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Seeding Growth: Maximizing the Return on Incentives

Executive Summary

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The EDRP Program is the "think tank" component of IEDC, designed to help economic development professionals weather the challenges and grab opportunities from economic changes affecting our communities. EDRP members are leaders in the field of economic development, working through this program to improve the knowledge and practice of the profession.

IEDC would like to thank the Economic Development Research Partners program for providing the impetus and resources for this project.

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Acknowledgements

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Executive Summary

Given the prevalence of incentives, economic developers should ensure that they are using these tools as effectively as possible. At present, many jurisdictions do not track the amount of incentives they commit, nor do they calculate the economic benefits of the incentives they have actually awarded. Better management techniques would maximize the value of incentives and provide the data necessary to demonstrate the effectiveness of this economic development tool.

Incentives are *investments* made on behalf of *stakeholders*-- the citizens of the locality or state that the EDO represents-- with the objective of generating a *return on incentives (ROI),* a term that borrows from the private sector concept of return on investment, also commonly abbreviated as ROI. Like private investors, economic development organizations (EDOs) should manage their incentives with the goals of *maximizing ROI* and *minimizing risks*.

In a recent survey, 83 percent of IEDC members reported that it would be helpful to have guidelines for awarding incentives.[1] The following guidelines are not intended as a "set" that must be adopted or rejected as a whole. Rather, it is recommended that EDOs, as they design and administer incentive programs, should select tools from this list that are best-suited to their intended objectives.

This report offers models that EDOs can use to calculate ROI. By rigorously evaluating the efficacy of their incentives, EDOs can reduce their costs, minimize risks, increase regulatory compliance, and spur innovation. Organizations that regularly perform evaluations of their investments and actively manage their portfolios are significantly more likely to achieve their projected returns.[2]

The Government Finance Officers Association writes,

> "Providing a thorough and rigorous analysis of each project is critical… Responsible use of public funding requires that projects funded provide a suitable return for the jurisdiction, are consistent with overall community goals and priorities, and require that investments are made in a transparent manner with full understanding of all short- and long-term costs and benefits."[3]

This report also offers model standards of practice that can be adapted by EDOs to design and administer high-performing incentives programs, including:

- Methods to lay the groundwork for high returns,

[1] International Economic Development Council members' survey, 2013.
[2] Project Management Institute, "Portfolio Management." Retrieved December 11, 2014.
[3] Government Finance Officers Association, "Evaluating and Managing Economic Development Incentives," 2014.

- Best practices in designing incentives programs and agreements, and
- Mechanisms to collect the information required to project ROI.

Set the Context

To build a framework for effective incentive programs, economic developers should identify long-term community economic development objectives, create strong cooperative regional partnerships, deploy non-financial incentives wherever possible, and acquire the equipment and human resources needed to manage incentives programs effectively.

Design Effective Programs

EDOs can create high-performing incentives through good program design. Designing an effective incentive program begins with articulating a statement of the incentive's purpose; identifying target industrial sectors, locations, and project types whose attraction will help meet strategic economic development objectives; and explicitly stating clear criteria for projects that will qualify for financial incentives. Economic developers should employ financial structures that provide a high degree of effectiveness for cost and create mechanisms that reward companies for achieving public objectives.

Draft Incentive Agreements

An incentive agreement is a legal document that specifies the characteristics of individual incentives investments, including details of the financing to be offered, the conditions upon which it will be offered, and whether financing will be available based on projections or performance. Incentives agreements contain standard clauses for all incentive recipients, such as the financial structure of the incentive, the means in which the incentive assists in accomplishing strategic goals, and the ways that data will be collected. Most critically, the agreement includes legally binding criteria and metrics that must be met for incentive funds to be disbursed, such as the minimum capital investment and minimum number of jobs to be created.

Design an ROI Calculation

Monitoring portfolio performance involves collecting the information that agreements require recipients to disclose; collecting data about jobs growth, and local budgets; and evaluating the Return on Incentives (ROI).

ROI demonstrates the effectiveness of an incentive by comparing its costs and benefits. Considerations in the ROI calculation include estimating the percent of investment attributable to incentives, accounting for risks, accounting for the timing of expenses and benefits, controlling for the location of benefits and costs, and considering indirect and induced effects. EDOs must understand how these considerations affect the choices and assumptions they make in constructing ROI models and then communicate and explain those choices effectively to stakeholders, always maintaining high levels of professional integrity. Undertaking ROI calculation may require specialized staff training, cooperation

among multiple government departments or agencies, and the use of independent reviewers. ROI can be used at both the individual recipient level, to assess incentive applicants and to review the effectiveness of existing incentives agreements, as well as to comprehensively review an incentives program to demonstrate its effectiveness to stakeholders. Over time, comprehensive evaluations help economic developers to sharpen investment criteria and mitigate emergent risks.

Evaluate Incentive Performance by Calculating ROI

Economic developers have four models available to them for calculating ROI, which vary in their complexity, comprehensiveness, and accuracy:

- Economic Impact Analysis (EIA),
- Fiscal Impact Analysis (FIA),
- Cost-Benefit Analysis (CBA), and
- Social Return on Incentives (SROI).

Economic Impact Analysis models new spending that results from an incentive being awarded. Though it is the most commonly used and relatively easy to perform, EIA considers only spending benefits, not costs. Thus, in order to be used as a demonstration of incentive effectiveness, EIAs must be compared with those of alternatives, including other incentive awards. Fiscal Impact Analysis provides a rigorous accounting of both costs and benefits of incentives, and most closely resembles private-sector ROI. However, it usually does not take into account important private benefits and costs, such as the effect of wages paid to workers. Cost-benefit models take into account private economic costs and benefits, but it can be difficult to effectively delimit a scope for these calculations, as well as to avoid double-counting- an accounting mistake where an item appears more than once. Social Return on Incentives is a method that allows for intangible the costs and benefits of incentives-driven projects, such as civic pride and congestion, to be considered, but it can be difficult to decide which intangibles to include and how to value them. Economic developers should understand these varied calculations and select the methods that are contextually appropriate, communicative, and accountable.

Actively Manage the Portfolio

After measuring ROI, the next step is to decide whether incentives investments should be retained, expanded, or terminated. Incentive payments can be scaled in proportion to performance. For incentive recipients that fail to meet the performance and disclosure clauses in the incentive agreement, EDOs should recommend that non-compliant incentives investments be terminated, or that payments made to companies that have failed to achieve investment criteria be recovered.

Communicate with Stakeholders

Economic developers should communicate the success of their incentive investments to stakeholders through regular reports on program design and effectiveness of the EDO’s portfolio, regular comparison

with other economic development programs, and periodic comprehensive review of all incentives programs.

Conclusion

Economic developers can use the suite of tools contained in this paper to improve the design, administration, monitoring, evaluation, and communication of their incentives. Adopting best incentive practices can lead to more efficient spending and sustained economic growth.