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Abstract

This paper provides a guide to economic development policies for local government managers. Local economic development policies today include not only tax subsidies for branch plants, but also job training to provide workers to businesses, advice and support services for potential entrepreneurs, and extension services to help businesses modernize and export. To help local government managers, this paper suggests a number of guiding principles, including: local economic development should be pursued cooperatively across the local labor market; economic development programs should consider the quality of jobs created; tax subsidies are expensive per job created; development subsidies are more effective if the subsidy is frontloaded; high unemployment areas should be more aggressive than low unemployment areas in promoting job growth; many economic development services can be cheaply evaluated by business surveys.

Economic Development Strategies

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1. *Introduction*

In recent years, local governments in the United States have become increasingly active in "economic development programs"–government-run or subsidized programs that provide assistance to individual businesses in order to increase local jobs, lower local unemployment, and enhance the local tax base. Examples of economic development programs include: redeveloping a downtown or industrial area to attract additional business investment; marketing a city or metropolitan area as a site for new branch plants or new corporate headquarters; helping existing businesses with regulatory problems impeding their expansion; tax subsidies to business such as property tax abatements; government loans or grants to businesses to encourage them to start-up, expand, or locate in some particular political jurisdiction; customized worker training programs to encourage the expansion of businesses; industrial extension services to provide businesses with better information on modernization, job training, or exporting; and small business programs which provide management assistance to help small businesses start up or expand.

Economic development programs pose difficult issues for local government managers. What should be the relative emphasis on different goals, such as more jobs versus a larger tax base, or more jobs versus higher quality jobs for local residents? Should economic development efforts be run by government or by a private organization? Should economic development efforts be organized and run by individual local governments, or should the focus be more regional? Are tax subsidies to business cost effective? Can the government effectively provide businesses with services such as job training or modernization advice? Can economic development programs be evaluated?

This chapter has two goals: (1) to briefly describe what is currently going on in economic development policy in the United States, and (2) to suggest some principles of good economic development strategy that will help local government managers. Among other things, it is suggested that economic development is best pursued on a cooperative basis across an entire local labor market. Economic development strategies should consider the quality of jobs and who gets those jobs rather than just the total number of jobs. Tax subsidies to business for economic development are likely to be expensive per job created, so government managers should be selective in using the tax subsidy approach. Providing businesses with help with job training or modernization can be an effective economic development strategy. Relatively low cost survey methods can be used to evaluate many economic development programs.

2. *What Is Economic Development Today?*

A typical definition of local economic development is "changes that affect a local economy's capacity to create wealth for local residents…"[1] Based on this definition, local economic development is affected by anything the local government does. But "local economic development programs" usually refer more narrowly to programs that intervene more intimately with business in order to encourage local business growth and development.

At first glance, various local economic development programs may not appear to have much in common. Providing tax subsidies to a new branch plant is a quite different policy in many respects from helping a small manufacturing company figure out what new technology it needs. What such diverse policies have in common is that they provide publicly subsidized or encouraged assistance that is somewhat customized to the needs of individual businesses. The subsidy that one branch plant gets may not be the same as other branch plants; the modernization assistance provided to one manufacturing company may differ greatly from the assistance provided to others.

Publicly-supported, customized assistance to individual businesses is politically controversial. Some critics see such policies as a government attempt to "pick winners" and thereby overmanage the economy. And some see such policies as using public funds to benefit the wealthy.

Customized assistance to individual businesses can be difficult to manage. Once one decides to become involved with individual businesses, it can be difficult to stop. Customized services are also more difficult to deliver and monitor. An economic development strategy should limit how these programs will be used and promote their efficient management.

