Economic Development Basics

by James M. Klas

Tribes have become quite experienced and adept at major economic development projects over the past 30 years as Indian gaming has moved from its early bootstrap stages to the full-scale casino resorts of today. They are now using that experience, and the profits generated by gaming, to expand into other economic development projects both on and off the reservation. However, many tribes still have more limited experience and resources due to their geography, compact rules and other factors. Even for tribes that have more extensive development experience, new council members may not have the same background in basic development principals and terminology. For that reason, a review of development basics may be helpful.

Development Goals

An Indian tribe may pursue a particular development option with more than one goal and the same type of development may be pursued for different goals in different circumstances. While private development is overwhelmingly pursued with the primary or even sole purpose of generating profits, tribal development can be pursued for varying or multiple goals.

Profitability is still a major, even primary, goal for tribal development, just as it is in the private sector. However, tribes have an added economic incentive in some cases not available to private operators: tax revenue generation. As a taxing authority, tribes can obtain additional economic benefit from a tax generating business that can enhance its value to the tribe beyond what would otherwise be true. Indeed, for non-tribal governments, tax revenue generation is the primary reason that such governments provide incentives and even subsidies to encourage private businesses to locate within their jurisdictions.

Employment is often another key development goal for tribal economic development. The goal of generating employment can lead tribes to develop and even subsidize businesses that cannot fully support their own development and operating costs, provided that the subsidies are sustainable within the overall economic conditions of the tribe.

Meeting the product, service or quality of life needs of their membership is another major goal of tribal economic development. Often, a particular development option that does not generate significant profits or even significant employment may still be warranted because the local tribal community needs access to what it can provide.

The goal of simply broadening and diversifying the overall economic base of the tribal land and community may also warrant pursuit of developments that otherwise do not generate the highest levels of profits and employment. Often it is advisable to pursue or encourage a range of smaller and more diverse businesses so that the seasonal or market fluctuations of core businesses have a less severe impact on the overall economy. Where an economy is forced by location and circumstance to rely on a limited number of major drivers, such fluctuations and their side effects cannot be completely avoided; but they can at least be mitigated, with a more modest but still valuable level of economic activity sustaining the area until the fluctuations move back in a positive direction.

Development Categories

Any type of development can be classified into three broad categories: Supporting Development, Community Development, and Business Development. The categories are less rigidly separated or mutually exclusive than overlapping ranges on a continuum. An individual project may have elements that fit into more than one category and the same type of project may fall under one category in one location or set of circumstances and fall into a different category in another. However, it is important to understand the primary category a particular development option best fits in a particular location and set of circumstances to effectively determine its suitability. The characteristics of each category are described in the following paragraphs.

Supporting Development: The primary purpose of supporting development is to enhance the performance and customer value of a major core business that is already in place or that is planned to be the focal point of a particular location or development project. Examples would include doctors' offices or pharmacies in or near hospitals, gift shops or restaurants in casinos, tasting rooms or retail stores in wineries or agricultural ventures, convention centers in downtown areas or at resorts, gas station/convenience stores near tourist areas or business districts, parts suppliers or maintenance/repair services near manufacturing facilities or extraction/exploitation ventures, and any other development type that serves to support and survives off of the primary demand of another, usually larger, operation or attraction. The purpose is to take care of the core business. While the individual supporting development usually is intended to make money in its own right, it is dependent upon the existence of its symbiote that it supports and it does best when that symbiote does best. If the larger and smaller ventures are under joint ownership and management, such as the gift shop or restaurant in a casino mentioned above, then the maximization of profit in the supporting development may be sacrificed to some degree if it more fully benefits the larger venture it is designed to enhance. Where ownership and management are independent, there can be tension between the profit maximizing goals of the operator of the supporting development and the needs of the larger complex/district. However, both will function best when working closely together.

Community Development: Community development is designed to meet a need of its surrounding community, even if that means sacrificing profitability or maintaining unprofitable operations, provided that the cost of developing and maintaining those operations is sustainable within the broader economic environment. Community development is designed to improve quality of life, provide employment, enhance the economic stability of an area, meet product and/or service needs that cannot in themselves generate adequate investment grade profits, and provide opportunity for broader economic growth. Examples can include museums and cultural centers, community centers, business incubators, certain types of retail or manufacturing, or other development options that are intended to meet a particular need of a community that would not otherwise be met.

