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The Challenge of Business Incentives for State Policymakers: A Practitioner's Perspective

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Incentives are policy actions designed to attract investment and employment to a community and do so by addressing infrastructure, taxes and community assets. Incentives should be strategic, enhance strengths and mitigate weaknesses. In order to be effective, incentives must also influence the location decision of site selectors. Important recent incentive trends include an emphasis on capital costs, negotiated tax agreements and the use of personal income tax of new employees.

Incentive policy is a challenge facing state and community leaders. Economic development calls for governments to be active in attracting and maintaining investment and employment in their communities. Within this broad area of responsibility, incentives are a key component. The challenge to policymakers is to understand what incentives are, what purposes they serve, and how to design and implement them. In this article, a leading site selection and economic development consultant identifies some of the core issues that policymakers must understand and address in order to develop a successful and effective incentive program.

What Are Incentives?

Funk and Wagnalls defines incentives as "that which incites to action; a motivating force; a stimulus."[1] For economic development policymakers, the term "incentives" is not so simple. In some uses, incentives are broadly defined and include any location advantage that a community may have, such as position on a river, or mild four-season climate.

Incentives are best understood as distinct from location advantages. Economic development incentives might be defined as a deliberate policy or set of policies designed to make a location more attractive to particular investment decision makers.

This definition distinguishes incentives as policy actions as opposed to inherent geographic advantages of a location. It also distinguishes between general public investment and actions to attract specific industries or companies (Table 1).

Table 1 Location Advantages vs. Incentives

Location Advantage	Incentive
Location on a coast	Public port facility enhancement
Proximity to large population	Inventory tax exemptions
Strong, well drained soils	Free land

While all of the above characteristics are important and should be communicated as "selling" points for a community, only the deliberate policy actions will be recognized as incentives by the investment decision maker.

These policy actions can span a wide range of activities and still be understood as incentives. Most incentives can be classified into three broad categories: infrastructure, tax policy and community development. Table 2 is a broad list of some of the incentives that would fit in these categories.

In practice, incentive activity has focused on infrastructure and tax policy. However, with the ongoing shift in the economy from production line employment to knowledge worker employment, there is a growing recognition of the importance of community assets in investment location decisions.[2] As a result, community development assets are rising to the level of traditional infrastructure assets as economic development policy targets.[3] This classification distinguishes between "people" infrastructure and "hard" infrastructure while recognizing the growing importance of the community development assets.

Incentives in Economic Development

There are two basic principles regarding incentives in economic development:

1. Incentives should be designed to achieve the strategic economic development objectives of the community.
2. Incentives should meet the needs and influence the location decisions of particular investment decision makers.

If policy actions do not meet these principles, then they are not properly defined as economic development incentives. Failure to meet the first principle will likely result in lack of community support. In addition, a particular policy may be perceived as a sweetheart deal for a special interest rather than strategic public policy. Failure to meet the second principle will likely result in very little of anything – this would be policy

Table 2 Incentive Categories

Infrastructure	Tax Policy	Community Development
Utility energy water/wastewater communication	Base income sales property	Quality of Life arts / cultural assets recreation green space
Transportation road rail air water	Rate Timing / Frequency	Education primary secondary higher tech / training
Real estate		Medical

meeting the lofty visions of a community without any grounding in the reality of the investment decision maker.

Strategic Economic Development Objectives

Incentives should be approached as part of a state or community's overall economic development strategy. Economic development strategy and objectives should drive incentive policy, not the other way around. Incentives are not a policy objective, per se; rather, they are a policy tool. Even in the case of project-driven incentives, the community is best prepared to offer them when it has a sound understanding of its strategic goals and objectives.

At its core, economic development is best understood as the effort to improve the quality of life of citizens through the attraction and maintenance of capital investment and employment. In order to see how incentives fit into this mission, it is helpful to use segmentation to help understand the "markets" of economic development.

The market for economic developers is capital investment and employment, and it can come from a wide variety of sources. Like most businesses, economic development can benefit from understanding the various segments of its market. Such segmentation allows for a clearer understanding of the market and helps identifies unique characteristics of each segment that will call for different approaches,[4] including different incentives (Table 3).

Economic development strategy should account for each of the segments of the economic development market. Subsequently, incentive policy should be strategically designed to help achieve the objectives for each segment. Properly designed and executed, the incentives should "overlap" and complement the efforts in the other segments.

For example, a community may have as a strategic objective to develop more "high tech" activities. Accounting for the three classes of incentives as well as the three segments of the economic development market, the community may find itself looking at the following matrix of incentive policy opportunities (Table 4).

Influence Investment Decision Makers

Incentives should be crafted to support the economic development goals of the state and community. But to be effective, they have to influence the location decision of investors. So the incentive policies must be designed with a knowledge and understanding of the needs and preferences of the targets of the community's strategy. In particular, incentives are most effective when they meet the needs of the location decision makers by enhancing the strengths of a location and mitigating the weaknesses of a location.

