysis of interdependent capital sources such as equity and debt. Each assumption about a particular capital source affects the other sources and, ultimately, affects investor returns on a project.[54] In reality, gaps are not static, and it is misleading to represent them as such. Thus, gap analysis is wholly inadequate in approximating the analysis of a prudent investor. Second, even if the existence of a so-called "gap" is assumed, it does not help a local government evaluate and compare different legal means of addressing that gap. After all, a gap can be addressed through options ranging from leases to loans to grants, but gap analysis fails to help governments determine the appropriateness or necessity of each of the available options.

This article provides a more effective framework than gap analysis for constitutional gift determinations. The proposed analytical framework takes a project through a staged, sequential analysis of six general public aid options: (1) analysis and verification of assumptions; (2) public lease of space for public use in the private project; (3) construction or acquisition of public facilities on the site of the private project; (4) market rate public loan to private project with adequate security and risk-adjusted interest rate; (5) subsidized public loan to private project, which could involve inadequate security or an interest rate that fails to fully reflect the public's risk; and (6) equity investment or grant. The options were categorized and ordered by integrating a key legal principle with real estate development finance principles.

The key legal principle is that greater public control over public funds and facilities is favored in constitutional gift analysis. Accordingly, any legal framework for

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52 This article's proposed framework could be viewed as similar to a "prudent investor" standard. *See* Neb. Const. art. XI, § 1 (requiring municipalities to invest public endowment funds "in the manner required of a prudent investor who shall act with care, skill, and diligence under the prevailing circumstance").

53 MIKE E. MILES ET AL., REAL ESTATE DEVELOPMENT: PRINCIPLES AND PROCESS 340 (4th ed. 2007).

54 PEISER & HAMILTON, *supra* note 51, at 22 (explaining that feasibility analysis involves an "iterative process in which the developer obtains more and more precise information in each iteration" through five stages of analysis).

evaluating aid to a noncompetitive project should consider the level of public control.[55] In the framework proposed here, options that retain greater public control over funds and facilities are prioritized over options that surrender public control.

There are two development finance principles in operation in the framework. The first finance principle is that financial feasibility of a private project can be improved by arranging for prelease or presale of some portion of the private project.[56] In the context of public aid, the public could enter into a presale arrangement in which the government agrees to buy a portion of the private project at a reasonable price (no subsidy) to be used as a publicly owned and operated facility for a public use. A typical example of this sort of public-private partnership is development of a hotel and convention center, in which the private developer constructs the hotel and convention center together, and the public sector agrees to purchase the convention center (but not the hotel) from the developer when construction is complete. In the example, the public would exercise control over the convention center through ownership, which is more control than the public would exercise if it subsidized the convention center and left it in private hands. Another option would leave the convention center under private ownership, but the public would exercise control through a long term lease for space. Under the framework proposed in this article, public ownership or a long term lease would be favored over a scenario in which a public subsidy was provided without public control over the facility.

The second finance principle is that developers, when arranging financing for a development project, typically seek to replace expensive investor equity with less expensive debt whenever possible.[57] Applying this principle in the context of public aid, governments should consider offering loans, which improve project feasibility by reducing the amount of expensive investor equity required for the project, before considering a grant of any kind. In addition, when public aid takes the form of a loan, it provides more public control than a grant (a loan is secured and paid back with interest) and therefore is favored in the proposed framework.

The principles described above were applied to the six options, which were prioritized and then split into two stages: Stage 1 contains the first four options, none of which involves a direct subsidy to the private project, and Stage 2 contains the final two options, each of which involves some direct subsidy to the private project. Table 1 summarizes the framework and the level of public control over facilities and funds.

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[55] This framework compares different degrees of public control of facilities and financing in much the same way as Pinsky describes in his analysis of different forms of public aid for private enterprise. *See generally* Pinsky, *supra* note 10, at 280–89 (describing the evolution of case law regarding public aid of private enterprises and concluding that a key principle in determining whether public purposes are served is the degree of public control over projects and financing).

