

Incentives across borders:

Incentives and their impact on foreign investors in the U.S.

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Against the backdrop of a stubborn global economic crisis, a thus far anemic recovery, and a wide array of economic stimulus measures undertaken by both the federal and state governments, there has been renewed interest and activity in foreign direct investment (FDI) in the United States. With this comes renewed interest in and discussion of the type and amount of incentives that are being used to attract it. Successful and forward thinking US economic development agencies (EDAs), still absorbing and applying lessons learned from extremely robust global competition for FDI over the past 15 years – a competition where US agencies generally lost more than they won -- are actively reviewing, refreshing, and recreating their incentives programs, particularly those aimed at the foreign investor.

This reinvigorated interest in incentives raises the policy question of whether incentives are truly important to foreign investors or is the allure of accessing the lucrative US consumer and commercial market already incentive enough? The short answer is yes, but perhaps for different reasons than for domestic investors. Understanding what those reasons are, how they differ for foreign investors, and which incentives are most likely to be of enough importance and value to influence their location decisions can be vital to economic development agencies (EDA) when forming incentives policy and ensuring that their incentives “toolbox” is stocked with incentives specifically designed to meet the needs and expectations of foreign investors in specific industries and corporate functions.

The first step in determining how and which incentives are likely to be most attractive to foreign investors is to understand what drives “bricks and mortar” foreign investment -- factories, R&D centers, distribution centers, shared services centers, and the like – to the United States.

A company’s location requirements, and in turn the types of incentives that will likely be of most value to them, vary widely depending on their industry or business function. The EDA must understand not only whether the operation the company seeks to deploy is a manufacturing, distribution, or services oriented function, but also whether it is capital, labor, knowledge, or logistics intensive? If it is manufacturing, is it a heavy process (extensive use of raw natural resources, high utility usage, etc.) or a light manufacturing process (basic assembly or electromechanical operations)? Is the operation primarily cost or quality driven? And how might this evolve over time - what are the drivers of their other corporate functions which they might be interested or in, or could be enticed to deploy at this location in the future?

Knowing the business drivers behind both the industry and the function(s) they are seeking to deploy ultimately defines which incentives and policies are likely to have the greatest impact on their decision process. Naturally, the better the EDA understands industry and functional drivers, the more likely it can align its incentive policy and tools to the specific needs of that industry and function, for both immediate and potential future deployment opportunities.

For example, Figure 1 lists a set of conventional corporate location decision drivers, which type of industry or function they will normally influence, and the type of incentives or assistance that typically have more impact on these companies and functions:

Location Decision Drivers	Examples of Affected Industries and Functions	Examples of Likely Impactful Incentives
Access to Talent / Specific Skills	Knowledge-or Skill-Intensive: <ul style="list-style-type: none"> • Advanced Manufacturing • Life Sciences • Semiconductors / Advanced Electronics • Solar Wafers and Cells • R&D Centers • Headquarters • Software/IT Development • Financial or IT shared services • Help Desks 	<ul style="list-style-type: none"> • R&D grants • Recruiting and training • Customized training • Formalized university and technical college programs and R&D collaboration
Labor Costs	Talent/Labor-intensive: <ul style="list-style-type: none"> • Manufacturing assembly operations • High-skilled processing • Shared services centers • Call Centers / Help Desks • Large scale distribution centers (e.g., retailers) 	<ul style="list-style-type: none"> • Recruiting assistance • Screening assistance • Temporary recruiting and training space • Customized training • Subsidized training salaries / wages • Subsidized OJT wages • Subsidized travel costs for overseas home plant on location training • Ongoing technical college / university training collaboration
Real Estate	Land- or Space-Intensive: <ul style="list-style-type: none"> • Auto Assembly 	<ul style="list-style-type: none"> • Subsidized land or

	<ul style="list-style-type: none"> • Steel • Pharmaceuticals • Polysilicon • Chemicals • Aerospace/Defense • Large-scale Distribution Centers • Large scale HQ's • Software/IT Centers • Shared Service Centers • Call Centers / Help Desks 	<ul style="list-style-type: none"> • space cost (publically controlled real estate) • Pre-assembled and controlled land or space • Land preparation (clearing, leveling) • Property tax abatement • Zoning and permitting assistance – fast track • Road improvements • Utility infrastructure improvements
Utility cost, capacity, and quality (Electricity, Natural Gas, Water)	<p>Process- or Capital-Intensive:</p> <ul style="list-style-type: none"> • Polysilicon • Steel • Forgings • Semiconductors • Pharmaceuticals • Chemicals • Paper • Food Processing • Solar Cells • Data Centers 	<ul style="list-style-type: none"> • Line extensions • Line upgrades • Capacity upgrades (e.g., substation upgrade) • Rate reductions • Fast-track timing of extensions and connections
Freight Costs and Speed to Market	<p>Logistics-intensive, Time-Sensitive operations:</p> <ul style="list-style-type: none"> • Distribution Centers • Tier 1 and Tier 2 automotive suppliers • Wind Industry components • Food Processing 	<ul style="list-style-type: none"> • Fully-prepared buildings or sites close to major highway interchanges • Very high quality road access to highway • Subsidized sites • Abated inventory and other property taxes
Taxes	<p>High-margin, tax sensitive:</p> <ul style="list-style-type: none"> • Life sciences • high and emerging IT • Advanced manufacturing • Private- or closely-held companies • Headquarters 	<ul style="list-style-type: none"> • Tax holidays • Tax credits / abatements • Single sales factor tax

