

## A SIMPLE MEASURE OF LOCAL ECONOMIC IMPACT

Introducing LM3: An indicator of corporate impact on local economies

A discussion paper and invitation from TwentyFifty Limited and K2A LLP

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This paper is jointly-authored by K2A LLP and TwentyFifty Ltd. We have written this paper to present the opportunity for wider use of a simple tool developed in the UK that focuses particularly on capturing the contribution of corporate activity on local economies. LM3 is one solution to measuring the local economic impact of business activity. It does not provide a full assessment of your company's multiple economic, social and cultural contributions to the communities where you operate. However, we do believe LM3 is an addition to approaches already available (signposted in this document), and particularly helpful for companies wanting to get started with assessments and/or to fit local economic analysis into their existing strategic thinking and reporting. In order to explore this, we are co-hosting a business round-table **on January 23rd 2008 in London.**



## 1. THE OPPORTUNITY

Sometimes the most complex challenges are best served by starting with a simple solution. In this paper, we present an opportunity for businesses to measure their economic impact on local communities using an efficient and simple method. The approach (LM3) also allows your business to identify strategies and actions for improvement.

A healthy economy is an indicator of the general standard of living and wellbeing of the population. At a more sophisticated level, the idea of money flowing in a locality can be understood as the number and size of transactions within an economy. Greater flow indicates healthy commerce and the shifting of money from one person/group/business to another within the defined locality. This is an alternative way to monitor the spread of the benefits of economic growth in a defined locality, as compared to macroeconomic indicators such as GDP. However, flow per se is not enough. It is common for investment or expenditure in a particular locality to flow straight out of the locality – especially where the economy is unable to offer the products and services demanded. If money 'leaks out' of the local economy (e.g. by being spent on suppliers with minimal local expenditure or in the form of tax payments to central government) then the standard of living and wellbeing of local communities can suffer the equivalent of a 'glass ceiling'.

LM3 measures the multiplier effect of income into a local economy over three 'rounds' of spending. In short, LM3 is a composite measure of:

- a company's turnover or procurement and employee budget,
- how the company spends that budget, and
- how suppliers and employees re-spend their incomes.

LM3 is calculated with reference to a defined local area selected by the user. Following some basic multiplier calculations, the result is an indicator in the form of a single number. For example, an LM3 score of 1.50 would indicate that every \$1 earned by your company generates an additional \$0.50 for the defined locality. LM3 is based on the sales multiplier, a common indicator in economic analysis, combined with geographic information tailored to each LM3 project.

LM3 has been applied in the UK public sector at local government levels, with positive practical results around local supply chain creation. Though not part of the formal UK Treasury assessments<sup>1</sup>, the documented success of LM3 to shift public sector procurement practice, LM3 is now referenced in UK government policy on sustainable procurement and efficiency.<sup>2</sup>

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<sup>1</sup> Outlined in the HM treasury Green Book – All new policies, programmes<sup>1</sup> and projects, whether revenue, capital or regulatory should be subject to comprehensive but proportionate assessment, wherever it is practicable, so as best to promote the public interest. The Green Book presents the techniques and issues that should be considered when carrying out assessments.<sup>2</sup>, of policy/practice, whether revenue, capital or regulatory, should be subject to comprehensive but proportionate assessment, wherever it is practicable, so as best to promote the public interest. The Green Book presents the techniques and issues that should be considered when carrying out assessments. <http://greenbook.treasury.gov.uk/index.htm>

<sup>2</sup> LM3 is cited as a methodology for measuring economic sustainability in public procurement in *Procuring the future: Sustainable Procurement Action Plan*, Recommendations from the Sustainable Procurement Task Force, DEFRA, 2006, pages 21, 64. LM3 is accepted in *UK Government Sustainable Procurement Action Plan: Incorporating the Government response to the report of the Sustainable Procurement Task Force*, DEFRA, 2007,