Incentives that enhance the strength of a location reinforce a community's commitment to its base and ensure the decision

Table 3 Economic Development Market Segments

Recruitment	Capital investment and employment from outside your location
Expansion / Retention	Capital investment and employment from within your location (existing entities)
Entrepreneurial Development	Capital investment and employment from within your location (new entities)

Table 4 High Tech Segment and Incentive Matrix

	Infrastructure	Tax Policy	Community
Recruitment	Available site	Property tax abate	Higher education
Expansion	Utility costs	Income tax credits	Technical training
Entrepreneurial	Incubator space	Finance	Quality of life

Table 5 Incentives Meeting Needs & Mitigating Weaknesses

Location	Investor Need / Location Weakness	Incentive
Oklahoma (1880s)	Workforce / Population	Free land (Land Rush)
North & South Carolina (1960s)	Manufacturing workforce / Diversification	Technical training programs
Mississippi (1990s)	Set of auto attributes / Costs / Qualified workforce	Advantage Jobs Program (Infrastructure, tax, training)

Table 6 Effective Incentive Policy

Site Selection Fundamental	Incentive Policy Characteristic
Profit Driven	Impact Bottom Line (lower investment and operating costs)
Deadline Driven	Be Available When Needed (already enacted; fast discretionary decision)
Competitive	Distinguish Your Location (enhance strengths / mitigate weaknesses)
Comprehensive	Address Range of Needs (infrastructure, tax, community)
Risk Averse	Eliminate Uncertainty (available, reliable, sustainable)

maker that those aspects that are attractive right now will still be there in the future. Utility infrastructure may be adequate to meet current needs, but is it capable of meeting the needs of a particular prospect? Downtown redevelopment can create a major community quality of life asset but does it account for the need for entrepreneur space?

Incentives that mitigate the weakness of a location are critical in end stages of a location decision. These are typically a necessary condition to attracting investment and employment from any of the target segments. Incentives with this focus can have a major impact in both the short term (a particular project opportunity) and the long term (converting a weakness into a strength) (Table 5).

Incentives in Site Selection

Understanding the site selection process is critical in designing incentives that influence the location decision of companies. For the site selector, there are three critical characteristics to effective incentives:

1. Incentives must impact the decision.
2. Incentives must differentiate one location from another.
3. Incentives are generally more important later in the decision process.

For site selectors, it is understood that incentives cannot make a bad location good. However, incentives can make a location more competitive and in the end distinguish one good location from another. It is important for the public policymaker to understand some of the fundamentals of the location decision.

- Profit driven – investment projects exist to enhance the profitability of the investing company whether from making a new product, providing a new service, improving research or customer service capabilities, etc.
- Deadline driven – projects exist to seize a market opportunity, so as little time as possible should be spent deciding where to do the project and in getting the project into operation.
- Competitive – most projects face multiple location options and so countries, states/provinces and communities compete for investment projects.
- Comprehensive – the location decision is comprehensive and involves a large range of factors. Different projects have different weights on factors, and within a particular project the factor weight will shift over the life of the project. Incentives become more important in the decision later in the process.
- Risk Averse – while projects all carry considerable risk to the firms and individuals involved, a large part of the capital decision process (including the location decision) is a process of identifying and mitigating risk. Locations with more uncertainty (land availability, infrastructure capacity, workforce capacity, leadership commitment, etc.) are less attractive than those with less uncertainty.

As a result, as shown in Table 6, incentives that are effective should account for these site selection fundamentals.

Emerging Trends

In practice, there are trends in incentives that policymakers should be aware of as they work through their economic development strategies and attempt to design effective economic development incentives.

Competitive Pressure on Costs

The global economy has created a world of opportunity while at the same time 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 policymakers should be aware of this global pressure on companies for lower costs as they design their incentive policy.

Capital Cost Incentives

For most companies, reduction in project capital costs is critical, whether from internal or external (location) factors. In the location decision process, financial models account for multiple years, applying a discount, so costs that impact the project in early years have a particularly high negative impact on the decision. As a result, capital cost incentives can have a particularly high positive impact on the decision. Capital incentives that have become more prevalent in recent years and which have an impact on investment decision makers include:

- Land – land incentives can run from providing important site information, to gaining temporary control (options) at no cost to the prospect, to outright purchase and grant. Policymakers should note that almost every large project now seeks and receives land for their project at no or virtually no cost.
- Site Preparation – this is being offered to some degree with more frequency. In addition to reducing up-front costs, if some of it is done in anticipation of a project it can have a major schedule impact and be particularly attractive to prospects with 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 Incentives

Operating cost incentives mitigate costs that occur over multiple years. While lacking the up-front impact of capital cost incentives, these incentives can have considerable value over time.

- 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 (the granting authority provides the training services) to cost reimbursement (the granting authority reimburses a company for its training costs). Companies are more certain that the latter approach will genuinely impact their costs as well as provide the training they desire.
- Taxes – income tax incentives have been present for some time and most states have such credits for job creation and investment performance.

  Property tax incentives are very important for capital intensive projects, but can be challenging as 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 the 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.

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Community Incentives

Community incentives are not typically associated as a grant to a particular investment decision maker, but rather have been investments in the community itself. With the emerging trend of knowledge-based activities, some of these community based investments may evolve to include company-focused incentives. One example may be the establishment of a technical user's network. On a grander scale, it may involve joint investment in a graduate school chair.

Conclusion

In closing, it is important for policymakers to defend and even promote incentives as sound public policy. The most important step in being able to do so is to be sure incentives are designed to meet the strategic development goals of the community. Once in place, it is important for policymakers to note that infrastructure incentives are investments in the ground of the community, and training incentives are investments in the people of the community, and community incentives are in fact, investment in the quality of life of the community for the benefit of all its citizens.

Endnotes

1 Funk and Wagnalls editors. *Funk and Wagnalls Standard College Dictionary*, (New York: Readers Digest Books, 1966).
2 Joel Klotkin, *The New Geography: How the Digital Revolution is Reshaping the American Landscape*, (New York: Random House Books, 2000).
3 Richard Florida, *The Rise of the Creative Class*, (New York: Basic Books, 2002).
4 Philip Kotler, ed., *Marketing Management*, (Upper Saddle River, NJ: Prentice Hall, 1988).

Bio

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