Typical Goals of Economic Development Programs

"Increasing local jobs" is the most common overall goal of local economic development programs. According to a 1987 National League of Cities (NLC) survey of 326 mayors, 70 percent ranked "increasing employment opportunities" as one of their city's top three economic development goals.[2] In a 1993 survey of 125 local public economic development organizations by the National Council for Urban Economic Development (CUED), 50 percent of the respondents stated that the "number of jobs created" was the key criteria in determining when economic development incentives will be used.[3]

The second most important overall goal of most local economic development efforts is increasing the local tax base. In the 1987 NLC survey, 56 percent of the mayors listed "improving the city's tax base" as one of their city's top three economic development goals.[4]

In a 1989 survey of 975 cities and 131 counties by the International City/County Management Association, development goals were expressed in different terms. Thirty percent of respondents said their number one economic development goal was to retain and expand existing business, whereas 29 percent said their number one economic development goal was to attract new business. Downtown development was the number one goal for 18 percent of the respondents, and 16 percent listed their number one goal as "industrial" (manufacturing) development.[5]

Beyond these stated goals, some academics and political activists have called attention to a possible relationship between economic development efforts and local real estate interests. Local employment growth has been empirically shown to significantly increase local housing values and specific development projects may enhance the land values of specific parcels of property.[6] John Logan and Harvey Molotch comment that "for those who count, the city is a growth machine, one that can increase aggregate rents and trap related wealth for those in the right position to benefit."[7]

Organization and Funding of Local Economic Development Programs

Local economic development programs are run by a wide variety of organizations–cities, counties, Chambers of Commerce, public-private non-profit organizations, regional coalitions of governments, independent public agencies, community colleges, and universities. Local economic development programs are funded by a wide variety of sources–local government general and special funds, private contributions, federal and state grants, fees from assisted businesses, and revenue from property redevelopment. The organizational and funding arrangements that dominate differ greatly in different local areas. In most areas, a variety of different local economic development organizations coexist, sometimes cooperating and sometimes competing.

Consider the case of Kalamazoo. The lead economic organization is the CEO (Creating Economic Opportunity) Council, a county-wide, public-private economic development organization which focuses on marketing Kalamazoo County, helping solve the problems of individual businesses, and helping individual businesses with federal procurement. The CEO Council is funded by contributions from private businesses, and public funds from the city of Kalamazoo, the city of Portage (the largest suburb in Kalamazoo County), and the county government. Cities in the area generally provide property tax abatements for new manufacturing plants and plant expansions. The Community Development Department of the city of Kalamazoo runs a revolving loan fund for businesses using federal Community Development Block Grant funds. The city also controls an independent public agency, Downtown Kalamazoo Incorporated, which promotes the development of the downtown area, and is largely funded by tax increment financing from the development in the downtown area. The Kalamazoo Chamber of Commerce does the tourism promotion for the county, and operates the SCORE (Senior Corps of Retired Executives) program, which provides advice to private businesses. Kalamazoo College, a private college, runs a Small Business Development Center, funded by the U.S. Small Business Administration, which provides advice and training to existing small businesses and prospective entrepreneurs. Small business assistance is also provided by Western Michigan University's WESTOPS (Western Office of Public Services), funded by state appropriations. Kalamazoo Valley Community College runs customized training programs for area businesses; this customized training is mostly financed by the businesses served, but some costs of the community college are met by the state and special state grants from the Michigan Jobs Commission may pay for the training costs associated with a specific business location or expansion decision. Customized training can also be provided by the local Job Training Partnership Act (JTPA) program, funded by the U.S. Department of Labor, for those businesses that are willing to hire the disadvantaged and displaced workers who make up JTPA's clientele.

The "lead" economic development organization in an area may be a public sector organization, a private sector organization such as the Chamber of Commerce, or a public-private partnership. ICMA's 1989 survey asked local governments which type of organization was "most active" in local economic development efforts in their community. Forty-one percent said a local government organization was the most active local economic development organization, 29 percent a public-private organization, and 26 percent a private organization.[8]

Public sector economic development organizations may be set up as independent agencies, as regular local government departments, as part of one or more local departments, or as part of the local government manager's or mayor's office. Portland Oregon provides an example of an independent agency actively engaged in economic development.[9] The Baltimore County Economic Development Commission provides an example of an economic development agency which is simply another department within local government.[10] According to the 1989 ICMA survey, 36 percent of local governments locate economic development functions in the mayor's or city manger's office, 27 percent locate economic development efforts in a separate local government department, with the remaining 37 percent making economic development part of one or more local government departments or agencies.[11]