In the UK and European countries, LM3 is supported by LM3 Online, which simplifies supplier surveying, automates calculations and stores data for project management. LM3 can provide comparability between corporate results, and it opens up possibilities for businesses to:

- Capture a view of company impact on local communities based on company-specific versus macro-economic data/ statistics
- Identify opportunities to build local supply chains through enterprise development
- Leverage purchasing behaviours for community development
- Engage existing suppliers in the economic, social and environmental value of local purchasing
- Support supplier diversity strategies by Identifying which groups (gender, ethnicity, age, faith) benefit from local commerce;
- Secure its licence to operate by demonstrating local contribution

## 2. LITERATURE REVIEW: PLACING LM3 IN CONTEXT

LM3 allows companies to measure one specific component of their impact on a defined locality, namely economic contribution via any aspect of operations: donations, procurement and employment. This section provides a wider context of thinking and work done by the private sector in the area of economic and other impacts on communities. The purpose of highlighting the wider picture is to:

- Provide context for considering the value, applicability and appropriateness of LM3 to your business;
- Demonstrate that companies in a range of sectors measure economic impact and report on it in a variety of ways.
- Signpost companies wishing to undergo a broader assessment and rethinking of their socio-economic impacts, to leading/best practice from the extractives industry

### *BSR 2005 REPORT ON ECONOMIC IMPACTS*

*'6 out of 33 companies only included financial performance information and missed the point completely about accounting for the effects of money flows on the economic circumstances of their stakeholders'*

*Reporting on Economic Impacts: A report by Business for Social Responsibility for the Global Reporting Initiative (October 2005)*

In 2005, Business for Social Responsibility published a report to feed into the GR3 working group around this topic<sup>3</sup>. The report reviewed the most recent reports of 33 companies from a range of sectors as part of this work. Corporate interpretations of the Global Reporting Initiative (GRI) requirements on economic impact are a helpful indicator of the state of play internationally, as these are internationally recognised and widely adopted by the corporate community. Key findings included:

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pages 51, 58.

<sup>3</sup> [http://www.business-humanrights.org/Links/Repository/792836/link\\_page\\_view](http://www.business-humanrights.org/Links/Repository/792836/link_page_view) and [www.bsr.org](http://www.bsr.org)

#### Regarding GR2 'Direct Economic Impacts'

- Companies tended to report on their own financial performance. Where expenditure was reported it was in the form of a 'lump sum' globally or nationally (as per the report referenced above).
- Companies did provide helpful qualitative statement and assessment about their impact on national and local economies.
- Companies reported on philanthropic donations or community investments, which BSR recommended be shifted into another section of the reporting guidelines.

#### Regarding GR2 'Indirect Economic Impacts'

- Companies understood this in two different ways: a. using the multiplier effect approach connected to spend on suppliers and employees and b. assessing the benefits that their products and services have on the economy (popular among the ICT and Pharmaceuticals industries).
- Companies using the multiplier effect used national statistics and input-output accounting mechanisms. This was done through engaging external consultants and academic institutions.
- The GR2 guidelines did not contain any indicators for 'Indirect Economic Impacts'.
- With a few exceptions, companies reported their impact as inherently positive on the economy.

Finally, the report made a number of recommendations connected to the theme of this paper; namely to:

- Introduce indicators for 'Indirect Economic Impacts' to meet the GRI principle of *Comparability*.
- Create an indicator specifically focused on the local multiplier effect with the following guideline 'Significant economic impacts when supplier and employee income generated by the organisation is in turn spent on the local economy'.
- Utilise sectoral working groups to develop indicators and approaches to use in the G3 sector supplements.
- Introduce a new third aspect headed 'Local Economic Impacts'.
- Feed the innovation and deeper understanding of communities, poverty, local supply chains already being shown by some companies into guidelines for reporting.

#### *RECENT REPORTING*

The BSR report was conducted two years ago. In preparing this paper, therefore, we have conducted a brief review of 10 publicly available corporate responsibility reports from a range of sectors. Our conclusion is that the findings of the BSR report are still relevant and fair. We have found companies by and large not to report on the impact of procurement activities and their multiplier effects on a local economy, the area of focus for LM3. Total spend on goods and services is the most commonly referenced.

