The long arm of clawbacks

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INCENTIVES

Local municipalities and state governments alike are looking to protect their investments with provisions that hold companies to their promises.

NO CITY LIKES HEARING THE NEWS that an area plant or company is closing its doors, especially if it means major job losses. However dire that situation becomes, most people would agree that the worst-case scenario is this: The departing business breaks promises made to the community and leaves without paying back part or all of expensive public-funded subsidies.

Fortunately, many subsidy deals penned these days include a special contract provision - a "clawback" - that helps prevent these economic tragedies. While the name invokes thoughts of a fierce creature grabbing something it wants back, it actually is a probusiness, almost benign type of legal animal. Unless it's provoked...

`Trust, But Verify'

Greg LeRoy directs Good Jobs First (GJF), a Washington, D.C.-based organization working to ensure that subsidized businesses are held accountable for family-wage jobs. He also is author of No More Candy Store: States and Cities Making Job Subsidies Accountable, a compilation of state and local safeguards on job subsidies. Specifically, GJF tracks corporate accountability innovations in all 50 states to develop "best practices" solutions.

LeRoy contends that clawbacks came into being due to "the breach of corporate ethics." To combat this problem, he says, governments should learn to "trust, but verify" promises made by companies receiving public monies.

Simply stated, a clawback is a "consumer money-back guarantee," he explains. "It's a contractual provision which requires a company to pay back some or all of the public movies it was given if it fails to fulfill its responsibilities required by a subsidy agreement or program." Typically these movies are development subsidies in the form of grants, loans, tax breaks, and public investments.

While disclosure and public participation may reduce the likelihood of abuse, he says, "ultimately the greatest tool states and cities have is deterrence. That means raising the cost of failing to deliver on job promises with specific, legally enforceable regulations and contract language... If the recipient company fails to deliver, the subsidy must be refunded."

Clawbacks can be adopted in two ways. One is to insert them in a contractual agreement between a government and a subsidized company. Another incorporates them into the laws and/or regulations governing development programs and the development agreements they affect.

GJF's research reveals that clawback penalties typically invoked by cities and states include (1) full subsidy payback (with or without interest); (2) prorated subsidy payback (with or without interest) based on the degree to which the company fell short of its responsibilities; and (3) barring a company from receiving future subsidies.

GJF has found that clawbacks are commonly attached to these types of measurements:

Number of new jobs created

Wage levels of new jobs or all jobs

Level of capital investment

A specified length of time the company must stay at the subsidized location

LeRoy and his associates recognize that "one size" clawbacks don't fit all takers. "We like prorated clawbacks," he says. "If you're short 10 percent of your goal, you pay back 10 percent of the clawback."

Iowa is one state that prefers "proportional disallowance" (prorated) clawbacks. Since 1986 the state has built clawbacks into its financial programs. "Because of this, Iowa often has been called upon to advise other states who were putting financial programs into place for economic development," says Phil Thomas, marketing manager for the Iowa Department of Economic Development.

One Iowa program, the Community Economic Betterment Account (CEBA), has enjoyed a 95 percent success rate. So far, $78 million in CEBA funding has created nearly 43,000 jobs through 500 companies. (That five percent failure rate shows that while clawbacks don't come into play often, Iowa does use them.)

Disasters Fuel the Need

Sadly, there are many members in the U.S. "Subsidy Hall of Shame." Their conduct (or misconduct) explains why clawbacks are necessary in today's incentive-crazed environment.

One high-profile case experts tend to mention involved the General Motors Corp. (GM) facility in Ypsilanti, Mich. Since 1974, GM had received $1.3 billion in tax abatements on its two plants in the township, as well as 122 abatements in other communities in the state. In 1991, GM announced it would soon close either its Ypsilanti or Arlington, Tex., plant (both produced the Chevrolet Caprice) as part of a larger U.S. plant-reduction strategy. Bitter bidding wars began between the two communities. In February 1992, GM decided to shut down the Michigan plant.

