Incentives: The Proper Perspective

Learn from an expert how to understand financial incentive negotiations--from both sides of the table.

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The use of incentives--meaning the low-interest loans, grants, worker training, and other concessions a community or state will make to secure your expansion or relocation project--is as controversial a subject now as ever. It is, however, an important issue, and it warrants considerable attention from both economic development professionals and private sector investors alike.

It's appropriate to identify the purpose of incentives in the first place. At their very essence, incentives are tools a community can use to overcome inherent deficiencies, whether they are geographic, climatological, or the result of historical precedent. In a way, incentives are akin to David's slingshot when faced with the prospect of battling Goliath: take his slingshot away, and poor David would have been squashed like a bug. No wonder states and communities, which constantly do battle with giants in the economic development arena, are so keen to use incentives. Conversely, it is not surprising when the powerful industrialized states cry foul when a major employer is pulled away by economic incentives that they are either not capable of providing or simply prohibited by state law to even consider. In my mind (and in the opinion of the consulting firm I represent), incentives should be a minor consideration at the outset--if not totally discounted--until it is time to decide which of the final locations to select. We submit that incentives should be viewed in the context of the project and the relative cost-benefit over the long term.

Recent developments, such as the decision Cuno v. DaimlerChrysler, have questioned both the need and fairness of incentives. (In that October 2004 decision, the federal Sixth Circuit Court of Appeals ruled that Ohio's corporate income tax credit incentive program violates the commerce clause of the U.S. Constitution; the decision is being appealed to the U.S. Supreme Court and could have a monumental effect on the kinds of incentives states can offer growing companies. Congress, however, has the final say.) As a result, offering incentives is not as simple a task as in days past.

Nevertheless, the point of this article is not to debate the fine points of the law regarding the legality of incentives. Rather, my purpose is to point out that the terms "incentives" and "site selection" are not synonymous. In contrast, the pursuit of incentives is an additional activity that grows out of, and is a natural consequence of, an exercise that identifies the best place to do business. Incentives are then used to either level the playing field or create a competitive advantage--nothing more, nothing less. If viewed any other way, they could seriously undermine the integrity of your decision-making process.

There is little empirical evidence to support that incentives have a significant effect on the recruitment of industry to one region of the country over another. Companies that decide to move to a certain region tend to do so because of factors such as the cost of doing business, market access, transportation logistics, productivity issues, and other factors--not incentives. Some may not agree with this; however, the numbers I look at speak for themselves--and our experience in the industry confirms this. There is, however, substantial evidence to support that once a region has been decided upon, the incentive competition between states (regardless of the region) is intense and does in fact influence the final decision. What complicates the acceptance of this as fact is a combination of two things: 1) Unsubstantiated causative speculation in the media based on hearsay and rumor, and 2) the entry of non-viable competitor states in the final competition--the proverbial red herrings.

If one really thinks about this objectively, without bias, it should seem intuitively apparent. The success of any enterprise is based on its ability to provide goods or services at a competitive price and at sufficient quality to produce a revenue stream capable of covering cost, and ultimately, produce a profit. To our knowledge, we have yet to see a company whose long-term viability in the market place was dependent on incentives. What we have seen, however, are companies that require a skilled workforce, the ability to recruit and train them quickly, a pro-business climate that does not encumber business with excessive costs or unnecessary regulations, transportation infrastructure that will allow the prompt delivery of supplies and market access, and a safe place to work and live. Not all communities are equal. To a large extent, communities' success in industrial recruitment is directly proportional to their ability to provide a customized package that addresses their weaknesses individually. Obviously, these situations favor those states and communities that have a myriad of tools at their disposal to provide customized packages to accommodate the prospects needs. The opposite is true as well. Those states and communities who cannot (due to prohibitions of the law) or will not (as a matter of public policy) are at a distinct disadvantage.

So, it is important for you to focus first on the critical issues that make your business run efficiently and effectively, and look at the incentives last. While this may seem obvious, it is amazing how many companies focus 80% of their efforts during the site selection process on the incentive package instead of the fundamentals of the business. For instance, a company that concentrates on things such as land subsidies, tax abatements, or grants without first making sure that labor costs in the region will not hyper-accelerate, that power reliability will not cause production interruptions, or that pending air-attainment regulations will not require millions of dollars in air pollution equipment modifications, is in for a very rude awakening. Not a single incentive can correct a poor labor climate, correct a weak electric grid, or forgive you for failing to properly comply with regulations you happen to overlook.