Nonetheless, references to the commercial and societal benefits of local supply chains are growing. Business leaders are demonstrating an ever-deepening understanding of these issues. And, many multi-nationals already support local business through an array of enterprise development activities. Though not limited to this context, leadership and innovation is most obvious in South Africa given the legislative context of Black Economic Empowerment. The 2004 Act requires companies to support BEE via (among other things) preferential procurement, and enterprise development. Examples can be

found in the procurement behaviours of multiple sectors and include support for enterprises in textiles, cleaning services, recycling, catering and construction. This is achieved via investment, soft loans, management support, and technology transfer.

### *LEADERSHIP FROM THE EXTRACTIVES SECTOR*

We have also looked deeper into the work of the extractives (especially mining and metals) sector, widely recognised as leaders in assessing socio-economic impact. For those companies (and their stakeholders) wishing to undergo a broader shift in their understanding and strategies regarding socio-economic impacts, two initiatives stand out:

- The Resource Endowment project led by the ICMM<sup>4</sup> and
- Anglo American's Social and Economic Assessment Tool Box (SEAT)<sup>5</sup>.

Both have been written with consultation from business leaders, NGOs, governments, communities, global institutions, and a range of world-leading development and economic experts. Both encourage and guide companies to take a view of the wider (systemic and systematic) view of a corporation's contribution to the communities and countries where they do business. Importantly, this is done to support business leaders to understand the most effective mechanisms to maximise the positive impacts of doing business in a specific locality.

Both approaches contain a range of tools and concepts (that make use of qualitative and quantitative data) in understanding impact and in developing strategies for the future. Examples of what these tools offer include to: Profile the operation including spending on local versus non-local suppliers, Allow for a deep and thorough understanding of the business environment (at local and national levels); Identify appropriate questions and approaches for stakeholder engagement, Review the multiple positive and negative impacts that a business operation can have on local communities including in-migration, natural resource use, changes in power relations, crime/disorder levels; Developing management and action plans to respond to impacts and Case studies demonstrating local variances in applying the tools/frameworks by country and across different operations

Regarding to the specific focus of this paper, both pieces of work offer methodologies for measuring economic impacts. These include tax payments, other public sector contributions and community investment. They also include sections that operate at the same level of LM3 i.e. tools/approaches that

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<sup>4</sup> 'The Resource Endowment Initiative was set up to better understand how large scale mining activity in low and middle income countries can enhance the socio-economic development of host countries. The initiative aims to isolate the drivers of development effectiveness in the mining and metals sector and to document the policy frameworks, operational practices, and partnership arrangements that deliver sustainable outcomes on the ground. The project is being done together with UNCTAD and the World Bank Group'.

<http://www.icmm.com/project.php?rcd=16>

<sup>5</sup> 'The Anglo American Socio-Economic Assessment Toolbox (SEAT) is intended to help operations to benchmark and improve the management of their local social and economic impacts. The SEAT process enables operations to take a more strategic view of their interactions in relation to, for example, local employment; reducing the exclusion of disadvantaged groups; training; procurement and community social investment'.

<http://www.angloamerican.co.uk/cr/socialresponsibility/seat>

measure the economic impact of projects/operations on local communities (Stage 5 of the Resource Endowment Toolkit and 'Tool C5' in SEAT though other sections ask for relevant quantitative data). Examples of some of the calculations are:

- **Total number in community dependent (on Anglo) for their livelihoods** [No. of employees (Anglo and contractors) x Average family size x Average proportion of income derived from operation (SEAT, page 9)]
- **Value of domestic employment** [value of procurement purchased from domestic suppliers (based on sampling and multiplying sample) divided by total procurement spend to provide percentage of spend that is domestic (Resource Endowment Tool Kit, page 16)]
- **Calculating Community Social Investment Employment** [number of beneficiaries x time spent on project x Anglo contribution as % of total THEN x multiplier to weight-in additional job creation] (SEAT, page 70)

