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In our discussions with public officials over the years the question often arises as to the real impact that incentives have upon site selection decision making. The question is most often phrased as "Is an economic incentives package really the deciding factor in determining where a proposed project will occur or if a proposed project will be undertaken?" The correct question, however, should be presented in a different manner, "Is an economic incentives package a primary factor that influences the decision of where a project will occur or if the project will be undertaken?"

Many factors are primary in site selection. Site decision makers will often evaluate factors, such as labor markets, transportation infrastructure, tax burden, utilities, and other factors which they deem primary influences upon the success of proposed operations. Decisions regarding the most viable location for investments cannot be made without careful analysis of most or all of these factors. Incentives, for many decision makers are among the many primary factors that must be evaluated before a project proceeds.

We have worked directly with corporations where mandates from Boards of Directors or Capital Expenditure Committees have been implemented company-wide which require an evaluation of available incentives before an expenditure request will be considered. This typically applies to constructing new facilities, as well as to capital investments made to existing operations. The reasons that incentives are given such weight in the decision making process by board members and committees are several-fold.

> Incentives are looked at no differently from other economic factors. They have a direct financial impact on the outcome of a proposed investment. Incentives affect the return that a company realizes when undertaking capital investment in a project and may be a determinative of the proposed project's meeting return on investment requirements. These include both project start-up costs and on-going operating costs. The decision maker must ask, "Would the company realize a higher return on their capital if it were invested elsewhere?"
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> Incentives have a direct impact on other primary location factors. For many companies, the burden of state and local taxes is of great importance in their location decision making. Incentives have a direct impact on the long term tax liability that a company will face at each location being considered. Tax incentives may enable a location with a decided tax disadvantage to fare better than competing locations that have an initial tax advantage.
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> Incentives provide a definite competitive advantage to companies that are able to secure state and community support. More companies are realizing that competitors, which secure incentives, lower project start-up and operating costs.

This provides a competitive advantage to these companies that decision makers should not ignore.

Incorporating Incentives into the Site Selection Model

The evaluation of state and local incentives has become a greater part of the Site Selection or Location Analysis Model for companies seeking to identify the optimal location to site new facilities. It has also become an integral part of companies' decision making regarding the expansion of existing operations. But how do decision makers incorporate incentives into their analyses?

First it is important to differentiate between three general types of incentives. These are Tax Incentives; which account for a majority of incentives provided by state and local governments, Financial Incentives; that include grants, bond financing, and loans; and other Non-Tax Incentives; which cover a wide variety of offerings ranging from land and utility rate subsidies to in-kind services. Since Tax Incentives play a significant role in state and municipal offerings, it is beneficial to look at these first.

Tax Incentives have been primarily developed by state legislatures as a means to aid state and local governments in addressing greater tax burdens that businesses would face when undertaking operations within their jurisdictions vis-à-vis other jurisdictions where these operations could be placed. In this respect, lawmakers have recognized that their tax structures are less competitive when attracting or retaining business investment.

Likewise, corporate location decision makers recognize these differences in tax burden between states and municipalities. The impact of taxes over the long term are, in many cases, substantial enough to warrant evaluation within Location Analysis models. Typically, the Tax Burden Analysis includes a projection of state and local tax liabilities over a ten to twenty year period. This analysis will include state and municipal income/franchise taxes, sales and use taxes, real and personal property taxes (including inventory taxes), utility taxes, unemployment taxes, workers compensation, and other applicable taxes. The goal of the analysis is to understand and compare when appropriate, estimated long-term tax liabilities between locations, but also the corporate wide tax impact of placing a project in a given location. In other words, the evaluation of the tax impact of undertaking business investment in State A has upon existing operations in all other states is part of this process.

One of the keys to a meaningful Tax Burden Analysis is the formation of reasonable assumptions. Since the analysis is a projection of tax liabilities under the condition of many unknowns, it is extremely important that these unknowns be tempered with acceptable assumptions. A reasonableness test must be applied to those factors that are likely to change over the term of the analysis. These include future corporate taxable income, property values, tax rates, inflation, changes to tax statutes, changes and challenges to incentives programs, and other variability. The sources of data must also be acceptable to the location decision makers so that there is confidence in the analysis.

In order to fully understand the tax burden at a given location, it is necessary to determine if it is possible to secure state and local incentives for the operations and to what extent such incentives will lower the tax burden. The value of potential incentives is determined by identifying both "as-of-right" incentives whose value is based upon the ability of company to be aware of these incentives and discretionary incentives whose value is a function of negotiations between the company and granting authority. States and municipalities specifically use discretionary incentives as economic development tools that can be targeted toward projects that will achieve economic growth goals. Since the value of discretionary incentives is based upon negotiations, these values will be fluid as discussions proceed. It is, therefore necessary to utilize a model that is flexible so that the impact upon the Tax Burden Analysis can be updated accordingly.

