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CREDITS & INCENTIVES TALK WITH DELOITTE

A Roadmap of How One Governor Used Economic Development to Create a New Virginia Economy-Part Two

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When Gov. Terence McAuliffe took office in January 2014, Virginia faced economic development challenges. As the top recipient of U.S. Department of Defense contracts, the Commonwealth's economy is one of the hardest hit by the federal government's spending cuts to military and domestic programs. In addition, industries of the past have declined across the state, with many citizens facing possible unemployment and lacking the skills that modern businesses need.

What makes the situation in Virginia stand out is its governor's proactive, long-term strategy to turn the state into a global leader in economic development.

"The opportunity before us today is to use Virginia's tremendous assets to diversify our economy so we are growing in a more sustainable way," said Governor McAuliffe. "Working with the public and private sector to build a new Virginia economy-that is the job I'm trying to get done."

His hands-on approach starts with his personal involvement in major decisions impacting businesses, and continues as he works on the frontlines, recruiting companies into the state. His experience-including any successes and failures-may provide valuable insights from which other states facing similar economic development challenges can learn.

In the previous issue, I covered the first part of Gov. McAuliffe's New Virginia Economy strategic plan: various direct financial incentives that are enticing businesses to relocate to and reinvest in Virginia. Now I'll switch gears and discuss the indirect, big-picture incentives intended to provide staying power to the governor's plan. Then I'll look at a real-world example of how the plan has succeeded in bringing jobs and tax dollars back to Virginia. Finally, I'll touch on some of the all-too-familiar challenges that lie ahead.

Investments in indirect incentives

The New Virginia Economy strategic plan has solicited feedback from local and regional economic development organizations, chambers of commerce, business leaders, and educational institutions to develop a four-year strategic plan. Here are three important components of the New Virginia Economy that extend well beyond traditional tax incentive and grant programs.

1. Diversify and grow strategic industry sectors: The U.S. Department of Defense is the largest employer in Virginia. But with fewer dollars being spent on defense programs, the governor's office understands the importance of diversification and private-sector-led growth. The governor's team has identified the following sectors as having the strongest growth potential:

- advanced manufacturing,
- information technology,
- life sciences and medical technologies,
- professional and business services,
- tourism, and
- global exporting in agriculture and forestry.[1]

Within each of these potential high-growth sectors, Gov. McAuliffe and his team strive to attract new companies and expand investment by companies already located in Virginia. Industry roundtables, business expos, and Virginia-brand marketing campaigns are some of the ways the governor plans to communicate his commitment to each of these industries.

Gov. McAuliffe is also focused on promoting innovation and entrepreneurship, not just attracting and retaining Fortune 500 companies. For example, the Virginia Innovation Network for Entrepreneurs is designed to connect startups to the financial, legal, consulting, resource-sharing, and mentoring services they need to grow. Free patent clinics are also a proposed offering through Virginia law schools, as well as legislation to provide capital gains tax exemptions for technology startups and to expand angel investor and research and development tax credits.[2]

2. Equip Virginia's workforce with in-demand skills to meet business needs: The governor encourages Virginians to pursue post-secondary education in order to attract companies in many of the high-growth sectors targeted by the New Virginia Economy strategic plan. Virginia currently has 575,000 students enrolled in more than 100 in-state higher education institutions[3] and boasts at least one community college within 30 miles of almost every resident.[4]

Additional state funding for job training and education programs will help business by creating highly skilled workers capable of performing rewarding jobs that will improve their living standards. For example, the governor wants to strengthen the Virginia Jobs Investment Program, which provides free recruitment services and training assistance and offers direct funding to companies that create new jobs or upgrade the skills of their existing workforce.

Gov. McAuliffe also plans to offer financial aid to students who take noncredit instruction that leads to an industry certification or license in a high-growth industry. 500,000 business-driven certifications and licenses are proposed to be added by 2030, as well as the expansion of the state's registered apprenticeship, post-graduation internship, and alumni repatriation programs.[5]

Another win-win opportunity in Virginia is its pool of highly skilled, disciplined veteran workers. Virginia is currently home to about 800,000 veterans, and Gov. McAuliffe wants to lead the most veteran-friendly state in the union. He supports the Virginia Values Veterans (V3) initiative. Launched in June 2012, V3 trains and certifies employers on how to attract and retain veterans. To date, the program has generated more than 3,000 new jobs for veterans. Most of these employers are small businesses with fewer than 1,000 employees.

As a specialist in multistate tax issues who works with companies focused on veteran hiring and securing credits for such hiring, I've seen first-hand how the V3 program has resulted in many companies hiring veterans. In addition to the V3 program, the Northern Virginia Technology Council has also hosted a series of webcasts focused on helping companies improve their veteran hiring. These webcasts cover such topics as training on the business case, acquisition methods and approaches, and career-planning advice.