Equally guilty are economic development professionals who spend 80% of their time pitching incentives without recognizing the community's weaknesses and ways to apply these incentives to correct the deficiencies. A free building, free land, and a large cash grant will not entice a company to relocate if it is concerned about the availability of a skilled workforce, good highway access, and an abundance of natural gas in a location that has none of the above. The application of incentives should, in my opinion, be focused to meet the needs of your company, but should also be grounded in policy that specifically addresses the needs of the community to grow and prosper. As they say, easier said than done.

So how is it done? Ironically, the process of measuring the value of incentives is exactly the same for both your company and the state or community you are considering, with only a few minor twists. The following checklist, albeit very simplistic, describes how most site selection studies are performed.

1. Create or review the objective omission statement. In both cases (company or economic development organization) it is impossible to move forward in any rational way without the benefit of a comprehensive self-assessment of the mission and purpose of the organization. In some instances outside help is needed for this, but most the time it is just the application of common sense.

2. Assess the factors required to be successful. For you, this means revisiting your company and looking at the basics. You'll need to involve many different members within your organization who can represent their respective areas. For the economic development entity, it means a totally objective and critical review of resources at their disposal--an inventory if you will.

3. Compare the resources required versus those available to accomplish the mission. For your company, this means making a checklist of items that address infrastructure, workforce, taxes, logistics, business climate, training, etc. For the community, guess what? It's the same.

4. Evaluate your ability to obtain or provide resources. For you, this means making a go/no-go decision about the relative importance of a specific resource considered critical (i.e., interstate highway, airport, seaport, etc.), and if it cannot be provided, the elimination of the location. For the economic developers you will work with, it is simple--they have to ask themselves, does a given critical resource exist (or can it be created), and can we convey this fact to you, the prospect?

5. Perform a comparative cost-benefit analysis. For the company, this is usually a comprehensive pro-forma analyzing seven-15 years that reduces everything to costs, along with a risk assessment. For a community, this is rarely, if ever, done unless they are confronted with a high-impact project, in which case they would perform an economic impact assessment (EIA).

6. Negotiate to optimize the deal. On your part, this usually means improving the economic aspects of the deal. Some enlightened companies, or consulting firms, will perform an analysis to demonstrate the economic impact (direct, indirect, and induced) that a given investment will provide to a community, giving you some extra chips to bargain with. For the community, this usually means trying to stay in the game, with ad hoc actions such as legislative initiatives or committee brainstorming sessions--some may also require an EIA to be performed as well.

7. Make a decision. For you and your company's decision makers, this means looking at information and making a decision--all things considered. For the community, it means crossing their fingers.

Given this seven-step process, the next step is to determine how incentives can best influence the decision, given that a logical thought process has been followed. The following sections discuss some high-level ways in which both the company and the community should consider this question.

LOOK AT THE CRITICAL INPUTS REQUIRED TO BE SUCCESSFUL
You will need to focus on the inputs to your company's enterprise that are necessary to be successful, prioritize them according to their relative importance, then optimize them incrementally. Invariably incentives will be the means to apply funds to a specific input such as training, highway improvements, and other operational issues that will benefit not only the project, but the community and state as well.

The successful economic development entity should focus on the reverse. It should focus on the impact of a potential project in advance and determine the benefits to the community in the event a prospect comes around. It should develop tools, proactively, that can address specific inputs to the project. In some cases, this may require a proactive approach if the input is considered an inherent quality the community must possess.

USE INCENTIVES TO ADDRESS SPECIFIC NEEDS
Realize that, for your company, there is no perfect location; however, incentives can help bridge the gap. Seek out incentives that have a significant impact on your project's bottom line and yet can also benefit the community. Infrastructure, workforce training, and research and development incentives are rarely, if ever, considered objectionable by the public.

The economic development entity you deal with ultimately should recognize its weaknesses compared to its competition, and should not accept the status quo. If it can correct its weakness via the use of incentives, that's a good thing. If not, it should create value in other places that diminish the relevance of the weaknesses in order to attract your project.

In both cases, incentives should be guided by specific policy objectives and not randomly applied.

STAY FOCUSED

Make sure a balanced approach is used to perform any site selection undertaking or incentive negotiation on the part of your company. It is easy to let the "tail wag the dog," and become enamored with the total dollar value of benefits being offered. Remember, this dollar value is only relevant as far as its contribution to the goals of your project, so don't get carried away by any presentations the economic developers may make that emphasize this number. The long-term success of the company is what's critical.

Economic developers are focused on creating jobs and improving the welfare of the residents they serve. Their incentives should focus on not only on recruiting jobs that are based upon defined targeted objectives, but also on jobs that will be long-lasting. The economic developers need to be able to understand what drives your company, and attempt to provide incentives that will benefit the community and the company.