The extent to which local economic development agencies are regionally coordinated varies greatly. According to the National Council for Urban Economic Development (CUED), based on their survey of 35 large metropolitan areas, "...only a few of the metro areas have a comprehensive coordinated approach to promoting local economic development."[12] There are, however, many limited regional cooperative arrangements among local governments and other economic development interests. Louisville, Kentucky and Jefferson County, Kentucky have one public economic development agency whose director reports both to Louisville's mayor and to the County Executive.[13] The Downriver Community Conference is a multi-purpose regional agency, including economic development concerns, supported by 16 communities, with a combined population of over 400,000, in the suburban Detroit area.[14] The Macon County (Missouri) Economic Development Agency is a public-private economic development agency, located in a county of less than 25,000 people, supported by both the city of Macon and Macon County, along with the local Chamber of Commerce.[15]

Regional cooperative efforts are more likely to occur in economic development marketing than in other economic development activities. It saves time and money to market an entire region rather than each community separately. One advertising campaign can promote the entire region to businesses considering a new plant site. A company looking for a new site will want to see all the sites in the region on a visit. One example of a regional coordinated effort focused on marketing is the Greater Phoenix Economic Council, a quasi-public agency that markets the

Phoenix metropolitan area. Another example is the Beacon Council in Dade County, a private non-profit organization funded in part by the county, which seeks to market Miami and Dade County. Finally, the Denver Chamber of Commerce has supported a metropolitan Denver computer network which seeks to link Denver economic development organizations in a unified marketing strategy.[16]

Funding levels for economic development programs are generally low. ICMA's 1989 survey of mostly smaller cities and counties (cities of 10,000 or more, counties of 25,000 or more) found that funding for local public economic development organizations averaged around $2 per capita. Most local public economic development agencies in these smaller local governments have four or fewer staff persons.[17] CUED's 1993 survey of city economic development agencies, dominated by medium-sized cities of from 100,000 to 500,000 persons, found that these local public sector economic development agencies on average spent around $3 per capita. Average staff size was 5.6 persons, and most of these agencies had between 1 and 9 staff persons.[18] CUED's 1991 survey of mostly large metropolitan areas (about half with populations of 2 million or more) found that total spending of all economic development organizations, whether public, private, or public-private, averaged about $3 per metropolitan area resident. Expenditures by the central cities in these large metropolitan areas averaged about $7 per central city resident. Average economic development staff size in the metropolitan areas was about 3 staff persons devoted to economic development for every 100,000 metropolitan area residents.[19]

Some cities spend significant amounts on local economic development. For example, the Boston Economic Development and Industrial Council in fiscal year 1991 spend over $8 million to encourage economic development in a city of less than 600,000 persons, over $14 per capita. In addition, the Boston Redevelopment Authority spent over $33 per capita, although these funds were devoted to housing and community development as well as downtown development.[20]

Funds for local public sector economic development organizations come from many sources, and these sources vary greatly from one area to another. CUED's 1993 survey, dominated by medium-sized cities, found that on average about half (48 percent) of local public sector economic development funds come from the local government's general fund. About one-fifth (18 percent) of city economic development funds come from dedicated local public revenue sources such as tax increment financing. About one-quarter (26 percent) of local public economic development funds come from the federal government, principally the Community Development Block Grant program and to a lesser extent the U.S. Economic Development Administration. These averages conceal a great deal of place-to-place variation. One-fourth of the cities surveyed derived all their economic development spending from their general fund. One-tenth of the cities surveyed derived all their economic development funding from federal grants. Another tenth of the cities derive over 75 percent of their economic development funding from tax increment financing. Under tax increment financing, increases in property tax revenue in a designated area support economic development activities and services in the area, including paying off bonds for infrastructure improvement.[21]

State governments typically do not play a significant role in directly funding general local economic development efforts. The 1993 CUED survey found that on average cities received only two percent of their economic development funding from state governments.[22] But states do fund particular economic development activities that are operated at the local level. Total state economic development agency spending per year in the U.S. is around $1.3 billion.[23] State spending on technology promotion, some of which comes under economic development agencies, and some of which does not, exceeds one-half billion dollars per year nationwide.[24] Often this state spending on economic development and technology is distributed to local universities, community colleges, or special purpose organizations that use these funds for customized industrial training, joint research projects with local businesses, and technology and industrial extension activities.

