



POLICY REPORT

South Carolina Policy Council

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Are Retail Incentives Constitutional?

A Review of the Sembler and Bass Pro Shops Incentives Legislation

Are economic development incentives constitutional? If the state's frequent reliance on such incentives to attract firms like Boeing is any indication, the answer would seem to be an obvious yes. But that does not mean all incentives would pass constitutional muster. Rather, economic incentives must serve a public purpose. In effect, this means economic incentives cannot be used primarily for the benefit of a private party. This explains why lawmakers were so quick to point out the "multiplier effect" of the Boeing deal – that is, the spinoff jobs and investment that could be generated by Boeing's expansion in North Charleston. Boeing aside, such requirements raise important legal questions about other economic incentives currently under consideration by the General Assembly – in particular, incentives for retail projects like a proposed megamall in Jasper County (S 1054) and a Bass Pro Shops in Greenville County (H 4200).

How is Public Purpose Defined?

While the S.C. Supreme Court has taken up general questions related to economic incentives, a February 2009 opinion by the S.C. Attorney General's Office reviews the relevant case law as it pertains to retail incentives or what are referred to as "extraordinary retail establishments."

The letter outlines the following five points:

Public funds may only be used for public purposes. As the attorney general's office notes, citing *Anderson v. Baehr* (1975): "It is not sufficient that an undertaking bring about a remote or indirect public benefit to categorize it as a project within the sphere of "public purpose."

Public purpose does not exclude private benefit. The S.C. Supreme Court has confirmed that a public purpose must encompass the "promotion of the public health, safety, morals, general welfare, security, prosperity, and contentment" of a substantial number of state residents. Yet this does not exclude incentives that would also benefit a private party.

A four-prong test should be used to determine public purpose. Although the courts have usually deferred to the legislature in defining public purpose (a troubling precedent given the lack of separation of powers between the legislative and judicial branches in South Carolina), the Court has also developed a four-prong test to determine whether a public purpose is being met.

These four requirements, as articulated in *Caldwell v. McMillan* (1953), are as follows:

- The Court should first determine the ultimate goal or benefit to the public intended by the project.
- Second, the Court should analyze whether public or private parties will be the primary beneficiaries.
- Third, the speculative nature of the project must be considered.
- Fourth, the Court must analyze and balance the probability that the public interest will be ultimately served and to what degree.

A project with negligible public benefit is likely unconstitutional. Essentially, the Court has found that publicly funded private endeavors that have only a minimal public benefit are unconstitutional. The Court's ruling in *Anderson v. Baehr* is instructive. *Anderson* challenged a law permitting a municipality to acquire condemned land and lease it to a private real estate developer. "The Act undertakes to permit the city to effectually promote business undertakings to compete in free enterprise with other businesses which do not have the advantage which the Act would give," concluded the Court. "We think it a fair conclusion to say that benefit to the developer or entrepreneur would be substantial, and the benefit to the public would be negligible and speculative."

Special legislation is unconstitutional. The S.C. Constitution (article III, § 34) prohibits special legislation in many cases, including "where a general law can be made applicable." Whether this provision requires a uniform tax code is debatable, but precedent requires the Court to consider both the form and the "practical operation" when determining if special legislation meets constitutional muster. Given widespread agreement that S 1054 and H 4200 (not to mention the Boeing deal) are being passed for specific recipients, it is worthwhile to ask if these measures, especially in their practical operation, are instances of special legislation.

What is the Public Benefit of Retail Incentives?

While the attorney general's office did not address the legality of a particular economic incentives package, it did express grave reservations regarding the constitutionality of existing state law (12-21-6590) regarding extraordinary retail establishments. In particular, the attorney general's office voiced the following three concerns:

- The law does not clarify what public purpose is actually served by using sales tax revenue to fund retail establishment site construction and other improvements not owned by the state or one of its subdivisions.
- The legislation "promotes a business undertaking and thereby serves a primarily private interest."

- The law goes “so far as to allow sales tax to be used for the actual construction of a portion of the retail establishment.”

Given these concerns, it might well be asked whether the proposed Sembler and Bass Pro Shops incentives proposals would withstand constitutional review.

Consider the following points in relation to the Court’s four-prong test:

No net new sales and job creation. As indicated above, incentives legislation must serve a public purpose. This explains why S 1054 contains the assertion that it will create jobs and that the public will be “the primary beneficiary of the incentive notwithstanding the incidental benefits that may be derived by the private grantees.” The same bill, however, includes a statement of estimated fiscal impact that comes to the opposite conclusion. “This bill does not help to create productive capacity that sells product outside the state,” reads the analysis approved by State Economist William Gillespie. “Because the facility adds to an already well established retail sector, it is difficult to expect that the facility will create new sales, but rather will shift sales from existing retailers and not add to sales that would otherwise occur in the absence of the provision.” This conclusion is seconded by a Policy Council white paper showing that numerous academic studies have found retail incentives do not increase long-term employment.