Figure 1

In addition to understanding how incentive tools correlate with industry and functional decision drivers, for foreign investors, the EDA should also understand the cultural nuances and specific history and experiences of the specific foreign company they are targeting. How has the company's historical growth in its home country and in other countries where it has deployed operations affected their perspective of EPAs and of government incentives? These questions and issues can have equal or more influence than typical functional decision drivers, and can help guide the EDA in the creation and packaging of incentives that better match the foreign investor's needs and global experiences. For example, is the company based in, or do they have recent location selection experience in a country with:

- Lower or higher labor costs?
- Lower or higher taxes?
- Low cost or subsidized industrial land or high cost real estate?
- Robust or poor utility and transportation infrastructure?

Has the company recently deployed operations in:

- Low operating cost countries? Which are the low costs: labor, real estate, taxes?
- Countries with lucrative incentives? What type of incentives: cash grants, reduced taxes, real estate, infrastructure, training?

Beyond their operating and deployment experience, are their current operations typically deployed in:

- Highly urbanized, suburban, or more remote environments?
- Industry clusters with close customer and vendor connections?
- In areas with concentrations of specific suppliers and services?

Understanding the company's deployment history and experiences, especially recent history, can instruct the EDA on their target's expectations along with areas of focus for incentives and other assistance. For example:

- Quite often investors from Europe and Japan perceive that American workers lack experience and training in advanced manufacturing operations and have less developed skills than workers in their home country. In these cases, the company's operations may currently be located in regions with as high or higher labor costs than the US, but they workers with the education, experience, and skills their process requires. Therefore, incentives that subsidize wages during the training period may be less alluring than providing more robust and intensive skills recruiting and screening, customized training programs, or subsidizing travel expenses to fly new hires to the home country for intensive, on-location training at an existing company operation.

- Companies where land is expensive and less abundant find the ability to acquire land in the US at a relatively low cost with area sufficient for future expansions – preferably suitable for other products and functions – to be very enticing.
- Companies that have recently deployed operations in a low cost country with expensive and/or poor quality utilities, will find incentives that provide for free or low cost utility line extensions, line and capacity upgrades, and rate reductions push their location hot buttons.
- A scenario common to most US EDAs is the impression created by the high combined tax burden foreign companies will face when looking to establish operations in the US. While corporate tax burdens are being reduced or are already low in much of the industrialized world, the combined federal, state, and local tax burden in the US remains comparatively high. Incentives that reduce the state and local burden – corporate, property, sales – help lessen the impact of high US federal corporate tax rates. And providing insight and guidance as to how the foreign company’s federal tax burden could be lowered (e.g., tax credits for R&D or alternative energy manufacturing) can be seen as a valuable service to the foreign company, and display awareness to a specific competitive disadvantage.

Once the business drivers, cultural factors, and historical experiences underlying an investor’s specific case are better understood, it is important for the EDA to also determine which type of incentive is most likely to be highly valued by the foreign investor. Incentives are generally either “one-time” or “ongoing”, and either a “hard” or “soft” dollar incentives. Figure 2 summarizes common incentives along these continuums:

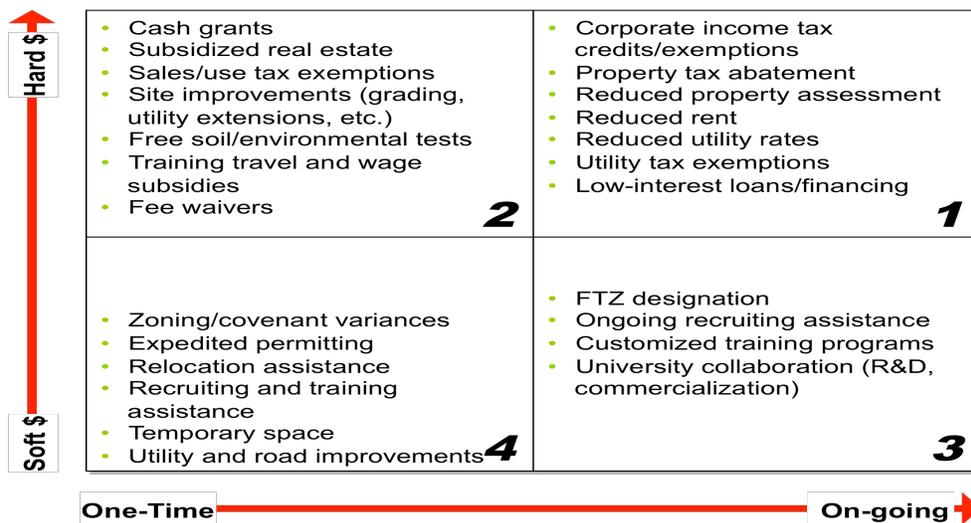


Figure 2

Foreign investors, like all investors, are typically most interested in all types of “hard” dollar incentives that lower capital and operating expenditures. Cash grants, subsidized real estate, tax burden reduction, and so forth are more easily quantified and translate in to bottom-line financial impact.