The overall trend in local economic development, from the late 1970s until quite recently, has been towards greater activity and prominence. CUED's 1991 survey of large metropolitan areas found that average local economic development funding increased by over ten percent per year from 1986 to 1991.[25] CUED's 1993 survey, dominated by medium-sized cities, found that average city economic development staff size increased from 4.3 persons in 1989 to 5.6 persons in 1993.[26]

City and county economic development efforts are becoming more likely to be carried out either by separate local government departments, or by independent public-private agencies. According to the 1984 and 1989 ICMA surveys, the number of local governments with a separate "economic development" department increased from 11 percent in 1984 to 27 percent in 1989. In these same surveys, public-private organizations were rated the "most active" group in local economic development by 29 percent of all survey respondents (local government officials) in 1989, whereas only 15 percent of the survey respondents said public-private organizations were the most active in 1984.[27]

In the last few years, the trend towards more activism has become more uncertain. Federal budget cutbacks, such as the elimination of the Urban Development Action Grant (UDAG) program in 1988 and cuts in the Community Development Block Grant (CDBG) programs, have hurt some local economic development efforts. Some state governments, faced with difficult budgetary situations, have cut economic development spending, some of which benefitted local economic development organizations. For example, in Michigan, when Governor John Engler took office in 1991, he eliminated the Community Growth Alliance Program, which had provided direct aid to local economic development coalitions.

But local economic development activism has been encouraged by changes in other state and federal policies. Some states have reallocated their economic development spending towards supporting local efforts. Pennsylvania in 1988 established the Industrial Resource Center program, which funded eight regionally-organized centers, operated by local public-private organizations, to help small and medium sized manufacturers become more competitive.[28] North Carolina's Rural Economic Development Center in the early 1990s set up a leadership training program to help rural community leaders become more knowledgeable about how to plan and manage local economic development programs.[29]

Some Clinton Administration initiatives will increase federal support for local economic development efforts. In 1993, Congress passed the Clinton Administration's "Enterprise Zone" bill, which will fund 9 "Empowerment Zones" and 95 "Enterprise Communities." In addition, the Clinton Administration has dramatically increased budgetary support for the technology development efforts of the National Institute of Standards and Technology (NIST), including a proposed increase in the number of regional Manufacturing Technology Centers from seven centers to 100 centers.

Methods of Pursuing Economic Development

The time and energy of economic developers is dominated by marketing, business problem-solving, and deal-making. According to the 1993 CUED survey of city economic development budgets, 31 percent of city economic development spending is devoted to "business development," 19 percent to real estate development, and 15 percent to marketing.[30] "Business development" appears to mean contacting local business, resolving problems they might have that could inhibit expansion or lead to contractions, and responding to requests for information on sites, regulations, or economic development programs.

The National League of Cities 1987 survey of 322 cities found that "the two tools most important to a city's economic development efforts are infrastructure improvements and the issuance of tax-exempt bonds for private development."[31] These tools are typically part of individual deals for particular economic development projects. Other important tools, according to the NLC survey, included condemning, acquiring, and clearing land, and reselling it to developers, "local surveys of business needs," advertising, and marketing.

The social resources devoted to local economic development are dominated by tax breaks, which far exceed in dollar value the explicit spending devoted to local economic development. There are no reliable national estimates of total tax expenditures for local economic development. Dollar estimates for economic development tax breaks are available for only two states, Michigan and New York. In Michigan, over $150 million annually in property tax revenues are foregone due to property tax abatements for local economic development purposes. This annual "tax expenditure" is over $16 per capita, far exceeding government spending on economic development organizations. In New York State, state and local tax exemptions for economic development purposes are over $500 million a year, over $27 per capita.[32]

Over the last 30 years, there have been three principal trends in local economic development methods:(1) more aggressive pursuit of the traditional sales activities, (2) adoption of a broader range of economic development tools, and (3) greater sophistication in how economic development is pursued. Local economic development organizations are more aggressive in that economic development subsidies to business are more direct and larger. For example, rather than just providing relief from increased property taxes, local economic development organizations are increasing their use of revolving loan funds and other methods of directly giving money to companies.[33] Since 1988, the State of Kentucky has given huge subsidies to new plants of six percent of their payroll, with one-third of the subsidy paid for by the local government jurisdiction, and two-thirds by the state government.