We have seen notable shifts in state and local tax liabilities that companies are likely to incur at a given location based the incentives that have been identified and secured for a project. In some cases, discretionary tax incentives have lowered the projected tax burden by tens of millions of dollars over a twenty year period, even exceeding a hundred million dollars for some larger projects. Therefore, it is if the impact of taxes is a primary factor influencing a corporation's location decision, then evaluation of Tax Incentives should be considered a key criterion in due diligence of the project.

The second type of incentives, Financial Incentives, may also have an impact upon corporate location decision making and upon determining if a project should move forward at all. Whereas, tax incentives primarily affect the longer term operating cost of a project, Financial Incentives typically tend to impact the start-up costs of the project. These incentives are offered primarily in the form of cash grants, bond financing, or favorable loans that are used to cover the costs of fixed assets, although some grants and bonds are often applied to operating expenses such as employee training. The eligibility and impact of financing programs upon larger corporations is restrictive in many cases. Their impact, however, upon mid-cap and smaller companies' projects can be significant. Such incentives will either directly reduce up-front expenditures or lower the longer-term cost of money that will be used to fund the expenditures. Location decision makers will seek to identify and compare the impact of these incentives upon the cost of funding or financing a project.

Our third category of incentives is a "catch all" for non-tax incentives that are not grants or loans in nature. These vary widely as mentioned above and are typically not included as part of a location analysis unless they directly impact an operating cost such as utility rates, employee training, land price and infrastructure support.

The Impact of Incentives upon the Site Selection Model

The impact of state and local incentives upon site selection is best demonstrated with an example. I will refer to a corporation that was seeking to establish a large facility in the U.S. The corporation's primary location factors included labor availability (less so cost),

transportation costs, and state and local tax burden. Of these three primary factors, transportation costs were deemed the most significant and it was strongly felt during most of the location analysis that one of two finalist states clearly would be selected based upon its transportation cost advantage. This state held three potential sites. A single competing location within a second state was initially given far less attention by the decision makers as the final site based upon anticipated shipping costs.

During the location analysis process, however, state and local incentives opportunities were investigated. As discussions and negotiations progressed between the company and state and municipal authorities, it became apparent that public officials in one state which had a comparative disadvantage, utilized economic incentives as a means to make their site more competitive and viable for the proposed operations. Although they could not impact transportation costs directly, they were able to offset such costs by reductions in taxes and provision of other benefits for a period of time sufficient favorably to influence the company's decision makers. The state and municipal officials did so based on an evaluation of the long term economic and fiscal impacts of the project upon the state and local economies and public treasuries.

To this company's decision makers, the incentives package offered by the state and municipality was evaluated for its ability not only to off-set start-up costs, but also to favorably impact on-going operating costs (i.e., tax liability). Normally the impact of incentives upon start-up costs, are viewed as a more important criterion in site selection decision making. In addition to tax and other incentives, the municipality offered assurances to counter future negative impacts that changes in certain tax statutes would have upon the project. In this case, the value of the incentives package not only included tangible benefits, but also potential benefits that may or may not materialize.

After evaluating the state and municipal incentive packages, the company then undertook legal, financial, and operational due diligence of the packages to ensure that the resulting benefits would provide anticipated results. The company's financial and legal advisors worked with representatives of the state and local authorities to properly document the obligations of all entities that would be parties to the incentive packages. In the end this site was selected for the project even though an initial costs comparison between competing sites did not favor this location. This demonstrates the definitive impact of incentives upon site selection.

Not infrequently, states and municipalities may impose various commitments on the company utilizing state and local incentives, such as covenants to open and operate, to hire a certain number of employees and to pay stated minimum wages/benefits. These are incorporated into the agreements documenting the incentives. State and municipal officials also may impose penalties, clawbacks or termination rights against the company as a result of its failure to meet these commitments. Therefore, another part of the company's due diligence process includes an evaluation of the nature and type of commitments by the company and the remedies available to public officials based on their non-compliance. This process also may include negotiations with public officials to soften commitments and to mitigate any clawbacks, penalties or termination rights so as

to reduce the exposure of the company receiving the incentives. The outcome of these negotiations may have as significant of an impact on the company's decision making to locate a site in a particular state or community as the incentives themselves.

Our experience with companies that dedicate significant resources to evaluating the best locations to establish new operations or reinvest in existing facilities shows that a growing number of decision makers are including the impact that economic incentives may have in the short and long terms upon their proposed investments. In many cases, location decisions are not made without fully understanding the impact.