But EDAs should not neglect the value and importance of properly targeted “soft” dollar incentives. One-time and service-in-kind assistance, such as permitting assistance, recruiting and training services, and the provision of temporary space during start up are valuable and helpful services to foreign investors, especially those new to the US. Ongoing services, such as established training programs developed with local vocational and technical schools, or the creation of relationships with area universities for R&D and commercial development build long- term goodwill with the foreign investor that are not only be a factor in the decision to invest the first time, but also to continue to expand and evolve the investment in the community over time.

Finally, it is becoming increasingly important for EDAs to understand how the location decision process is evolving, particularly for the larger and more sophisticated companies, and how these investors are seeking to achieve more from their US location choice to meet a broader range of future business objectives.

Historically, most companies investing in foreign countries have been primarily driven by a need to create or enhance access to new markets and customers. Whether activated by a desire to reduce logistics costs, increase speed to market, or improve brand awareness, establishing a physical presence within the foreign country has been of paramount importance. And then depending on what factors and issues drive their operations – are they talent, utility, or transportation intensive -- a particular region or city within the foreign country further defines a second set of project drivers, such as the abundance of a specific talent set or access to plentiful and low cost electric power. Recently, more foreign investors are employing a more comprehensive and integrated US location strategy, what we call the “convergence” model (Figure 3), to ensure a more holistic decision process that creates a flexible platform for long-term success in the US market.

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Convergence Deployment Model

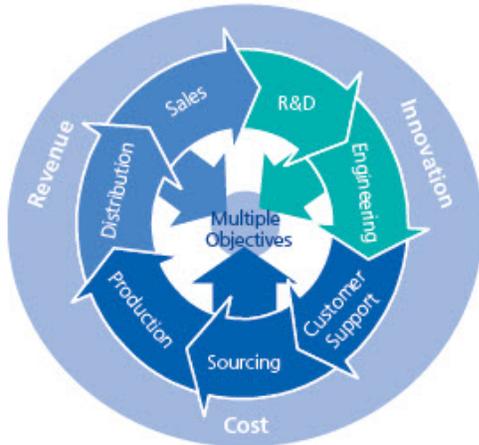


Figure 3: Convergence Model

Simply put, the convergence model prescribes that rather than basing the location decision solely to satisfy one set of market or operating objectives -- such as proximity to a specific customer(s) or reducing labor costs -- a more holistic decision process is utilized that looks broader and longer term, and seeks to squeeze more out of the foreign capital expenditure. The choice for the new US location should therefore seek to optimize multiple factors and objectives, including perhaps for functions or products not currently under consideration. For example, if a foreign company is seeking to establish in the US primarily to serve a specific market or customer with a specific product or service, the driving location decision factor will likely be optimizing physical access to that market or customer. Normally then, the closer the better; the company may simply seek workable real estate as close to the customer as possible. When employing the convergence model, however, although still requiring a location with acceptable proximity to the customer, the more holistic decision process requires that the company look more broadly across multiple issues and factors to identify locations that satisfy not only the immediate functional requirements of the operation making the current site decision, but also those of other company products, services, or functions, even though these are not immediate location requirements. The company may decide to look for a deeper, more flexible and innovative talent pool than may be required by the initial investment. They may seek to ensure that variable operating costs -- both start-up and ongoing costs -- are optimized across a wider spectrum of factors, thereby meeting the potential future needs of other corporate products and functions.

The convergence model decision process may seem to be more complex than what would be necessary for the decision at hand, but it also leads to a more robust and flexible decision with longer "shelf life". If and when the company expands its US

footprint in the future - adding more or different products, services, or functions - they are now more likely be pre-positioned to deploy the new investment at the existing location -- both faster and cheaper. Had they made the original decision based solely on the primary determinant of that specific function and that time, they may instead be forced to launch a new location search for yet another single-function or single-operation site decision.

Successfully attracting the longer-view foreign investor employing a more holistic decision process in turn demands that the EDA portray a broader, more comprehensive image of regional economic capabilities, and in turn, demonstrate a broader, more flexible set of incentive tools appealing not only to the company's investment at hand, but also to their other products, services, and functions that may follow in the future.

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Incentives are no less a strategic tool for EDAs in the attraction of foreign investors than they are for domestic investors, and indeed, may be more so. But the type of incentives and how they are offered, packaged, and deployed are often quite different. For an EDA to be consistently successful in attracting and growing foreign investment, they should not only thoroughly understand the requirements of and competitive trends within the industry and function of the target company, but also the company's past experience with foreign investment, the cultural nuances of business and expansion within their home country, as well as the company's other products and functions that could well co-invest at the site in the future. Packaging this knowledge with an understanding of which specific incentives, hard and soft dollar, one-time and ongoing, are likely to best resonate with and have real value to the investor will go a long way towards establishing successful experiences in the attraction and expansion of foreign investment.