3. Enhance the economic development infrastructure: Virginia already possesses world class transportation assets, including 14 commercial airports, six major interstates, an extensive railroad system, and a high-tech port-the deepest on the eastern seaboard-capable of handling Post Panamax vessels. Its centralized location puts Virginia within a two-day drive to approximately 70% of the U.S. population and over 307,000 manufacturing companies.[6] However, there's more to infrastructure than transportation assets. Gov. McAuliffe also plans to expand Virginia's communication and energy capabilities.

Quick, reliable, and affordable Internet access is essential for all businesses, but coverage is sporadic across Virginia. In the most rural parts of the state, only about 25% of the population has high-speed or broadband coverage.[7] The governor plans to use state-owned real estate to provide aid to local governments to increase connectivity. He has also proposed limited tax incentives and low-cost financing as ways to offset the costs of private sector investment in enhancing communications infrastructure.

Equally important to economic development is widespread access to low-cost, reliable energy sources. By providing a diverse menu of energy options, Virginia won't be over-reliant on any single source. The creation of a $5 billion natural gas pipeline is in the works, which will expand access to traditionally underserved and restricted market areas, such as the central and coastal parts of the state.

In addition, Gov. McAuliffe has established the Virginia Solar Energy Development Authority, modeled after the Virginia Offshore Wind Development Authority. Both of these programs accelerate development of innovative, renewable energy alternatives. Other programs seek to reduce greenhouse gas emissions and energy consumption. The governor's administration aims to reduce its electricity consumption by 15% and encourages local municipalities to follow suit under the Energy Performance Contracting (EPC) initiative.[8]

Lessons learned

The largest economic development project in Virginia to date is the construction of a new $2 billion advanced manufacturing plant by Shandong Tranlin Paper Co. near Richmond that will create 2,000 jobs through 2020.[9] This project is the largest greenfield investment by a Chinese firm in the United States-and Virginia successfully competed against several other states to win it.

The plant uses an innovative process that makes eco-friendly paper and fertilizers from corn stalks and other agricultural field waste. "Based on the agricultural supply chain opportunities associated with the project, the economic benefit to farmers in this region alone could exceed $50 million per year once the project is complete and operating at full capacity," said Virginia Secretary of Agriculture and Forestry Todd Haymore.[10]

To help secure this project, Gov. McAuliffe approved a $5 million grant from the Governor's Opportunity Fund. His team also worked tirelessly to find suitable megasites for Tranlin's plant with the requisite access to rail, road, water, sewer, electricity, fiber (such as straw and corn stalks), and natural gas assets. Only three sites fit the bill. And the governor learned a valuable lesson: Unless the state increases its inventory of "project ready" sites and regional training centers, Virginia could lose out on future economic development opportunities.

The Tranlin project prompted the governor's office to further enhance the state's economic development database to assist developers that are considering investing or expanding in Virginia. The database, which allows corporate executives to search the state's sites and buildings from anywhere in the world for potential business locations, will at all times include at least one or two mega and medium sites and five or six mini sites throughout the state at various stages of development.[11]

The Tranlin project also caused the governor and his team to explore creative options to support site development, such as an accelerated permitting process at the state and federal levels, additional state grant programs to help local governments develop project-ready sites, energy credits for job creation to offset costs, and a state infrastructure loan program to fund the last stages of project development.

Performance benchmarks

The Tranlin project is expected to cost Virginia about $31 million in state incentives, including performance grants and job training assistance, according to Vince Barnett, vice president of communications and promotions at the Virginia Economic Development Partnership.[12] This has prompted critics to ask, "What's Virginia's return on investment (ROI)?"

As explained by the governor's office, "Virginia uses discretionary incentives prudently, and only in approximately 15% of all Virginia Economic Development (VEDP)-assisted projects. VEDP employs a proven ROI model on every project where discretionary incentives are considered, and all state grants are included in that analysis for a comprehensive fiscal review."

Over the next five years as Tranlin builds its new plant, the governor's office estimates that the project will bring about 2,000 new jobs and infuse about $2 billion into the state's economy. Once the plant is up and running at full capacity, Virginia Secretary of Agriculture and Forestry Todd Haymore estimates that the economic benefit to Virginia farmers alone could exceed $50 million per year.[13]

"The Tranlin operation in Chesterfield County represents a project of historic proportions for Virginia," said Governor McAuliffe. "Advanced manufacturing jobs are the heart of a strong and growing 21st century economy, and attracting companies like Tranlin to Virginia is how we will build the new Virginia economy."

Despite these expected results, requests for cost justification have become increasingly common as many states face budget deficits. Now that the economy is improving, some of the tax incentives offered during the recession are being cashed in-and costing more than the states expected. In the last few years, 10 states and the District of Columbia have passed legislation that requires mandatory review of economic development incentives to determine whether they're effective. Ineffective programs are required to be improved or cancelled.