The affected Michigan communities fought back, claiming that a recent tax-abatement contract with GM had promised employment at the plant until 2003. They won an injunction at the circuit-court level forbidding GM from transferring Ypsilanti's production to another facility. The judge in the case stated, "There would be a gross inequity and patent unfairness if [GM], having lulled the people of Ypsilanti into giving up millions of tax dollars which they so desperately need to educate their children and provide basic governmental services, is allowed to simply decide that it will desert 4,500 workers and their families because it thinks it can make the same cars a little cheaper somewhere else."

When the state court of appeals over-turned that decision in 1993, a prominent union leader contended that the ruling "basically means you can go ahead and lie to get tax breaks." Not long afterwards, GM received two tax abatements from Ypsilanti for its other facility there. However, thanks to a 1994 Michigan law, the newer abatements were much more meticulously detailed and "safer" for the generous community than previous subsidies.

Over the past 18 years, LeRoy has tracked many of America's other infamous lawsuits pitting communities against once-treasured corporate citizens. In all these disputes, he says, was a common thread - Without clawbacks "it was legal to take the money and run."

In the wake of revelations like those in the late 1980s and the 1990s, "things got very hot and angry," says GJF's director. That's when cities and states began to take more notice of clawbacks. Today, "there's less ambiguity and more predictability" in contracts, LeRoy says, with each party knowing exactly where the other stands.

Yet lawsuits continue, even in this clawback-enlightened environment. In September 2002 a Kansas City redevelopment agency sued Aquila Merchant Services Inc. to retrieve tax break monies it had given the business. The suit claimed that the company violated an agreement to employ at least 400 workers downtown, and in doing so activated a clawback designed to reimburse the incentives. Two months later, Aquila settled by returning $1.57 million in tax abatements to the agency.

On the other hand, United Airlines illustrates the progress clawbacks are making without lawsuits. In the early 1990s the company signed a deal giving it about $300 million in tax breaks for a new maintenance hub at the Indianapolis International Airport. In return the airlines made two promises: To invest $800 million by year-end 2001 and to create at least 6,300 fulltime jobs by year-end 2004. When United failed to meet that first promise, it agreed to pay $31 million to Indiana government agencies in prorated clawback fines.

The Man Behind the Claw

Since Dr. Larry Ledebur co-introduced the clawback issue into U.S. public policy debate, he may be called one of the "first parents" of the American clawback revolution.

Now associate dean for research at the Levin College of Urban Affairs in Cleveland, in the early 1980s Ledebur did research on how states were scrambling to attract firms and build tax bases with incentives. "Even then there was intense competition between states, often within the same regional boundaries," lie notes. Fascinated by this activity, Ledebur and his research partner wrote an article about investing public funds into subsidies. This landmark piece was published in 1990 by Economic Development Quarterly.

"We argued the rate of return over cost should be at least greater than one," explains the professor. "And we began to play with a set of ideas, originating in Western Europe, saying these negotiations should be done in a business-like manner. If a firm promised to create 'x' number of jobs or 'x' number of dollars, there should be a contractual agreement to achieve those ends - or some way to `clawback' the public dollar. In other words, there would be penalties."

Initial reaction to the clawback article was quite good in some areas, he recalls. "It had immediate impact. Not long afterwards, when they were building the Denver airport, [claw backs] were in their contracts." From there, the idea of promoting "recapture" contract provisions took off throughout the country.

Why are clawbacks flaring up in the news now more than ever before? Ledebur thinks the answer is tied to the sluggish economy. "As incentives became more common [over] the past 20 years, more expanding companies received them. Then, -when we hit this latest economic downturn, it was inevitable that some of those deals (old and new) would go sour. If it's found there aren't clawbacks in them, eyebrows are going to go up."

Clawbacks in Friendly Business Environments

LeRoy claims there's no evidence that accountability laws featuring clawbacks harm it city or state's business climate. On the contrary, he says, accountability standards are becoming increasingly popular because public officials realize they're necessary to ensure that taxpayers get a "bang for the buck."

"An agreement giving public money to a corporation is a contract, with the government acting as the people's agent in dispersing their money. And respect for contracts is a fundamental element of a good business climate," lie asserts. "Companies want certainty; they want to know where they stand, and they want to know that they are being treated fairly compared to others."

