Responsible Economic Development Incentives, LLC

Helping communities and businesses find mutually beneficial solutions for the greater good.

Examining the efficacy of the "but for"

This is the second in a series of articles where we will study why discretionary economic development incentives are not functioning as intended, reforms that need to be implemented, and tactics that can be used to build consensus for changes to the systemic issues.

Background

Discretionary economic development incentives are supposed to be subject to the "but for" provision, that is, "but for the availability of the incentive, the project (e.g., capital investment, job creation, etc.), will not proceed." This requirement is in place to prevent waste, or incentivizing projects that will occur regardless of the incentive award. Yet research indicates, for incentivized projects, the same decision would have been made 75% to 98% of the time without the incentive.[1] But why is this so?

We will dive into this answer, cover policy and process improvements that will put an end to this madness, and discuss strategies to help us move beyond the prisoner's dilemma by covering a variety of topics. In our first article, we highlighted the importance of "leverage." We now move on to "competition," leverage's sometimes vile uncle.

Competition: Real or purposefully concocted to maximize incentives

In order to meet the "but for" condition, there must be some uncertainty about and/or competition for the project, the existence of which happens to be the source of incentive "leverage." While there are surely times where the location of a project has yet to be determined, and such project genuinely could be located in multiple states and/or localities and still meet the needs of the user, it is our humble opinion that equally desirable locations where incentives can make the difference for site selection decisions rarely exist (perhaps this is the 2% though).

The following are the primary strategies used to display uncertainty about and/or competition for a project:

- Competing/Alternative site(s)
- Financial gap
    - Compared to competing/alternative site(s)
    - Return-on-investment (ROI)/Internal-rate-of-return (IRR) thresholds
- Internal competition for limited capital/competing projects
- Project prioritization (based upon ROI/IRR)

Some projects, the best ones from the perspective of some (especially if a contingent fee is involved), provide the ability to use a combination of uncertainty and competition factors as leverage. Rather than delving into the euphoric nature of these projects, we will tackle each strategy separately.

Competing/Alternative site(s)

Having multiple location options is obviously one of the top ways to drive competition and incentive leverage for a project, especially if the possibilities include sites in two or more states. Interstate competition provides the opportunity for incentives to be maximized at both the state and local levels, and the offers can be further enhanced if the sites are served by different utility companies.

Interstate competition can even come into play for projects where one would not normally expect it to exist, for say a distribution center project that will serve a specific metropolitan area. However, if that metro area happens to be near a state border, bingo, all that is required is a stalking horse site across the state line to maximize incentives.

If one finds itself in the unfortunate position of not being able to argue that the specific project could be located in two or more states, not to worry, multiple location options within the same state can still drive local incentive opportunities, and it may be possible to fall back on one or more of the other leverage strategies for state, and possibly utility, incentive purposes as well.

Financial gap

Financial gap arguments can arise in one of two ways. First, if there are multiple site options, whether interstate or intrastate, a financial gap can be determined by comparing the two locations. A valid comparison would involve rigorously analyzing the differences in start-up costs, operating costs, taxes, and incentives over a period of time, preferably in the range of 20 to 30 years, and applying a discount factor to compute the gap on a net present value (NPV) basis.

However, often times, this full-blown analysis is not performed, and the so-called "gap" is determined by simply comparing incentive offers (or presumed incentive availability in the case of a stalking horse site) or via some severely limited analysis, and on a total dollar basis instead of the more suitable NPV approach. Further, it is not uncommon for folks to be unwilling to share the amount of the supposed "gap." It is easier to just indicate that there is a gap, your community is behind, and you need to enhance your offer, to the max of course, if you want to have any chance to "win" the project.

The second way that financial gap arguments can arise involves ROI/IRR thresholds for project funding approval. It makes sense that incentives improve a project's ROI/IRR. Thus, if a project has yet to receive internal funding approval and it is not meeting the typical required ROI/IRR, it is possible to determine the amount of incentives needed to get the project over the hump. However, again, the amount of the gap is not frequently shared and, instead, vague references are made to the ROI/IRR deficiency and how the incentives, or lack thereof, *could* impact the ability or desire to proceed with the project.

Internal competition for limited capital/competing projects

Similar to the ROI/IRR financial gap position, in order to claim the internal competition for capital/ competing projects contention, the project must have yet to receive internal funding approval. In this instance, the argument is that many potential projects are simultaneously competing for funding, and, as is true for every organization, funding is limited. Again, this is a nebulous argument. Minimal details are shared, other than the project has yet to receive internal funding approval, and wishy-washy language is used to support it.

As with the case of the ROI/IRR assertion, it is referenced that the incentives, or lack thereof, *could* or *may* impact one's ability or desire to proceed with the project. Further, it is stated or implied that the projects that have the highest ROI/IRR are the ones that will be approved/receive the limited funding, so the incentives, or again, lack thereof, *could* make a difference in your project being able to move forward.

<u>Project prioritization (based upon ROI or IRR)</u>

By far the weakest "but for" strategy of them all, next we have the project prioritization position. This argument is used when there are no competing/alternative sites for the project, and the specific project has already received internal funding approval. Wow, can you really still obtain discretionary incentives for a project like this you ask? Hard to believe, but yes.

In order to be successful, one just has to contend that there are many projects on the docket, which is true for almost every large organization at any given time, and that the projects with the best ROI/IRR *could* or *may* be prioritized and implemented first. Although a flimsy overall line of reasoning, this strategy tends to work well when an organization is at the onset or in the midst of an initiative that involves establishing multiple new facilities across the country over a number of years.

<u>Summary</u>

Now that we have covered all of the different ways that uncertainty about and/or competition for projects can be demonstrated, you again may ask, what's the point? The point is that you can now start to see why 75% to 98% of incentivized projects would have been implemented exactly as they were even without the incentives. There likely was no true competing/alternative site, no valid financial gap to overcome, the incentives did not matter in securing internal funding approval for the project, and/or the incentives almost certainly did not influence the prioritization of the project ahead of other "competing" projects.

In fact, many times, the exact site upon which the project will locate is known, and the afterthought of securing incentives simply becomes a race against time before a commitment is made that jeopardizes incentive maximization. However, as noted in our first article on incentive leverage, it is almost impossible to fully relinquish it in the current system.

As also stated in our first article, we are currently not asking the right questions. There is information asymmetry, and insufficient documentation requirements. We are playing poker and one party can see the other party's cards, while keeping theirs close to the vest. We are at a severe disadvantage, and the cracks are being exploited. So how do we fix this?

In our next article, we will cover the all-important topic of "transparency." This is not transparency in the usual incentive context, which aims to ensure the general citizenry is aware of potential incentive awards well in advance of public meetings where the deals will be formally considered for approval, in order to provide sufficient opportunity for public discussion and input. While that is certainly also a crucial reform, our transparency refers to transparency between incentive granting bodies and potential recipients during the site selection and incentive negotiation process. This type of transparency alone can cure many of the ills we are currently facing in these lopsided transactions.

P.S. One last item before we go. Be mindful of project names that are used to maintain confidentiality for site selection projects as well. It would not surprise me if code names were deliberately selected to reinforce the idea of uncertainty about and/or competition for a project, or even to convey a much larger search or service area (e.g., "Project Midwest" for a distribution center that will serve Indianapolis, Indiana). Again, all in the name of incentive maximization.

By C.J. Girod | February 10, 2021

[1]Bartik, Timothy J. 2018. "'But For' Percentages for Economic Development Incentives: What percentage estimates are plausible based on the research literature?" Upjohn Institute Working Paper 18-289. Kalamazoo, MI: W.E. Upjohn Institute for Employment Research.