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 fourth (and sorry, not final as previously stated) 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 three articles, we highlighted the importance of "leverage" with respect to maximizing incentives, how project and/or location "uncertainty" and "competition" are used to gain leverage, and how a new requirement for "transparency" in the incentive negotiation process can level the playing field for incentive granting bodies. We now move on to the "current culture" in the economic development incentive arena. Future articles will analyze the changing landscape, ethical considerations, and additional appeals that can be made to help drive positive transformation.

Current Culture: Strategic and coordinated manipulation

As discussed in prior articles, incentive granting bodies are presently at a serious disadvantage. Uncertainty and/or competition for economic development projects is extremely easy to manufacture or conjure up, and the lack of transparency in the incentive negotiation process makes it quite simple to establish and maintain, albeit most times weak, "but for" arguments.

Over the past 30 years, the amount of incentives handed out annually has tripled to ~$50 billion.[2] Is it any wonder that incentives have become an expectation for just about all types of projects? Manufacturing plant, corporate headquarters, research and development facility, data center, call center, distribution center, hotel, restaurant, retail store, etc., it doesn't matter, the game will be played and incentives will be pursued, especially in the case of larger, more sophisticated and/or connected companies.

It is estimated that there are over 500 consulting firms that offer site selection services,[3] the vast majority of which also offer economic development incentive negotiation services. These include site selection, real estate, accounting, tax, law, public affairs, and specialty boutique economic development firms, some working on truly competitive site selection projects, but many simply helping corporate America exploit the gaps in the current system, and often on a contingent fee basis.

Companies have also created internal teams made up of representatives from their real estate, facilities, finance, tax, legal, government affairs, human resources, and communications departments to work together in a well thought out and coordinated effort, sometimes with the assistance of a consultant, to secure and maximize incentives, often for projects for which there is no uncertainty or real competition from a project or location decision standpoint. Some companies have even created formal "economic development departments" within the organization, but it is unclear if these departments do anything more than just focus on securing and administering economic development incentives (my hope is that they are also working with the communities in which they locate to reinvest incentive savings locally in order to enhance the community's infrastructure, education, and services for their employees and their employees' families, which would also serve to attract additional industry, but I digress).

To further illustrate the point (i.e., this is a game that many if not most consultants and companies have mastered), I'll pose a question. Have you heard of "The Golden Ratio?" I must say, I just recently came across this term. In essence, it's a company's savings received in a given year from tax credits and incentives divided by the company's capital expenditures for the same year. Apparently, there is a belief amongst some company executives and consultants that this figure should be 25%. In other words, someone else, generally the government (i.e., taxpayers), should subsidize 25% of every private company's capital expenditures, every year.

While I'm all for incentivizing items that will have a positive impact and genuinely need to be induced (e.g., investments and job creation in brownfields and distressed areas, clean energy innovation, etc.), a 1:4 Golden Ratio takes things to another level. In order to achieve this, assuming incentives are not obtained for routine annual capital expenditures (e.g., maintenance, repairs, replacements etc.), incentivized projects would need to produce a return-on-investment significantly higher than 25% in order to achieve an overall Golden Ratio of 1:4.

If incentives matter in only 2% to 25% of project/location decisions (I would strongly argue toward the lowest part of this range), then how are companies able to meet the "but for" in their quest to attain a 1:4 Golden Ratio? In most cases, it is merely a timing issue, and competition or uncertainty is purely theoretical. In order to maintain the "but for," in other words, in order to be able to somewhat honestly make non-committal statements such as "the incentives may [or could] impact our ability and/or desire to proceed with the project [at the specific location]," companies must pursue and secure incentive approvals prior to making a definitive commitment to the project. Otherwise, to make even these types of namby-pamby statements would be blatant falsehoods.

As we've all heard in the past, timing is everything, but this is especially true when it comes to incentives. This is the reason why there is literature out there from consultants stressing the importance of starting incentive discussions early. Incentive availability is commonly couched as part of the "due diligence" process, which helps, or at least strives to, give the impression that incentives matter as much as all of the other things that really matter most in site selection decisions, which we all know include items such as the availability of skilled labor, highway accessibility, energy availability and costs, quality of life, labor costs, occupancy and construction costs, etc.

With the knowledge of the private sector's strategic and coordinated approach toward and mastery of exploiting the current economic development incentive system, as well as its goal to continue to push further to attain 25% public funding for all capital expenditures, the question now becomes what can we

do about it? In our prior article, we provided a straightforward solution: ask more/strategic questions, require transparency in the incentive negotiation process (including gap analyses), and require companies to certify that the project will not proceed "but for" the awarding of the incentive(s). This is not akin to unilateral disarmament. Not every state or local government must simultaneously implement these types of protective measures, though they all should at some point in the near future. Communities that enact them aren't going to be automatically eliminated from consideration by companies, and don't let anyone try to convince you otherwise.

In fact, many local tax increment financing (TIF) programs, as well as a new state incentive (i.e., the New Jersey Emerge program), already include some of these requirements. By combining the best parts of each, significant progress starts to unfold in terms of a responsible and effective approach to incentives. It is completely reasonable to ask [require] the recipient of an incentive to confirm that the award will actually induce an action, rather than reward the company for doing something it was intending to do either way (more gravy please).

If the incentives matter, the company will provide and do what is required to receive the incentives. If the incentives do not matter, the company will either still locate the project in the specific jurisdiction, or it will not. If the company locates elsewhere, it will not be due to the stricter incentive requirements, as incentives were still available. Rather, it will be because the other location simply met more of the company's needs, preferences, and/or biases.

Thus, we can't be afraid to lose. If the community was going to lose a project, it was almost assuredly going to lose even if it had less stringent incentive requirements and/or offered more incentives. In the current one-sided environment chock-full of information asymmetry, it's actually the projects we win that we should be more concerned about. Did we really need to offer incentives and at that level to "win" the project, or were they coming anyway?

As the late former U.S. Treasury Secretary and CEO of Alcoa Paul O'Neill said, "…if you're giving money away, I'll take it, you know. If you want to give me inducements for something I'm going to do anyway, I'll take it. But good business people don't do things because of inducements. They do it because they can see that they're going to be able to earn the cost of capital out of their own intelligence and organization of resources."

Let's stop giving away money for things companies are going to do anyway, and instead use the savings to improve our communities.

By C.J. Girod | March 30, 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.

[2]Bartik, Timothy J. 2019. Making Sense of Incentives: Taming Business Incentives to Promote Prosperity. Kalamazoo, MI: W.E. Upjohn Institute for Employment Research.

[3]Podkul, Cezary (2019, May 18). Meet the Fixers Pitting States Against Each Other to Win Tax Breaks for New Factories. *The Wall Street Journal*. https://www.wsj.com