[56] STEPHEN P. PECA, REAL ESTATE DEVELOPMENT AND INVESTMENT: A COMPREHENSIVE APPROACH 120–21 (2009) (explaining that arranging for presale of a portion of a project can satisfy common preconditions for debt financing).

[57] MILES ET AL., *supra* note 53, at 227 (using an example to illustrate how an investor group sought to "maximize" permanent debt financing because doing so would "provide the cheapest overall financing").

Table 1. Framework for determining necessity of public aid in a noncompetitive context

Stage 1: No direct public subsidy, greater public control		
Options (in sequence)	**Public control—facility**	**Public control—financial**
1. Analysis and verification of assumptions	**Not applicable**	**Full**: Analysis directed by public and conducted for public benefit
2. Public lease of space in project	**High**: Public lease and control over space, private ownership	**High**: Public funds pay rent for public space only as needed
3. Construction or acquisition of public facility on the site of the private project	**High**: Private construction but public ownership/ control of the public facility	**High**: Public funds used only to acquire publicly owned and controlled facility
4. Market-rate public loan to private project, adequate security and risk-adjusted interest rate	**Low**: Privately owned project; public granted security interest in the project	**Medium**: Public funds loaned to private project but terms include adequate security and risk-adjusted interest rate
Stage 2: Direct public subsidy provided, less public control		
Options (in sequence)	**Public control—facility**	**Public control—financial**
1. Subsidized public loan to private project, security inadequate and/or interest rate fails to reflect public's risk	**Low**: Privately owned project; public granted security interest in the project	**Low**: Public funds loaned to private project but loan is not backed by adequate security and/or fails to earn risk-adjusted return
2. Equity investment or grant	**Minimal**: Little or no public control over facility (perhaps some contractual restrictions on development or use)	**Minimal**: No public control over public funds (perhaps some contractual restrictions on development and reporting). Risk-adjusted return may or may not be earned.

Putting the framework into practice is straightforward. For any particular project, the court or other public body tests each option in sequential order before proceeding to the next one. Thus, options described in Stage 1 are tested in sequential order to determine the effect on feasibility of the private project. If any of those options, individually or in combination, make the project financially feasible, then Stage 2 is not even attempted because Stage 2 options cannot be "necessary" to make the project go forward in the community and are therefore unconstitutional gifts. If no Stage 1 option or combination of Stage 1 options makes the project feasible, then Stage 2 options are attempted in sequential order: a subsidized loan is attempted before making an outright grant, because a grant cannot be "necessary" if a loan—which retains more public control over public funds than a grant—would achieve project feasibility. Thus, as noted previously, the necessity of any subsidy is knowable because feasibility is knowable.

Each stage and its sequentially ordered options are described in greater detail below.

<u>Stage 1: Improve Project Feasibility without Direct Subsidy</u>

In Stage 1, the government initially completes its own financial feasibility analysis of the project to determine independently whether the project is feasible for private investors without any direct subsidies.[58] This action benefits the private developer as well, because it validates (or corrects) the developer's assumptions and sets expectations for negotiating any future public-private partnership related to the project. The government entity expends minimal resources in conducting this analysis and retains control over its funds and facilities, so it is the most obvious first step.

If feasibility analysis reveals that the project is not feasible on its own to achieve legitimate public purposes, then it would be appropriate to test other Stage 1 options that involve no direct subsidy to the developer. It is important for government officials to recognize that public aid to private enterprises need not take the form of a direct subsidy. As illustrated by the options in Stage 1, there are a number of meaningful ways for public participation to enhance project feasibility without directly subsidizing the project. Sometimes mere government cooperation can improve feasibility for a development project.[59] To the extent that any exchange with the private sector is contemplated in Stage 1—such as a lease or a loan—the exchange occurs at fair market value. However, each subsequent option within Stage 1 represents less public control over public facilities and funds, thereby increasing the public's exposure to private risk and decision-making.[60]

A court need only evaluate whether the options described in Stage 1 were attempted, preferably in sequence. Evidence of compliance with this staged analysis could be submitted by the private developer and tested by experts who could support or refute any claims about the effect of Stage 1 options on project feasibility.