EMERGING TRENDS

There are trends in incentives that you and government policy makers should be aware of as you work through your location search. Leaving aside issues of the legality of specific incentives for now, the first of these trends is the competitive pressure on costs. The global economy has created a world of opportunity while it opened up a world of competition. Migration of manufacturing and technical services jobs to lower cost locations outside the United States is a characteristic of the current global dynamic.

As a result, companies making investment location decisions are faced with very low cost alternatives to U.S. locations. Incentive policy makers should be aware of this global pressure on companies for lower costs as they design their incentive policy. For most growing companies, reduction in project capital costs is critical, whether the reduction comes from internal or external location factors.

In the location decision process, financial models account for multiple years, applying a discount. This means that costs impacting the project in early years (such as the start-up costs of land, training, and machinery) have a particularly high impact on your decision. As a result, capital cost incentives can very positively influence your decision. Capital incentives that have become more prevalent in recent years and which have had an impact on investment decision makers like you include:

Land. Incentives for land can run from providing important site information, to gaining temporary control (options) at no cost to the prospect, to outright purchase and grant. Almost every large project now seeks and receives land for their project at no or virtually no cost, and you should, too.

Site Preparation. This is being offered by communities with greater frequency today. In addition to reducing up-front costs, if some site preparation is done by a community in anticipation of your project, it can have a major schedule impact and be particularly attractive to if you have tight deadlines.

Infrastructure. In many parts of the United States it is presumed that infrastructure costs (utility and transportation) are the responsibility of the public sector. This can be a very significant distinguishing factor between locations, and again, most of the large projects in the past several years have had all the infrastructure costs met by incentive.

OPERATING COST INCENTIVE TRENDS

Operating cost incentives mitigate those costs that occur over multiple years. While they lack the up-front impact of capital cost incentives, these incentives can have considerable value over time. Two major kinds of operating cost incentives are:

Training. This is a very important part of almost any operation. Start-up and ongoing training costs are a noteworthy cost item for most firms and incentives can create real value. One trend in training incentives is a move from cost avoidance (where the granting authority directly provides the training services) to cost reimbursement (the granting authority reimburses a company for its training costs).

You'll probably find that the latter approach will genuinely impact your costs as well as provide the training you desire.

Taxes. Income tax incentives have been present for some time, and most states have income tax credits for job creation and investment performance. Property tax incentives are very important for capital intensive projects, but can be challenging because property tax is often the primary source of revenue for local functions and schools. Negotiated fee-in-lieu-of-tax programs are well established and provide some flexibility for the community to meet its financial needs, while mitigating the negative impact high property taxes can have on a project location decision.

The personal income tax capture programs of the past 10 years are powerful, high-impact incentives. Often called job development programs, these programs capture a portion of the personal income tax of new employees and divert it back to your company as an incentive. This is done as an outright grant or as a credit against capital expenditures, or as a means to finance training. For large high-impact projects, states with such programs have a distinct financial advantage over those that do not.

COMMUNITY INCENTIVE TRENDS

When I talk about community incentives, I'm referring not to any money going directly to your company; rather, it's money that has been invested in the community with the specific purpose of making it more attractive to business. With the emerging trend of companies viewing knowledge as their core asset (think research and development or software companies), some of these community-based investments may evolve to include applicable company-focused incentives. One example might be the establishment of a technical users' network, or other things to cater to knowledge employees. On a grander scale, it could involve joint investment in a graduate school chair.

Keep in mind that the mission of the community/state and the company are the same--the long-term success and prosperity of each, and the protection of their respective interests. As stated previously, there is considerable controversy surrounding incentives. Consequently, there will be far more scrutiny on incentives from both a fairness as well as legal standpoint. As has been demonstrated recently with Cuno v. DaimlerChrysler, incentives can be taken away if called into question. If this were the case for your company, what effects would it have on profitability, cash flow, market perception, or company morale? Hopefully none; however, the prospect of this event should be a wakeup call to those engaging in either the crafting or seeking of incentives.

Whether you are a company seeking incentives for a new project, or a policy maker/community leader contemplating the development or application of a new incentive policy, it is important to take away three points with regards to incentives. First, know that generous incentives will not overcome a bad business plan or a bad location. Second, make sure you understand your needs and weaknesses, as well as those of your bargaining partner before you begin incentive negotiations. Third, recognize that you have choices in your final decision, and that any incentive package should serve only to make a community the best overall choice. In the long run, the partnership that grows out of your pact will affect both parties for decades--hopefully, for the better.

Do you have a question about this article for Ed McCallum? E-mail it to kkhan@groupc.com with the subject line, "March Feedback-Incentives" and we'll print Ed's response.

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