
The Tool That Local Economic Developers Should Rely On.

A cost-benefit model is the best route to creating fiscally prudent incentive packages.

There's little doubt that the use of taxpayer-funded incentives will remain the subject of intense disagreement among public officials, researchers and the public. Regardless of the larger debate, however, local economic developers are often expected to offer incentives to attract and retain businesses. How can you provide them in a fiscally responsible way?

The local government's elected body sets a vision for the type of economic activity the community desires. Policies then need to be written stating when and what types of incentives can be used. At this point, economic developers need a good fiscal tool to ensure that incentives are being offered wisely.

There are three types of fiscal tools that can be used to look at economic projects: an economic-impact model, a fiscal-impact model and a cost-benefit model.

An economic-impact model, such as the ones produced by the federal Bureau of Economic Analysis as well as private companies, estimates the impact on taxes, jobs, wages and economic activity should a business move into a community. However, it often overlooks additional costs associated with this business, such as project-specific capital expenditures or increased demand for services from local governments, resulting in overstated benefits.

Conversely, a fiscal-impact model focuses on costs associated with business activity. However, it doesn't look at indirect revenues very well and tends to overstate costs. When reviewing a fiscal-impact study for La Plata County, Colo., for example, we found that the report did not credit any sales-tax revenue attributable to increased residential housing, even though half of all retail sales were from residents. It also did not account for property tax revenue from machinery and equipment for manufacturers and wholesalers, which comprise more than half of all property tax from these businesses.

A cost-benefit model balances the approaches of economic- and fiscal-impact modeling. It evaluates the change in economic activity, government revenues and costs for a new project, as well as the cost of any incentives offered, and it measures these impacts over several years.

One key element in a cost-benefit model is identifying both the fixed costs and variable costs to the governing body's budget. As a business generates new jobs and housing, there will be an increase in some public costs, such as police calls, as well as revenues, such as activity fees for a community recreation center. Other parts of the budget, such as the costs of city administration, may not change when a new business moves in. In Lawrence, Kan., we identified these fixed and variable portions of the city budget internally. Other communities, such as Lee's Summit, Mo., hired a consultant to create this analysis.

A good cost-benefit model allows you to more accurately assess the risk associated with the project, giving you answers to questions such as what happens if a project creates fewer jobs than forecast.

In Lawrence, this proved quite helpful in responding to questions from residents about whether proposed projects would perform according to the company's projections.

For a cost-benefit model to be effective, policy should require a "coverage ratio" similar to what banks use for issuing loans. For instance, the policy we had in Lawrence required that a project generate $1.25 in new revenue for every $1 in new incentives and costs.

Finally, the cost-benefit model should be managed in-house. This allows staff to be the experts and respond to questions from elected officials, city management or the public, and to provide more detail as needed.

When we built our cost-benefit model in Lawrence, two of biggest challenges we found were learning to negotiate and balancing the model's flexibility with ease of use.

City leadership can be nervous about negotiating with businesses. However, most businesses are used to negotiating and are willing to yield a little in their requests, if you can explain why you can't meet a request and what you can do as an alternative. Using negotiations, Lawrence was able to craft an incentive package that met the city's fiscal requirements and still allowed for a critical expansion for one of its largest employers.

Cost-benefit models also have trade-offs between ease of use and flexibility. Typically, the more flexibility you want, the more complicated the model is to use. Flexibility became a challenge in Lawrence, and after almost a decade with the same cost-benefit model, a new one needed to be found. Finding a balance between flexibility and ease of use and creating quality training documents are important for the longevity of the model.

Every economic-development project carries risk. However, with a solid vision, good policy and a quality cost-benefit model, local economic-development professionals can provide fiscally prudent incentive packages that increase the benefit to the community overall.

GOVERNING.COM

By Roger Zalneraitis

JULY 8, 2019 AT 4:00 AM