### 3. ABOUT LM3

#### *IN PRACTICE*

LM3 measures the multiplier effect of income into a local economy over three 'rounds' of spending. In short, a company looks at its turnover or a specific budget, then how the company spends that budget, and finally how those people and businesses re-spend their incomes. All of this with reference to a defined local area that the company deems appropriate. Following some basic calculations, the result of the process is an indicator in the form of a single number. For example, an LM3 score of 1.50 would indicate that every \$1 earned by your company generates an additional \$0.50 for the defined locality.

The final phase — 'how these people and businesses re-spend their incomes' — is distinct from many approaches to economic impact analysis as it works with real-time, company specific data versus macro-economic, and often out-dates statistics. *The methodology therefore requires supplier engagement.* This approach creates a mutually beneficial strategy for you and your stakeholders to 'plug leaks' in the company's supply chain by building supplier and community capability. The ability to complete LM3, as well as to take action on the results, does depend on the quality of your relationships with suppliers. While supplier engagement on these issues is equally, if not more, sensitive than engaging on labour and environmental standards, the strategy poses win-win benefits for businesses and the communities they serve. On the plus side, the analysis does not require that you survey every single one of your suppliers. Also, note that the analysis does not at any point ask employees where they spend their money.

How long does an LM3 analysis take? This depends on the particular circumstances. Some organisations have completed LM3 in just one week. For the UK market, K2A have recently launched an online tool that allows the user to simply upload his/her business's spending data, such as a contract or organisational turnover, specify the target local area, and the system then does all the surveying and calculations. This also helps for data organisation and retention.

#### *BENEFITS*

LM3 starts with the core business. It recognises the primary role of business as an economic engine in

the community as opposed to a charitable institution. LM3 has been pioneered by the founding partners of K2A in the UK public sector, and is based on the local multiplier effect (hence, Local Multiplier 3). The approach puts procurement activities — as opposed to the philanthropic, community investment or employment activities — at the forefront of the analysis. The approach can easily work in these other areas, but purchasing of goods and services simply leads the analysis. The suggestion is that companies already have a large (normally unmeasured and unreported) impact on communities simply by purchasing goods and services. For example, one major global mining company recently reported its 'Economic Value Distribution' (i.e. expenditure breakdown) in five categories with percentage breakdown. This showed employees/payroll (10%), distribution to capital providers (9%), government (19%), community investment (0.5%) and purchasing of good and services (62%)!

#### **LM3 BENEFITS**

- Simplicity and resource effectiveness
- Leveraging purchasing behaviours for community development
- Clarity and Comparability: LM3 Delivers a clear, simple indicator
- Getting a 'real' view of impact: Analysis is based on your own companies data/expenditure
- Identifying opportunities to build local supply chains
- Engaging local suppliers in questions of local economic development is one way to encourage a culture of transparency and responsibility in the supply base
- Engaging existing suppliers in the economic, social and environmental value of local purchasing
- Supporting supplier diversity strategies by Identifying which groups (gender, ethnic, age, religious) benefit from local commerce.

#### **4. CONCLUSION & GETTING STARTED**

We believe that LM3 is a simple initial response to the complex challenge of understanding the tangible impact that businesses have on local communities. As well as being simple, we believe LM3 ticks multiple boxes that has the potential to contribute to corporate thinking and practice around community engagement. If your company is interested in applying this analysis, then please contact us.

#### **ABOUT THE AUTHORS**

With its concern for the business impact on human rights, TwentyFifty recognises the importance of measuring impacts for business leaders, both to better understand impacts and challenges as well as to secure the ongoing commitment of the business. The K2A team has been instrumental in shifting the mindset and practice of the European public sector towards an accountable, measurable and simple method for leveraging procurement budgets for regeneration purposes. K2A LLP exists to develop and mainstream tools and methodologies for measuring and improving the impact of public

and private practices.

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