Business Development: Business development is designed with the primary purpose of making money in its own right and primarily in its own strength, although it may benefit from and perhaps at times even require one of the other development forms in conjunction with it. Business development is pursued for profits, for investment and growth and, uniquely in a tribal setting, for tax revenue. To support profitable operations, business development requires a sufficient demand base, an effective means of distribution, adequate employment and supplier base, and an adequate gap between the cost of production and distribution and the price the market is willing to bear. The absence of any one of these factors can make an otherwise attractive business venture unsuccessful. Thus, demand may exist for a particular business development but not at price or not in a volume that can satisfy the barriers to entry and cost of production. Similarly, an area can have the requisite raw materials and work force in abundance to produce a valuable product or service but insufficient demand to support a viable venture. While exporting can alleviate that problem, it adds to the cost of providing the product or service to the end user and increases the cost and complexity of attracting their demand.

Ownership/Management Structures

There are multiple options for the ownership and operation of the various major development components, as well as lesser components such as individual businesses, beyond simple direct tribal ownership and management. The merits of various options are discussed below.

Leasing: Under a leasing structure, the developing tribe would provide the land or buildings (i.e. strip retail centers) to an independent operator who would pay rent, common area costs, utilities and other fees for the rights to the space for a specific period of time. The independent operator would own and manage the business and all movable goods and furnishings. The tribe would act as a landlord. The advantages of a lease arrangement include lower costs, lower business risk and much lower management overhead. Disadvantages include lower potential return, at least in total dollar terms, more limited control and the risk of on-going vacancies.

Franchising: Under a franchise agreement, the owner/operator obtains the right to use the name, proprietary products and processes, marketing programs, purchasing power and industry expertise of the franchisor in exchange for paying franchise, royalty and/or marketing fees and agreeing to abide by their rules, quality standards and marketing initiatives. Sometimes this includes purchasing raw materials or finished product for resale directly from the franchisor or an approved vendor. Advantages of franchise agreements are the name recognition, expanded marketing reach, access to industry expertise and prepackaged design and operating standards. Disadvantages include the need to conform to and participate in the programs, standards and marketing initiatives of the franchisor, the cost of the franchise and marketing fees, and the fact that, although training and standardized methods and design are available, the owner/operator still must actually develop and run the business, taking the associated risk and supplying the necessary financial and human capital.

Management Contracts: Under a management contract the owner engages an outside entity to run the business for them in exchange for a fee and possibly a direct or indirect share of the profits. The management company is responsible for training, operation, hiring and firing, and meeting profit goals. The owner gains the added benefits of ownership while hedging somewhat against the inherent business risk. Management contracts may, but often do not, include licensing rights to the name and marketing programs of the management company. Management agreements are most advantageous when an owner wishes to develop a business but does not have the time or expertise to run it themselves.

Joint Ventures: In a joint venture, the developing tribe would partner with another individual or entity, perhaps more than one, to own and manage the business. The roles of the various partners would be defined in the agreement and typically would not be a simple split of all functions but rather an allocation of entire functions between the partners based upon their relative strengths and interests. One partner may provide day-to-day management and a limited contribution to capitalizing the business while the other would provide the majority of the capital and maintain a less direct role in the operations. Business risks and profit potential are shared in proportion to the amount of the partnership or joint venture each entity controls.

Investment Returns

Regardless of the development goals, the type of development and the operating structure used, the inherent taxing authority of tribal governments should be used to obtain the maximum tax revenue generation possible for each development consistent with the tax regulations and rates of the broader area in which the development is located. Typically, tribes set rates and regulations that mirror the state, county and local taxes for the same development type in surrounding non-tribal communities. Occasionally, tribes may choose to forego the full tax benefits available for development they own and operate outright in order to gain a price advantage over the surrounding competition. However, a mirrored tax structure is more common. The tribe must develop its own suitable tax regulations, rates and collection infrastructure and/or reach compact agreements with their surrounding state to govern tax collections and disbursements.

In terms of profitability, tribes must avoid what is known as the "IRR Trap" in evaluating potential development opportunities. IRR, or Internal Rate of Return, is a common tool in evaluating the potential merits of an economic development, but it has an inherent weakness in its implicit assumption that all profits generated in a given year can be reinvested in some form that will also generate profits at the same rate. The problem for tribes with casino resorts is that few other development options generate the same profit percentages and investment returns as casinos. However, a lower profit margin does not mean that a different form of development is a poor investment. Since there is a practical (or compact) limit to the number and size of casinos a tribe can develop, alternative development opportunities must be evaluated on their expected profits relative to other businesses of their type, and/or relative to other non-gaming development options or investments available, rather than to the profits a casino can generate. Otherwise, tribes can forego potentially valuable development opportunities simply because they, like most businesses, cannot generate casino-level returns. ♣

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