Stage 1 options are described in greater detail below.

1. **Project Analysis and Verification of Assumptions**. Are the assumptions being made by the developer or retailer reasonable? Key assumptions include the cost of capital provided by lenders and investors, the cost of construction, the strength of demand for the project in the market, and the net operating income of the project upon completion.[61] In the author's experience assisting government officials, there have been several instances in which for-profit developers have made overly conservative assumptions in their pro forma financials and then used those overly conservative assumptions to argue (mistakenly) that the project requires local government subsidy to be financially feasible. Assumptions can be verified by neutral third-party development experts.[62]

[58] *See supra* notes 51–54 and accompanying text regarding financial feasibility analysis.

[59] Examples of government cooperation include making public streetscape improvements or timing the construction of nearby public parking to coincide with private development.

[60] Pinsky, *supra* note 10, at 281 ("Adequate protection of the public financial interest necessitates public control consonant with public financial risk.").

[61] For a detailed description of how to perform feasibility analysis, *see* MILES ET AL., *supra* note 53, at 177–187.

[62] If assistance from a third party development expert is not available or affordable, then governments should review the *pro forma* financials that were provided to prospective lenders and investors by the developer. Financials provided to lenders and investors tend to contain more optimistic assumptions about project feasibility, because developers use them to "sell" investors and lenders on the project in order to secure debt or equity investments. Development experts can assist legislative bodies (or reviewing courts) with evaluating financial documents. The author launched a program called the

2. **Public Lease of Space in the Private Project**. Could the government lease space in the private development project for government use at an objectively fair price, without a subsidy or gift?[63] With a government pre-lease in hand, the project will look more appealing to banks[64] and may be able to secure a greater amount of low-cost debt as compared to high-cost equity,[65] thus improving the project's feasibility without the need for any direct subsidy.[66] This assumes that the government can put the leased space to good use for legitimate public purposes.[67]

3. **Construction or Co-location of Public Facilities on the Site**. Could the government turn some portion of the private project into a publicly owned facility?[68] For example, a government could acquire some of the undeveloped land around a project and own it as a public park. The acquisition of unused land from the private project at fair market value (no subsidy) injects capital into the private project, eliminates some of the private owner's capital expenditures and ongoing operating expenses associated with the land—and, importantly, does not

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Development Finance Initiative (DFI) at the University of North Carolina to provide such development and finance expertise to local governments. *See* Practical Considerations and Conclusions, *infra*.

[63] Ampt v. City of Cincinnati, 1896 WL 541, at *4 (Ohio Cir. Ct. July 1896), *modified sub nom*. Alter v. City of Cincinnati, 46 N.E. 69 (Ohio 1897) ("While if a constructing party would build the works, it would have to furnish the money until such favorable time as the city might find in which to buy the plant. Whatever aid the constructing party would derive from this arrangement would only be such as it might derive from its profits, if any, from the building and leasing of the works. There could be no more aid in this than is given to every party who constructs a street or any other improvement for the city."). *But cf.* Gallo v. Twp. Comm. of Weehawken, 437 A.2d 738, 742 (Law. Div. 1981) ("Under settled principles, therefore, the guarantee of the bonds by Weehawken under the guise of a lease is declared illegal.").

[64] MILES ET AL., *supra* note 53, at 206 (explaining the value of creditworthy tenants to developers but also noting that "creditworthy tenants know the value they bring to a real estate development and they negotiate lower rents"); PECA, *supra* note 56, at 120 ("A common condition precedent [for a construction loan] is the prelease or presale of space in the building."); *cf. id.* at 126 (indicating that pre-leasing requirements are relaxed when markets are at or near their peak and banks are competing to make loans to projects).

