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11-30-2011

State Economic Development Policies: What Works?

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Citation

Bartik, Timothy J. 2011. "State Economic Development Policies: What Works?" Presented at the 19th Annual State Fiscal Policy Conference, Center on Budget and Policy Priorities, Washington, D.C., November 30, 2011.

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“State Economic Development Policies: What Works?”

Presentation by Tim Bartik, Senior Economist, Upjohn Institute

November 30, 2011

Presented in Washington, D.C., at the 19th Annual State Fiscal Policy Conference, Center on Budget and Policy Priorities

I will briefly outline today some state economic development policies that have rigorous evidence for being cost-effective.

To identify the best economic development policies, we must first decide what goal state economic development policy should aim for. I have argued in many publications that the appropriate goal of state economic development policy is not an increase in overall growth, but an increase in earnings per capita that is broadly shared among state residents. Job growth is a means to an end, not an end in and of itself. Job growth is not worth very much if all the new jobs are low-wage, or if none of the new jobs go to the state’s unemployed.

To increase earnings per capita, we can work on labor demand or on labor supply. We can directly target employers to increase the number and quality of jobs. Alternatively, we can directly target state residents to increase the quality of their labor supply. An increase in the quality of a state’s labor supply has been shown by research to have powerful indirect effects on increasing the number and quality of jobs in a state.

Either labor demand or labor supply policies can work. However, for economic development policy to have significant impacts on earnings per capita, we must focus on policies that have large effects on earnings per capita per dollar of the policy’s costs. Because state government resources are small relative to the size of a state’s economy, you need high bang-for-the-buck policies for affordable economic development policies to have large percentage effects on earnings per capita. In addition, we need high bang-for-the-buck policies to offset the negative economic effects of financing any new or expanded program. It’s easy to get positive effects on a state economy of any program funded with outside funds from the federal government or a national foundation. It’s harder to get positive effects from a policy that must be financed by tax increases or spending cuts. All the policies I will propose today have high-quality research showing increases in state residents’ per capita earnings of at least \$3 per \$1 of program costs. The online version of my speech, which will be available later today at the Upjohn Institute website, and through my blog, provides the research support for that assertion.

One policy option that is usually NOT cost effective in increasing state economic development is an across-the-board cut in business taxes. General business tax cuts simply aren’t targeted enough to have a high bang-for-the-buck. General business tax cuts go to retail businesses, whose growth is driven by consumer demand, not state taxes. General business tax cuts also go to businesses that are not in any position to create new jobs, which is wasteful. As a result, general state business tax cuts wouldn’t be particularly effective in generating new jobs and earnings per capita even if they were financed by the

federal government. Once one accounts for the opportunity cost of paying for business tax cuts through cuts in public spending or increases in household taxes, the economic development benefits of general business tax cuts are usually less than their costs, and may even be negative.

Targeted business tax cut incentives have the theoretical potential of being more cost-effective. However, in practice our political system has great difficulty in keeping business tax incentives targeted on high-wage businesses that are most likely to create net new jobs.

What policies that target employers are cost-effective in increasing state economic development? There is good research evidence for several policies that provide services to increase the productivity of small and medium sized businesses. Two policies with rigorous evidence of cost-effectiveness are customized job training and manufacturing extension programs.

Under customized job training, state governments totally or partially subsidize the provision of job training, either for new workers or incumbent workers, which is customized to the particular skill needs of an individual employer. This customized training is frequently delivered by local community colleges.

Under manufacturing extension services, manufacturers are provided with free or highly subsidized advice on how to improve their productivity or product design, and how to find new markets.

Customized job training and manufacturing extension are of the greatest assistance to small and medium sized businesses. These smaller businesses frequently don't have sufficient expertise or financing to access needed services to enhance their productivity. Public policy can have a high impact by overcoming these barriers for smaller businesses.

There are several good studies that suggest that well-run customized job training and manufacturing extension services are far more cost-effective in creating jobs than is true of general business tax cuts or business tax incentives. The estimates suggest that per dollar invested, customized job training and manufacturing extension are probably around 60 times as effective as general business tax cuts in creating increased jobs and earnings in a state economy. Therefore, if a general business tax is being proposed in your state, it is reasonable to propose as an alternative expanding these business services, at one-sixtieth the cost. Obviously it will be much easier to finance this smaller expansion of business services without cutting valuable public spending programs or raising household taxes.

Turning to the labor supply side, what policies are cost-effective in targeting state residents with programs to improve the quality of their labor supply? At early ages, we know that adding additional learning time, if that additional learning time is delivered by reasonable quality programs, can be effective in dramatically changing the future earnings of many children from all income classes. At later ages, educational and job training programs can still work to increase labor supply quality and earnings. But at later ages, the effectiveness of labor supply programs depends on targeting the programs at persons with good basic skills and focusing on the skills needed by employers.

Among early education programs, there is the most extensive rigorous evidence of long-run effects on adult earnings for high quality preschool. I discuss preschool and other early childhood programs in my recently published book, *Investing in Kids: Early Childhood Programs and Local Economic Development*.

Early childhood programs boost adult earnings by getting children off to a good start in terms of developing both academic skills and social skills. With this good start, former participants do better in kindergarten, which further increases their skills, and then they do better in first grade, and so on into adulthood. In other words, when we develop a broad enough set of skills at an early enough time, such skills do not depreciate over time, but rather appreciate.

Early childhood programs can boost local economic development because two-thirds of all participants in early childhood programs will spend most of their working career in the state in which they spend their early childhood. Therefore, a state or local area's investment in early childhood programs will affect a local economy's long-run labor force quality. In today's global economy, higher local labor force quality is perhaps the most important competitive factor affecting a local area's attractiveness for the location and growth of business.

