The Market for Prosperity:

Understanding the Economic Development Process.

Prepared for:

The Texas Ecomonic Development Council

by M. Ray Perryman, PhD, President, The Perryman Group

Update
June 2013

The field of economic development has become increasingly sophisticated and more professionalized over the past thirty years. Experts in the field, such as economic development professionals, corporate real estate specialists, and site location consultants understand the workings of the economic development process. However, as global competition for investment intensifies, it is increasingly vital for elected officials and local community leaders outside the field to also understand how economic development works at the local and regional levels.

To that end, the Texas Economic Development Council (TEDC), the more than 800 member state association of professional economic developers, contracted with Nobel Prize nominee Dr. M. Ray Perryman, to prepare this brief and highly-informative white paper: *The Market for Prosperity: Understanding the Economic Development Process*

This paper is designed to provide non-experts with a solid understanding of the economic development process, including the factors considered by companies making site location decisions and the appropriate, cost-effective uses of financial incentives.

We support Dr. Perryman's conclusion that incentives play an essential role in economic development, but that they must be used judiciously. Community leaders should carefully analyze incentive packages—and under most circumstances reserve their use for attracting or retaining primary jobs—jobs that infuse new dollars into the local economy by creating or selling a product or service that is ultimately exported to regional, statewide, national, or international markets.

We invite you to contact the TEDC if you would like additional copies of this report or if you are interested in scheduling an educational seminar for leaders in your community. We also invite you to consider becoming a TEDC member. Our members come from diverse backgrounds and enjoy a wide range of benefits, including legislative representation, education opportunities, and information resources.

Carlton Schwab
President/CEO
Texas Economic Development Council

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Introduction

The location of economic activity has always been driven by the need to optimize results. Long before markets existed, the earliest civilizations formed around great rivers that provided water, fertile land, and transportation arteries. As commerce expanded, natural ports enjoyed an era of prominence.

Once business activity became more prevalent, advanced, and integrated, locations tended to follow points of economic interaction (e.g., stagecoach and railroad depots, terminal points of cattle trails, major crossroads). In the contemporary world of instant global communication and multi-modal rapid transportation, the process of selecting sites for new or expanded business activity has become more complex and sophisticated. The basic premises, however, remain the same.

This paper explains the modern economic development process. When viewed in a broad and appropriate context, many aspects of sound economic development strategy become clearly defined—and many "dos" and "don'ts" unambiguously emerge. Because of the innate uncertainty of the economic development process, it is not possible to be totally prescriptive. Nonetheless, a better understanding of the factors that influence site location decisions provides invaluable insight into both the formulation of economic development policy and in obtaining meaningful rates of return on the investment of scarce public resources.

Understanding the Economic Development Process

The Basic Framework

Essentially, there are two key players involved in site location decisions—businesses and geographic localities (states, cities, etc.). Each player has a very specific agenda. Businesses are seeking to maximize shareholder value (or returns to owners in the case of private companies), while localities are typically trying to secure long-term prosperity for their residents and sustainable, high-quality economic growth.

Both players may be represented by "agents." Businesses are frequently represented by management or site selection consultants, while communities are typically represented by chambers of commerce, economic development corporations, or economic development professionals. These two players may be thought of as participants in a relatively well-organized market—the market for progress! The business firms are "suppliers" of economic activity; the communities are "demanders." Given the large number of communities seeking to attract or expand business activity relative to available opportunities, it is clearly a "seller's" market and likely to remain so for the foreseeable future.

Economic development *is the process by which new dollars are infused into a local economy by primary employers.*

Primary employers *are companies whose products or services are ultimately used in statewide, national or international markets.*

The principal goal of economic development is to increase the per capita income levels of local residents.

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Thus, it is imperative that communities develop aggressive and innovative economic development strategies. It is also critical that public resources, such as incentives, be utilized efficiently to optimize expected returns. To that end, key elements of a viable economic development strategy are considered below.

Don't Lose Sight of the Big Picture

It is always important for communities to keep in mind the objectives of business firms considering new investments or projects. Their goal is to maximize value, which in a reasonably efficient world is achieved by maximizing the cash flow that can ultimately be distributed to investors. While incentives are often a critical part of the final site location decision, they tend to be considered *near the end of the process*. Any company seeking to locate or expand is going to be initially concerned with the fundamental factors that impact cost. Some of these items are beyond the control of local or state entities, such as proximity to customers, suppliers, or necessary raw materials. The only real lesson in such instances is that economic development resources should not be invested in projects for which essential conditions cannot be met.