[65] PEISER & HAMILTON, *supra* note 51, at 202 ("Equity is the most expensive source of funding because equity investors receive returns only after other lenders have been repaid."). Equity investors can demand risk-adjusted annual returns in excess of 10% over the interest rate of a standard bank loan depending on the level of risk associated with a particular equity investment.

[66] Turken v. Gordon, 224 P.3d 158, 167 (Ariz. 2010) (articulating the principle that payment for lease or purchase of public space, if it far exceeds the value of the leased or purchased space, "quite likely violates the Gift Clause").

[67] *Id.* at 164 ("No party questions that payments by the City under the Parking Agreement would serve a public purpose. The parties agree that providing parking is a legitimate public purpose and that the City could have erected a parking structure of its own without violating the Gift Clause.").

[68] Citizens Word v. Canfield Twp., 787 N.E.2d 104, 108 (Ohio Ct. App. 2003) ("We hold that a governmental entity can improve its own property regardless of whether it will benefit a private developer."); Wilmington Parking Auth. v. Ranken, 105 A.2d 614, 628 (Del. 1954) ("The evil forbidden by the Constitution is not the investment of municipal funds in a public project operated solely by the municipality or other public body. 'It forbids the union of public and private capital or credit in any enterprise whatever.' And the history of the adoption of these or similar constitutional provisions in the various states, following widespread default on railroad securities guaranteed by municipalities, shows that the provision was not intended to prevent a municipality from devoting funds to its own public improvements." (citations omitted)).

involve a gift. In another example, public parking could be constructed and parking spaces leased to the private project at the fair market rate,[69] thereby reducing the amount of expensive up-front capital required for the private developer to construct its own private parking.[70] Again, this improves the financial feasibility of the project without providing a direct subsidy or gift.[71] An additional benefit to this approach is that the government retains the property it owns and can sell or reuse it for other purposes at the conclusion of the useful life of the project.

4. **Market-Rate Loan (Adequate Security and Risk-adjusted Interest Rate)**. Developers typically seek to maximize the amount of low-cost debt capital in development projects, because loans—even loans with relatively high interest rates—are still less expensive than equity, thereby reducing the overall cost of capital for the project.[72] Thus, a government can improve the feasibility of a development project simply by providing a loan at an appropriate risk-adjusted rate of interest.[73] The meaning of "appropriate risk-adjusted" interest rate is that the loan carries terms that would be expected for comparable loans in the market, including a market rate of interest and appropriate security in the form of a deed of trust or lien on the project.[74] The interest rate can be high, as appropriate, to compensate for the level of risk accepted by the government in providing the loan.[75] In the author's experience, a loan from a foundation or local government—even at a relatively high interest rate—can be sufficient to make a development project feasible.[76] If feasibility can be achieved through an unsubsidized loan, then an outright grant cannot be "necessary." Thus, so long as making a loan is a

[69] Chun King Sales, Inc. v. St. Louis Cty., 98 N.W.2d 194 (Minn. 1959) (analyzing tax exemption of public property leased to a private entity).

[70] PEISER & HAMILTON, *supra* note 51, at 195 (explaining that, for private developers, "[r]ecovering the full cost of parking can be challenging").

[71] PECA, *supra* note 56, at 120–21 (explaining that arranging for presale of a portion of a project can satisfy common preconditions for debt financing).

[72] MILES ET AL., *supra* note 53, at 227 (using an example to illustrate how an investor group sought to "maximize" permanent debt financing because doing so would "provide the cheapest overall financing").

[73] *Id.* at 222 (noting that when the internal rate of return (return for an equity investor) of a project exceeds the interest rate on debt, the use of debt reduces the amount of equity required and magnifies investment returns to the equity investor).

[74] MILES ET AL., *supra* note 53, at 204–05 (explaining that lenders and equity investors consider the "riskiness" of any loans or investments they make and "price" the expected return accordingly).

[75] *Id.* If the borrower provides security to the government lender that is anything other than the primary (or first) lien on the project—for example, if the government lien is subordinated to some other lender's lien—then the government is accepting higher risk than the primary lender, and the government's higher risk should translate into a higher interest rate for the government-provided loan.