In my book, I calculate that for each dollar invested in high-quality preschool programs, the present value of a state's per capita earnings increases by \$3. These programs pay off purely in economic development terms, without even considering such social benefits as lowering the crime rate.

Obviously much of preschool's benefits for higher local earnings per capita are long-term. We're not sending preschoolers out to find a job at age 5.

However, there are considerable short-run economic benefits. Parents value their child's access to higher-quality education opportunities. Hence, a local area with better preschools will attract parent in-migrants, and experience an increase in home values. For example, we know that higher 3rd-grade test scores raise property values. In my book *Investing in Kids*, I calculate how much we would expect universal preschool to raise local property values simply due to its effects on 3rd grade test scores. This calculation suggests that universal preschool will increase local property values by 13 times the annual program costs of universal pre-k.

Other early education initiatives that have good evidence of success include mandatory summer school in early elementary school. High-quality mandatory summer school can increase average learning by 2 or 3 months per summer, at a reasonable cost per student.

At later ages, it is still possible to intervene to increase labor force quality. However, the later the intervention, the more difficult it is to upgrade the skills of workers who lack fundamental basic skills. What later interventions can do is make sure that workers with reasonably good basic skills also have the skills needed by employers that are expanding decently-paying jobs. For these later interventions to be successful in creating the skills needed by employers, an essential element is to have employers involved in program design and in hiring program graduates.

Among the later educational programs with good evidence of success are high school career academies. Career academies are small learning communities in high school that are organized around a career theme, and that have strong partnerships with local employers. Studies show about an 11 to 1 benefit-cost ratio for Career Academies. These benefits are highly concentrated among students who otherwise would drop out of school or not attend a four year college.

Adult job training programs have a bad reputation that is undeserved. Adult job training programs can be highly effective if they target unemployed or disadvantaged workers with good basic skills, and involve employers with the programs. For example, well-run community college job preparation programs that target the right workers, and are oriented to growing occupations and employers, can increase earnings by as much as \$12 per dollar of costs.

So far I have focused on policies that would increase a state's long-run earnings per capita, by either making employers or workers more productive. But in our current economy, there is an immediate need for job creation.

What is the most effective way of increasing state job creation in the short-run? I think the most effective way is a well-designed wage subsidy program that targets job creation for the unemployed. The particular program design that I think is best is the one used by Minnesota in its MEED program during the 1980s.

Under Minnesota's MEED program, local job training agencies received a pool of money to provide wage subsidies to local employers for hiring unemployed residents referred by these local training programs. MEED provided hefty wage subsidies, of \$10 per hour in today's dollars, for up to six months. But in return for these hefty subsidies, MEED imposed some stringent requirements. To minimize displacement of existing workers, the subsidized workers had to be hired into newly created jobs, not vacancies in existing jobs. Employers were required to keep subsidized workers for at least one year after the six month subsidy period. And the subsidies were controlled by the local job training agency, which could choose which employers would receive the subsidy, and which workers would receive the subsidy. The local training agency could use its discretion to identify the employers that would be most likely to use the subsidy to expand employment and provide useful employment experience. The local training agency could also use its discretion to identify the unemployed workers who benefit the most from this additional employment experience.

Created jobs could be in either the public sector or private sector. Most jobs were in small non-profits or small and medium sized businesses. Small and medium sized businesses seemed most responsive to the MEED subsidies.

Based on data from the MEED program, I calculate that for each \$1 invested in MEED-style wage subsidies, the present value of local earnings per capita increases by \$6.

In sum, it is possible for state governments to choose economic development policies that can significantly raise state earnings per capita at an affordable cost. This cost effectiveness means that such policies can be paid for without large tax increases or budget cuts.

These high bang-for-the-buck economic development policies include services to enhance the productivity of a state's small and medium sized business sector, such as customized job training and manufacturing extension programs. We can also boost earnings in a cost effective way by directly increasing the productivity of the labor force, either by early interventions that can develop broad skills for many groups, or by later education and job training programs that are more targeted on particular workers and skills. Finally, job creation in the short-run can be encouraged by subsidizing small non-profits and small businesses to create jobs and hire the unemployed.

Sources of more information on the effectiveness of the programs in this speech

The effectiveness of across-the-board business tax cuts versus business incentives is discussed in a recent [blog post](#) at my blog. Some empirical estimates comparing the two are presented in my [paper](#) with my colleague George Erickcek. Some simulations of the negative demand-side effects of public spending cuts necessitated by business tax cuts are presented in a [paper](#) I wrote with Erickcek and Wei-Jang Huang on Michigan's economy. The negative supply-side effects of public service cuts necessitated by business tax cuts are discussed in several reports I have written, most notably some [research](#) done for the Economic Policy Institute.

The evidence on the effectiveness of customized job training and manufacturing extension services is discussed in chapter 5 of my book [Investing in Kids](#). Evidence on the effectiveness of these programs is also discussed in my recent [report](#) for the Hamilton Project at the Brookings Institution. The evidence is also reviewed in my [paper](#) on long-term economic development strategies for Michigan.

The evidence for benefits of mandatory summer school is also discussed in my [paper](#) on Michigan's long-term economic development strategies. This paper also discusses the evidence for career academies and adult job training programs. The adult job training results here come from results for job prep programs at community colleges discussed in a [report](#) by Kevin Hollenbeck and Wei-Jang Huang.

The effectiveness of MEED is also discussed in the paper on Michigan's economic development strategies. A more extensive discussion of MEED is in: a recent [presentation](#) in Minnesota; a recent [presentation](#) on job-creation options; an [article](#) for the Upjohn Institute newsletter; my book [Jobs for the Poor](#).

A recent [report](#) of mine on state economic development policies was presented to Wisconsin policymakers in 2009.