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There are, however, many ways in which states or localities can positively impact the cost of doing business (and therefore, the attractiveness of a location) on an ongoing basis. Most high-quality projects need a well-trained workforce, quality infrastructure (transportation, communications), and adequate public safety and health. Businesses are also likely to value excellent schools and a variety of community amenities, such as parks and cultural venues. Virtually all companies benefit from a fair and competitive tax structure, as well as responsive governmental entities and a favorable regulatory climate.

All of these items, quality workers, good schools, efficient and modern infrastructure, are critically important to businesses making site location decisions. It is highly doubtful that financial inducements or incentives will be effective if a location is simply undesirable or likely to impose long-term costs.

But, there are obviously some trade-offs involved as well. For example, businesses clearly benefit from low taxes, but not at the expense of essential infrastructure or educational quality. Thus, it is essential that state and local fiscal policy be fair and efficient while providing public services in a workable manner. It is also highly advisable for state and local governments to employ a streamlined process for regulatory and permitting issues and a proactive approach to problem solving. States and localities also need to remember that they are often competing in what is increasingly a global environment.

Do your Homework

Every area has unique attributes that make it more competitive for some types of economic activity than others. In other words, the principle of comparative advantage works in the economic development market just as it does in any other market. In light of this fact, many areas (including Texas) have organized their economic development efforts around specific "clusters" of industries that tend to locate in proximity to one another.

It is important for community leaders and elected officials to understand the local business environment extremely well in order to properly deploy economic development resources. Some regions, for example, have excellent health care facilities that can foster emerging medical technologies. Others have research universities that are critical to various nanosciences. Some communities have environmental constraints; others enjoy strategic locations.

Communities should carefully and objectively assess their individual strengths and weaknesses and target those clusters for which they have the greatest probability of success.

While some factors, such as the availability of suitable building sites, are almost universally required, the needs of business firms and the capacity of localities to supply them are extremely diverse. Identifying ideal sectors for a focused recruitment effort is an admittedly imprecise and dynamic process. Nonetheless, through systematic and realistic evaluation, it is possible to greatly enhance the efficiency and rate of return associated with investments in economic development.

What About Incentives?

Assuming that an area has a competent economic development effort and seeks businesses within sectors where it has a comparative advantage, it can reasonably expect to receive serious consideration for new economic activity.

In order to go from "close" to "win," however, is normally going to require the use of incentives. On a philosophical level, the value and merits of such financial inducements may be legitimately debated. Moreover, there is little doubt that economic development resources have been misdirected or used inefficiently at times, leading some to advocate their elimination. As a practical matter, however, incentives are absolutely essential to an effective growth strategy. They should certainly be used in a prudent and rational manner, but they must be available.

The role of incentives can be readily viewed by again considering the economic development process in a market context. It is rare that a facility can only locate in one area. There are typically several suitable sites for which long-term costs are more or less equivalent. As a result, businesses typically develop a "short list" of potential communities that meet their workforce, transportation, and other

***Comparative advantage** is when a country, individual, company or region can produce a good at a lower opportunity cost than that of a competitor.*

*A **cluster** is a group of similar, interrelated firms concentrated in a geographic area. Silicon Valley's electronics and Seattle's aerospace industries are classic examples of clusters.*

Communities should carefully and objectively assess their individual strengths and weaknesses and target those clusters for which they have the greatest probability of success.

fundamental needs. As the final site selection process unfolds, the management of the firm seeking a new location has a fiduciary responsibility to provide optimal value to its owners. Similarly, if site selection consultants are involved, there is an expectation that they will bring substantial "value-added" (i.e., something extra) to the process.

Like most modern markets, the site location process is characterized by high levels of information access. Companies are well aware of the availability of incentives and the process of obtaining them. In this type of environment, states and localities must differentiate themselves from one another. The idea is to create a "tipping point" which drives the decision. In most instances, this objective can only be accomplished by offering a competitive incentive package.

It should be noted, however, that the fact that some incentives are essential does not suggest that all incentives are good. Incentives should be used properly and efficiently in a manner designed to maximize return on investment. The following sections describe some of the key components of the appropriate use of this critical economic development tool.

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Using Incentives Wisely

Focus on Exports and Primary Jobs

Promoting growth in a community (state, nation) requires that external funds flow into that area. To be effective, incentives must be directed toward activity that is export-oriented (i.e., sales outside the area, not necessarily only to foreign countries as the term is often used). Sectors that sell into external markets create "primary" jobs and investments (i.e., those that are supported by resources from other areas) and provide the foundation for sustainable prosperity.