[76] *See* MILES ET AL., *supra* note 53, at 227–228 (describing how one project maximized debt to improve returns); Andrew Trump, *How a Local Government Loan Can Make a Revitalization Project Possible*, UNC SCH. OF GOV'T, COMMUNITY AND ECONOMIC DEVELOPMENT IN NORTH CAROLINA AND BEYOND (Sept. 4, 2015), http://ced.sog.unc.edu/how-a-local-government-loan-can-make-a-revitalization-project-possible/ [https://perma.cc/P8H9-EFJA] (describing how a mezzanine loan improved project feasibility).

legally permissible activity for governments,[77] a loan can provide an elegant solution for project feasibility without passing along an unnecessary subsidy to the private enterprise.

Stage 2: Minimize Any Subsidy to a "Necessary" Level (If No Feasibility after Stage 1)

If any of the options provided in Stage 1, alone or in combination, make a project feasible, then a grant or direct subsidy cannot be "necessary"—that is, direct subsidy above what is necessary for feasibility must be an unconstitutional gift regardless of the project's perceived benefit.[78] However, after employing all of the options in the first stage, the most challenging projects may still require some direct subsidy in order to achieve feasibility.

In such cases, some governments consider offering direct subsidies to make projects feasible in noncompetitive situations. If such subsidies are authorized in pursuit of a public purpose,[79] the level of subsidy nonetheless should be minimized[80] and should be roughly proportional to the public benefit received[81] from the project in order to avoid making an unconstitutional gift. To that end, the following options should be evaluated in sequential order.

1. **Subsidized Loan (Security Inadequate and/or Interest Rate Does Not Reflect Level of Risk)**. A subsidized loan typically involves a lower-than-market interest rate or deferred interest and principal payments with a balloon payment upon sale. Such loans contain an implicit grant—the grant component buys down the interest rate or reduces the debt service payments during the term of the loan. Ideally, the grant component of the loan should be treated as a form of equity investment in the project, entitling the government to some additional risk-adjusted return in the event the project achieves profitability. There are two important points related to a subsidized loan. First, governments should be wary of lowering the cost of their capital (such as a low interest rate on a government-provided loan). When a government offers capital at a subsidized rate, the rational developer will elect to replace expensive private capital with the subsidized public capital, even if reliance on public capital is not necessary. The government should instead make its capital more expensive, in order to motivate the developer to seek alternative (private) sources of capital and to reduce its reliance on public sources. Second, it

[77] Port of Longview v. Taxpayers of Port of Longview, Cowlitz Cty., 527 P.2d 263, 271 (Wash. 1974) ("The loan of money or credit by a municipality to a private corporation is a violation of our state constitution regardless of whether or not it serves a laudable public purpose.").

[78] *See supra* notes 1622–31 and accompanying explanation in Part I about the difference between public benefit analysis and necessity; *see also* Turken v. Gordon, 224 P.3d 158, 167 (Ariz. 2010) ("We find it difficult to believe that the 3,180 parking places have a value anywhere near the payment potentially required under the Agreement. The Agreement therefore quite likely violates the Gift Clause.").

[79] *See supra* note 14 and accompany text.

[80] *See Turken*, 224 P.3d at 166 ("The potential for a subsidy is heightened when, as occurred here, a public entity enters into the contract without the benefit of competitive proposals.").

[81] *Id.* at 164 ("When government payment is grossly disproportionate to what is received in return, the payment violates the Gift Clause."); *see also supra* note 78 and accompanying text.

should be obvious that courts and legislative bodies should only rarely, if ever, find it necessary to move beyond this option. After all, one can envision an extremely developer-favorable loan that defers all interest and principal payments to a balloon payment due when the project is sold or refinanced. Such a loan will, in most cases, make a project feasible, because it not only replaces expensive equity, but it also involves no payments during the term of the loan, so it behaves nearly identically to a grant in that it does no harm to the project's operating income nor to the project's ability to obtain other financing.