Virginia regularly evaluates its economic development incentives, and an internal working group evaluates current policies and studies the ROI on incentive programs. If a business would have moved to Virginia or expanded its facilities without receiving an incentive, then that incentive is ineffective because the state needlessly incurred costs or lost out on tax revenues. Even when incentives do influence a company's investment decision, the state must factor in incremental spending on infrastructure and other public investments when determining its ROI.

Research in other states shows that business relocation decisions generally aren't based on incentives available 10 or more years in the future.[14] So policymakers might consider focusing on shorter-term incentives that occur within the first 10 years of relocation or expansion. As seen with the Tranlin project, it can also be beneficial to incentivize businesses that export products to another state or country-thus confirming that the revenue of local suppliers isn't cannibalized by a new economic development project.

So, how is Virginia's economy faring more than a year after Gov. McAuliffe took office? In his first year, the state offered up to approximately $51 million in state incentive grants. But the upside is that the state attracted and closed a record 292 economic development deals in the governor's first 365 days in office, which are expected to generate $5.93 billion in investment and 23,404 jobs over three years.

According to the governor's office, as of May 11, 2015, the McAuliffe administration has closed 382 economic development deals in Virginia, with more than $6.62 billion in capital investment.

The governor's plan also provides indirect incentives that will help Virginia *retain* private sector businesses. Together, it is hoped that these incentives will help position Virginia as a leader of global economic development in the 21st century.

Looking to the future

Numerous obstacles-including budget cuts and overall market conditions-potentially stand in the way. Partisanship is perhaps the biggest threat. State tax incentives sometimes get a bad rap. Some individual and corporate citizens may resent tax incentives because they feel they're being forced to shoulder an added tax burden so that newcomers can be incentivized with discounted state tax bills. Other citizens as well as state legislators may see tax incentives as a form of corporate welfare. But those views may be short-sighted.

Regular evaluations of incentive programs may be the key to achieving bipartisan support and enhancing the state's return on its economic development costs. Effective financial incentives that help states attract new investments, combined with indirect incentives that help convince businesses to stay, promise significant benefits, including added jobs and tax revenue. But only time will tell whether Gov. McAuliffe's plan will accomplish all of its aggressive goals and reshape Virginia's economy.

[1] *New Virginia Economy,* Governor Terence McAuliffe website, p.13-15, https://governor.virginia.gov/media/3501/new-virginia-economy-12052014.pdf.

[2] *New Virginia Economy,* Governor Terence McAuliffe website, p.18, https://governor.virginia.gov/media/3501/new-virginia-economy-12052014.pdf.

[3] *Fast Facts: Virginia is the Best State for Business,* Virginia Economic Development Partnership website, http://www.yesvirginia.org/AssetRich/FastFacts.

[4] *New Virginia Economy,* Governor Terence McAuliffe website, p.5, https://governor.virginia.gov/media/3501/new-virginia-economy-12052014.pdf.

[5] *New Virginia Economy,* Governor Terence McAuliffe website, p.19, https://governor.virginia.gov/media/3501/new-virginia-economy-12052014.pdf.

[6] *New Virginia Economy,* Governor Terence McAuliffe website, p.7, https://governor.virginia.gov/media/3501/new-virginia-economy-12052014.pdf.

[7] *New Virginia Economy,* Governor Terence McAuliffe website, p.11, https://governor.virginia.gov/media/3501/new-virginia-economy-12052014.pdf.

[8] *New Virginia Economy,* Governor Terence McAuliffe website, p.10, https://governor.virginia.gov/media/3501/new-virginia-economy-12052014.pdf.

[9] *New Virginia Economy,* Governor Terence McAuliffe website, p.11, https://governor.virginia.gov/media/3501/new-virginia-economy-12052014.pdf.

[10] http://virginiafreecitizen.com/2014/06/18/governor-mcauliffe-announces-2000-new-jobs-chesterfield-county/.

[11] *New Virginia Economy,* Governor Terence McAuliffe website, p.11, https://governor.virginia.gov/media/3501/new-virginia-economy-12052014.pdf.

[12] http://www.13newsnow.com/story/local/2015/01/28/14871306/.

[13] *Tranlin announces 2,000 new jobs, $2b project in Chesterfield County,* Greater Richmond Partnership website, June 18, 2014, http://www.grpva.com/news-and-media/details/governor-mcauliffe-announces-2000-new-jobs-in-chesterfield-county.

[14] Nora Macaluso, *Michigan, Other States Re-Evaluate Effectiveness of Business Tax Incentives,* BNA Daily Tax Report & TaxCore, Feb. 18, 2015, at p. 2.