__Primary jobs__ are jobs available at a company for which a majority of the products or services of that company are ultimately exported to regional, statewide, national, or international markets, infusing new dollars into the local economy.

Historically, the focus was on manufacturing, as such products are typically sold in national or (increasingly) global markets. Thus, virtually all of the money that supports local payrolls and purchases is originally derived from elsewhere. In recent times, there has been an increasing trend toward service businesses that reach large markets throughout the world. Tourism also brings in spending from other areas, and significant destinations can be important to community prosperity. From a state perspective, tourism brings net gains only to the extent that it attracts out-of-state visitors.

As a general proposition, establishments that primarily serve local areas should not be provided with significant incentives. Retail outlets, restaurants, and personal services establishments (e.g., drycleaners or nail salons), for example, tend to locate where there is an ongoing level of activity sufficient to support their requisite sales volumes. The resulting jobs and investments, while often substantial, are "secondary" in nature. They exist because of the strength of the primary sectors.

It is unlikely that these retail-oriented businesses will locate in an area with an inadequate economic base (and equally unlikely that they will avoid an area that offers them opportunities for long-term profitability).

What's more, unlike export-oriented sectors, establishments serving local markets are not choosing among competing areas around the country (or world) for a specific location. The only significant exception to this rule is a unique and large retail location that in and of itself becomes a major destination that attracts much of its business from outside the area. These types of venues are unusual, but they do exist. The basic premise remains true—economic development incentives should support export activity associated with primary jobs and investments.

The ideal incentive package provides the tipping point to attract new activity while simultaneously offering the community a suitable return on its investment.

Don't Give Away the Farm

Because of the intensity of competition and the pressure for success, there is a natural tendency for communities to offer incentives that are excessive relative to potential gains. The purpose of inducements is to create a "win-win" situation for the firm *and* the local area. An ideal incentive package provides the tipping point to attract new activity while simultaneously offering the community a suitable return on its investment. Within this framework, companies and their representatives are naturally going to seek as much as possible (much as some non-primary employers will pursue incentives). Companies have a responsibility to their shareholders to do so. It is equally the responsibility of local officials to only offer incentives that make economic sense. As such, cost-benefit analysis should be a part of the economic development process. In addition, firms receiving incentives should be held to some level of accountability for promised performance.

It must be noted, however, that the criteria for evaluating incentive packages must be carefully considered. "One size fits all" formulas rarely work. As a general proposition, the standards should go beyond the recoupment of public resources. If a project brings high quality jobs and investment relative to other available alternatives, it may be a viable use of public funds even if it has a relatively long "payback" period. On the other hand, a project that offers a rapid return of the public investment, but is not compatible with local economic objectives may not be worth pursuing. The bottom line is simply to be thoughtful about the process and only provide incentives that are justified on a cost-benefit basis.

Recognize the Realities of the Modern Economy

Traditionally, the focus of economic development efforts has been on job creation. In today's economy, however, a broader set of objectives may be justified. In particular, high levels of capital investment are often more important to future prosperity than simply the number of direct jobs created. As the global economy has evolved, there has been a definitive pattern toward the outsourcing of lowerskilled manufacturing and service jobs to other countries. Thus, locations which bring large numbers of relatively low-wage jobs are particularly vulnerable to international competition. Substantial capital investment (buildings, equipment), on the other hand, tends to be associated with technology-oriented industries that bring long-term benefits and opportunities for economic growth. Different communities have varying capabilities and resources, and a healthy dose of common sense is clearly required in recruitment efforts. It should be emphasized, however, that capital investment is often an excellent barometer of the value of a new or expanded location.

Maximize the Multipliers

When deciding the best allocation of economic development resources, it is important to optimize the "bang for the buck." This objective is achieved by focusing efforts on projects exhibiting high "multiplier" effects.

The economic benefits associated with a particular business relocation or expansion increase with the value of local purchases and spending. Therefore, a community receives more economic benefits if it has a network of suppliers and the capacity to provide the new business with needed services. This pattern is one of the key reasons why it is so important for communities to concentrate on "clusters" of activity. For instance, a rural area may obtain more payoff from an agricultural processor that can use local production as a primary input, whereas a large urban area may be better suited for an emerging technology. Because of transportation costs, compatible labor requirements, and other synergies, an emphasis on maximizing multipliers is typically synonymous with providing companies with a cost-minimizing strategy, thus heightening the chances for success.