Direct and substantial private benefits. If the megamall planned by Sembler is not expected to create new retail sales (and thus jobs), there is no reason to believe the much smaller, and even less unique, Bass Pro Shops destination will create jobs. What, then, is the public benefit of this legislation? Tourism? This benefit is incidental to the primary purpose of both sites, which is to bring financial gain to Sembler and Bass Pro Shops through retail sales and the leasing of space related to such sales.

Another reason to question the constitutionality of these two proposals is the attorney general’s objection that subsidizing site prep, the construction of real or personal property, and the creation of parking areas “will likely be viewed by a court as primarily benefitting the retail establishment.”

Speculative nature of the project. While S 1054 claims the incentives package for Sembler has been designed to “avoid speculative risk,” representatives from Sembler suggest otherwise. According to Sembler president Jeff Fuqua, the mall proposed for Okatie Crossings is highly speculative, such that “with the incentive, it is just acceptable.” The risks for the public are magnified because S 1054 does not include clawback provisions should Sembler default on its promised job and investment targets; the bill also does not include a cap on the sales tax break that Sembler is to receive. As highlighted in a recent SCPC report on economic incentives transparency, such mechanisms are necessary to protect taxpayers from risky investments.

No evidence of public benefit. Absent reforms, such as the newly introduced Economic Incentive Transparency Act, which would require independent analysis of economic incentives deals, along with public hearings and ongoing monitoring, it is very difficult to

determine whether the public interest is being served by economic incentives. As reported by *The Nerve*: “[Incentives] negotiations on the front end and finalized agreements on the back end typically are done behind closed doors. And even if agreements are eventually released, taxpayers aren’t informed about the specific costs of certain incentives because they are considered private tax records.” On the other hand, many economists agree that economic incentives – in particular, retail incentives – are ineffective. As found by Michael Hicks’ 2007 study on incentives for mega-retailers like Cabela’s, “From a public policy standpoint there is nothing to recommend regional polices to attract or dissuade the location of retail firms.” Again, there is no reason to expect that either the Sembler deal or the Bass Pro Shops plan will produce different results.

Legal Challenges in Other States

Taxpayers in several states, most notably Arizona, have challenged the legality of economic incentives. In 2006, the U.S. Supreme Court ruled in *DaimlerChrysler Corp. v. Cuno* that taxpayers as such do not have standing to challenge state tax incentives or spending decisions in federal court. This ruling, however, does not prevent such challenges from moving forward in state court.

Arizona. In January 2010, the Arizona Supreme Court unanimously ruled that economic incentives violate the gift clause of the state constitution unless such incentives can be shown to have a tangible and equitable public benefit. In effect, the Court ruled that indirect benefits – such as job creation and tax revenue – are insufficient evidence that the public good is being served.

The case (*Turken v. Gordon*) arose from a 2007 incentive agreement in which the City of Phoenix gave a \$97.4 million subsidy to a shopping center called CityNorth, a \$1.8 billion high-end retail development in an affluent part of Phoenix. The subsidy was to be provided in the form of a sales tax rebate to the private real estate development firm, Klutznick Company. (Sounds a lot like the proposed Sembler deal currently under consideration by the General Assembly.)

North Carolina. Like South Carolina, our neighbor to the north has doled out millions in tax incentives, with Dell topping the list in 2005 at \$259.9 million. (Dell announced last year it was closing the Winston-Salem factory that prompted the multimillion incentives package.) The state also passed another high-tech incentives deal in 2006, giving Google \$100 million in tax breaks to build a data center. In 2007, the North Carolina Institute for Constitutional Law sued (*Munger v. State*), arguing that the incentives legislation violated the public purpose and exclusive emoluments clauses of the North Carolina constitution. The public purpose clause states that “the power of taxation shall be exercised in a just and equitable manner, for public purposes only” while the emoluments clause states that “no person or set of persons is entitled to exclusive or separate emoluments or privileges from the community but in consideration of public services.” In addition, article V, § 2 of the N.C. Constitution requires uniform taxation for all classes of property. In February 2010, the state Court of Appeals rejected the suit, holding that “the mere fact that plaintiffs pay North Carolina income and sales and use taxes ... does

not give them standing.” The 30-page opinion did not substantially address the merits of the case, focusing instead on questions of standing.

Conclusion

In a down economy, it is tempting to embrace every bill promising new jobs as a boon for the economy – and thus the state as a whole. In order to stimulate real economic growth, however, these new jobs must, in fact, be new. Retail incentives have been shown to produce no net new job growth. Rather, such incentives are merely a taxpayer subsidized prize to the benefit of one private retailer over another. As such, a strong case can be made that retail incentives, such as that proposed in S 1054 and H 4200, are unconstitutional.

Nothing in the foregoing should be construed as an attempt to aid or hinder passage of any legislation.

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