2. **Equity Investment (or Grant as a Last Resort)**. Finally, if all of the above measures have been applied and none achieves feasibility for a private project, then perhaps a direct equity investment is indeed "necessary" to make the project go forward as proposed. A number of state constitutions explicitly prohibit equity investments,[82] but if permitted, such investments (or grants) should be made on the same basis as other investors; that is, the investment in the project should earn a return if the project is profitable. As a leading real estate development text notes, "Investment of public dollars requires a return for risk taking *apart from increased collection of property taxes*, based on some form of . . . profit participation in future project revenues."[83] Indeed, this notion of public return apart from tax revenue is reflected in case law. Arizona's Supreme Court, en banc, explicitly rejected the notion that payment of taxes alone could serve as consideration for a subsidy.[84]

Practical Considerations and Conclusion

In general, each successive option outlined in the framework above involves a deeper level of public participation—that is, subsidy or risk or both—than is required for the preceding option. If one of the first options makes a private project feasible, then consideration of subsequent options is neither appropriate nor "necessary." Courts could use the framework to determine the necessity of any form of public aid to private enterprise in a noncompetitive situation. So, for example, a grant would not be deemed

[82] *See, e.g.*, S.C. Const. art. X, § 11 ("Neither the State nor any of its political subdivisions shall become joint owner of or stockholder in any company, association, or corporation."); Nebraska League of Sav. & Loan Ass'ns v. Mathes, 266 N.W.2d 720, 721–22 (1978) ("Article XI, section 1, of the Nebraska Constitution, provides: 'No city, county, town, precinct, municipality, or other sub-division of the state, shall ever become a subscriber to the capital stock, or owner of such stock, or any portion or interest therein of any railroad, or private corporation, or association.' That section of the Constitution was adopted in 1875 and has remained unchanged since that date. Approximately 40 states have similar constitutional provisions. In general, such provisions were designed to prevent the use of public funds to aid in the construction of railways, canals, and similar undertakings. The intent was to keep states and political subdivisions out of private business."); *see also* Briffault, *supra* note 4, at 915 n. 42 ("One nineteenth-century restriction that may have survived the twentieth-century expansion of public purpose is the prohibition on state investment in business corporations."). *But cf.* 2008 Neb. Laws 6 (amending Article XI to authorize investment of public endowment funds).

[83] MILES ET AL., *supra* note 53, at 340 (emphasis added).

[84] Turken v. Gordon, 224 P.3d 158, 166 (Ariz. 2010) (opining that the duty "to pay taxes arises from law applicable to all, not out of contract," and therefore tax payments could not serve as consideration flowing to the City under a parking agreement with developer).

necessary unless it could be shown that each of the preceding options was employed, sequentially, before resorting to the grant.

If a government attempts all of the options and nonetheless arrives at the final one—using public funds to make a grant or to invest directly in a private development project—then officials should begin to question whether the project makes sense to pursue at all. If a project requires direct public subsidy, then is it truly feasible and self-sustaining? This last question is more a policy issue than a legal matter, but the process leading to the policy answer is the same as that needed to answer the legal question.

Finally, the necessity framework proposed in this article is not merely a theoretical concept. This approach has already been tested and employed for projects seeking public aid from state and local governments. At the School of Government at the University of North Carolina at Chapel Hill,[85] students in a graduate level course taught by the author apply this legal framework when helping local governments understand their options for improving the feasibility of development projects. In one project in a rural area, for example, a graduate student team applied the framework to the redevelopment of a historic landmark and found that feasibility could be achieved through a market rate loan (Option 4 in Stage 1 of the framework).[86]

Similarly, in a university program launched by the author called the Development Finance Initiative (DFI), development professionals apply the same framework to test public aid options for state and local governments on larger, more complicated development projects.[87] In one successfully financed project, DFI proposed the development program and conducted financial feasibility analysis for a public-private partnership for construction of public parking as part of a larger private mixed use development in an urban downtown. DFI applied the framework and found that feasibility for the project could be achieved simply through the acquisition of public parking from the developer. Thus, the project was shown to be feasible using Option 3 of Stage 1 of the framework.[88] In that case, Stage 2 subsidies would have been unnecessary, constitutionally questionable forms of public aid.