__Multipliers__ are a way to quantify economic relationships among different business sectors—or, put more simply, the "ripple effect" one business activity has on another. The higher the multiplier, the greater the economic impact.

Lessons Learned

What does this all mean for economic development and the use of incentives?

The economic development process is intensely competitive.

Attracting and retaining business activity is an intensely competitive and organized market, defined by sophisticated participants and substantial flows of information. The market is relatively efficient and requires a concerted effort from communities seeking to be effective "demanders" of long-term progress.

The site selection process involves much more than incentives.

While attention and controversy inevitably surround the subject of incentives, the overall economic development process is much more comprehensive, encompassing public education, workforce training, infrastructure, tax policy, regulatory matters, and a host of other factors. Without adequate attention to these issues, even the best of incentive programs is largely superfluous.

To be effective, incentives must be centered on export activity that creates primary jobs and investment and brings in external funds.

Incentives are a fact of life in the economic development market.

The next key lesson is that, like them or not, incentives are a fact of life in the economic development marketplace. To be effective, however, incentives must be centered on export activity that creates primary jobs and investment and brings in external funds to circulate in the community. Incentives should also be distributed in a systematic manner that effectively balances costs and benefits for the betterment of the state or locality. They should provide an appropriate emphasis on investment and long-term prosperity and be geared toward those areas that offer maximum returns and probabilities of success.

Economic development occurs in an uncertain environment.

As a final note, it must be recognized that, like most modern markets, economic development occurs in an uncertain environment. It is therefore unrealistic to expect community leaders and economic professionals to function with perfect foresight and never make mistakes. The criteria for evaluation should be geared toward achieving the highest "expected" returns, a standard synonymous with following the systematic processes outlined above.

Looking Ahead

After a long period of lagging behind, the State of Texas has become extremely competitive in its economic development effort. The combination of the Texas Enterprise Fund, the Texas Emerging Technology Fund, Chapter 313 appraised value limitations (HB 1200), the local option economic development sales tax, and numerous other state and local initiatives, has led to impressive achievements in the past few years, despite the national economic slowdown.

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Future success is critically dependent on three key factors: (1) aggressively providing infrastructure, education, and other key elements of the business climate within the context of a favorable regulatory environment and fair, equitable, and efficient tax structure; (2) enhancing certain economic development programs, such as job training, in which Texas, despite the popular Skills Development program, is not yet fully competitive; and (3) maintaining the current program of state and local incentives while ensuring that public resources are used in a proper and efficient (though not perfect) manner. Through such efforts, communities across Texas can be assured of a meaningful opportunity to pursue their destiny and achieve sustained prosperity.

About the Author

Dr. Perryman is Founder and President of The Perryman Group (TPG), an economic and financial analysis firm headquartered in Waco, Texas.

He has authored several books, including *Survive & Conquer*, an account of the Texas economy during the turbulent 1980s. A popular speaker, he addresses hundreds of audiences throughout the world every year.

During his more than 25 years of experience, he has been presented citations for his efforts from both the Congress of the United States and the Texas Legislature. He is a Fellow of the International Institute for Advanced Studies and recently received the Institute's prestigious Lifetime Achievement Award.

Cited by major media as "a world-class scholar" and "the most quoted man in Texas," Ray Perryman is an active participant in the state, national, and world economic scenes. He has been a member of dozens of state, federal, and international task forces, served as editor of both academic and trade journals, and led conferences within the fields of economics, statistics, forecasting, modeling, and simulation. A member of several corporate boards and advisor to numerous governmental leaders, Dr. Perryman has been honored by the Texas Legislature for his "tireless efforts in helping to build a better Texas." In 2012 he was named Texan of the Year at the 46th Annual Texas Legislative Conference.

About the TEDC

The Texas Economic Development Council (TEDC) is an Austin-based, statewide professional association dedicated to the economic development profession in Texas. TEDC members include economic development professionals, elected officials, and community volunteers from every part of the state.

The TEDC provides information, educational and legislative services to more than 800 members. The Council's objective is to expand existing industry, recruit new firms to the state and develop strategies that promote a positive business climate in Texas.

The TEDC has played a leadership role in the formulation of Texas' economic development policy, and has actively worked in support of legislation creating the Economic Development Sales Tax, the Skills Development Fund, the Texas Enterprise Fund, the Texas Emerging Technology Fund, and other critical programs.

Texas Economic Development Council
1011 San Jacinto, Suite 650
Austin, Texas 78701
Phone: 512.480.8432
www.texasedc.org

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