Spelling out expectations clearly in a contract helps avoid misunderstandings and reduces the likelihood of disputes, LeRoy adds. "Anyone borrowing money for a home, car, or tuition has the same obligation."

Most companies understand why municipalities think they need clawbacks, says Tom Hamer, vice president at Moran, Stahl & Boyer in Chicago. "If a company makes a deal with a vendor, they want to make sure their vendor makes good on it." That helps explains why clawbacks "are fairly well accepted" by businesses these days, he relates. Companies recognize themselves as being the vendor in subsidy situations.

"No, clawbacks won't damage your business environment, not at all," Hamer continues. There won't be a problem, he says, if a company and a community carefully consider the pending deal. "From a community's standpoint, a clawback may even allow it to give a little richer incentive, as it knows it has a guarantee [the subsidy will be returned] if the company doesn't perform."

Dr. Ledebur believe that in some instances introducing clawbacks can reduce the value of a public subsidy in the eyes of the firm considering an area. "But that doesn't mean it's not a not wise and prudent thing to do," he notes.

And if things go wrong? In those circumstances, taking a firm to court over a failure "always raises concerns on what effect [a lawsuit] will have on a business climate," Ledebur remarks. However, when talking about the most pressing problem - clawback enforcement - he believes public recourse "has to be through the courts."

There's no doubt clawbacks have come of age. Hamer says there are more of these provisions today. "And they tend to be more legislative from the state level now. Many are based on performance, i.e., if you don't meet a threshold of salary or employment then you don't get an incentive. That's a form of a clawback."

According to Good Jobs First, at least nine states now have disclosure laws or procedures generating annual, company-specific data about subsidies given to thousands of businesses. Eighteen states have clawbacks or moneyback-guarantee language attached to at least one economic development program. An estimated 100 or more cities use clawbacks. Moreover, at least 37 states, 25 cities, and six counties have attached to subsidies job-quality standards such as wage and/or healthcare requirements.

Just a decade ago only two states and three cities had such safeguards. America is "clearly moving towards more accountability," LeRoy states.

Are Clawbacks Symptoms of a Larger Problem?

Multinational Monitor, an activist magazine devoted to "examining activities of multinational companies," published an editorial in 1993 that commented on the landmark Ypsilanti/GM debacle. At its core the piece questions the intrinsic value of tax abatements, with or without clawbacks. Ten years later, its arguments may be more valid than ever.

The publication opined that Ypsilanti was "symbolic of the vast numbers of U.S. communities which feel forced to sacrifice social services and their children's education to corporate blackmailers. Corporations now routinely demand tax abatements before committing to opening new facilities, and frequently threaten to close existing ones unless they receive tax breaks. The threat of job loss, of relocation to lower-wage communities or countries pressures workers to make wage and benefit concessions, and communities to mortgage their futures."

The Ypsilanti experience, continued the Montitor, "demonstrates the futility of the tax-abatement strategy. There is always another city or town willing to offer even greater concessions than the last. And, in any case, most corporate decisions about plant location are based on internal business concerns of far greater magnitude than the amount of state or local taxes avoided."

Ledebur contends that the real culprit here is competitiveness among states and jurisdictions. "It's very hard to change that," he muses. One solution? "I think there should be regional compacts among these communities, large and small. They'd promise not to offer subsidies to firms moving from jurisdiction to jurisdiction within the same region. The core argument here is that the economy is regional. Jurisdictions are not economies, therefore they need to collaborate to enrich the entire region."

In the meantime, clawbacks fill a public-policy gap as the "war between the states" continues to put incentives under the public-policy microscope. "The truth is, many subsidies given away today are a 'wash' for states and the U.S. economy as a whole," LeRoy says. He regards clawbacks as "the next logical, needed responsibility governments should insist upon when they contract with vendors or agencies to deliver public services." Although the whole development of giving out subsidies is relatively new for governments, he says, they have a history of asserting "some sort of control over whom they deal with."

"Demanding accountability for public investments is what's demanded by the public," he continues. "A subsidy is already on favorable terms; already a favor Is being done. So asking the public to pay for a negative result - I don't think that's reasonable. Taxpayers have a right to get a return on their investments, and a right to pull the loan if those investments don't pay off."