In an even more complex project involving the master development of an 800-acre site in a rural region, DFI applied the framework to a project where some officials believed that private development would be possible only if it were subsidized. However, DFI conducted feasibility analysis (Option 1) and determined that financial feasibility for private development was achieved through a combination of public leases (Option 2),

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[85] Visit the school's website at https://www.sog.unc.edu/ [https://perma.cc/V4Y2-3BSB].

[86] *See, e.g.*, Trump, *supra* note 76 (describing how a graduate student team used the framework to identify local government options for improving feasibility of a key development project in a small town).

[87] *See Development Finance Initiative,* UNC SCH. OF GOV'T, COMMUNITY AND ECONOMIC DEVELOPMENT IN NORTH CAROLINA AND BEYOND (2009), http://ced.sog.unc.edu/category/development-finance-initiative/ [https://perma.cc/8H5M-DP52].

[88] Information about this project, which was located in Wilmington, North Carolina, along with other DFI project examples, is available at https://www.sog.unc.edu/resources/microsites/development-finance-initiative/wilmington-north-carolina-water-street-parking-deck [https://perma.cc/H78H-C6A9].

acquisition of public facilities (Option 3), and market-rate loans (Option 4)—all within Stage 1 of the framework where no direct subsidy is provided to private enterprise.[89] Once again, the framework proved to be practical and effective in recognizing that Stage 2 subsidies would have been unnecessary and therefore constitutionally suspect forms of public aid.

If the straightforward legal framework proposed in this article can be employed by students and development professionals alike, it should be possible for courts to employ it as well. Courts would not be required to perform the financial analysis themselves. They would simply ensure that executive or legislative bodies followed the framework in any particular instance of public aid to private enterprise and that the determination of necessity was credible.

Courts could exercise some flexibility in how they implement the framework. For example, the framework could be boiled down to a more simplistic formulation: (1) necessity must be present for discretionary public aid to private enterprises, and a determination of public benefit has no bearing on the determination of necessity; (2) so long as public aid is limited to Stage 1 (unsubsidized) options, courts could (and arguably should) defer to the executive or legislative body regarding which Stage 1 options are utilized, how they are combined, and the precise parameters of each; and (3) regardless of public benefit, public aid in the form of a grant cannot be necessary if a loan can be offered instead, and as already explained, a loan almost always achieves feasibility for a project. Accordingly, it is highly unlikely that grants are necessary in a noncompetitive context. Consistent application of this framework by courts should, in turn, impose some discipline on for-profit companies and government officials engaged in public aid negotiations for development projects.

Of course, this article's approach requires some astuteness on the part of state courts, which must ask the right questions and make appropriate findings to support the determination of necessity. Are state courts willing to play this important role? In many states, that question is as yet unanswered.

Tyler Mulligan is Albert and Gladys Hall Coates Distinguished Term Associate Professor of Public Law and Government at the School of Government at the University of North Carolina at Chapel Hill, where he teaches graduate students and counsels state and local government officials regarding development finance, community economic development, and revitalization efforts. Mulligan launched the School's Development Finance Initiative, which assists local governments with attracting private investment for transformative development projects, and now serves as faculty advisor for the initiative.

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[89] For an example of the framework being employed for an 800-acre master development project for the State of North Carolina, *see* C. Tyler Mulligan et al., [RE]IMAGINING BROUGHTON: A REUSE STUDY OF HISTORIC BROUGHTON CAMPUS 20 (2016), http://sog.unc.edu/dfi/broughton [https://perma.cc/839N-V7EV] (applying a protocol for evaluating public aid options based on the framework proposed in this article).