Local economic development organizations are increasingly providing a broader range of services, going well beyond the traditional sales activities. According to the 1987 National League of Cities survey, among the economic development areas that local governments most wanted to pursue in the future were entrepreneurial assistance, export assistance, and foreign trade zones.[34] Other new policy areas pursued by local economic development organizations in the 1980s and 1990s include joint applied research projects of universities and local businesses, industrial extension activities to help local manufacturers figure out how to modernize, employee training customized to the needs of individual firms, and small business assistance.

Much of the local innovation in economic development has been spurred by state and federal funding. Many states in the 1980s adopted technology development programs, which funded local university efforts to work with business on applied research and technology transfer; Ohio's Thomas Edison Program (started in 1983) and Pennsylvania's Ben Franklin Partnership (started in 1982) are two examples of this expanded state support for local technology development and extension. States have increasingly encouraged worker training that is customized to the needs of individual employers. Such customized training is often carried out through local organizations such as community colleges. For example, California's Employment Training Panel, started in 1983, and financed by a 0.1 percent unemployment insurance surtax, provides financial support for employee training programs run by local business trade organizations, consulting firms, unions, and in some cases community colleges. The U.S. Small Business Administration has financially supported the creation of numerous local Small Business Development Centers; federal support for SBDCs began in 1977 and there are over 500 SBDCs today.

Local economic development programs are becoming <u>more sophisticated</u> in that the programs are more formally planned and structured, and are more carefully designed to leverage private sector involvement. Local economic development organizations are more likely today than in the past to have a formal marketing strategy with explicit industrial targets. Programs leverage private sector involvement by charging fees for services, working with private groups to provide economic development services, and subsidizing banks to fill gaps in capital markets.

<u>Examples of Economic Development Programs</u>

To give a flavor of local economic development, the following "thumbnail" descriptions of various local economic development programs are provided. The programs described are more exemplary than typical.

Downtown development–Boston. Boston's Faneuil Hall Marketplace, opened in 1976, redeveloped three old wholesale meat and produce market buildings into space for specialty food and retail. This redevelopment involved a significant public subsidy to the developer James Rouse, with the public sector paying for almost 30 percent of the costs of the project. But the city also received a share of Rouse's profits; current estimates are that the eventual real financial rate of return to the city from the initial subsidy will be between one and five percent. In addition, the Marketplace has attracted many suburbanites and visitors from outside the Boston area–over one-third of Faneuil Marketplace customers live outside the Boston metropolitan area.[35]

Business recruitment–Mobile, Alabama. The Mobile Area Chamber of Commerce began a major marketing-oriented economic development program in 1985, in response to declines in the area's key local industries of shipbuilding and petrochemicals. Mobile's marketing campaign is largely financed by private sector donations, but about 15 percent of the campaign's funds have come from the city and county of Mobile. Mobile's economic development marketing program includes a staff of 11 persons, and a substantial advertising effort. Marketing efforts have focused on recruiting firms in the target industries of office building operations, advanced material applications, and aviation-related industries. Mobile has also developed an industrial/business park. The Mobile Chamber of Commerce claims that its economic development program has attracted $2.5 billion in additional business investment, and created over 11,000 jobs through new companies and expansions.[36]

Targeting jobs at disadvantaged local residents–Portland, Oregon. The Portland Development Commission, the city's economic development agency, operates the JobNet program which encourages employers locating and expanding in Portland to hire disadvantaged, displaced, or unemployed local residents. JobNet is a consortium of local public job training and placement agencies. Companies receiving economic development aid from the city are required to use JobNet as their first source in hiring for non-managerial positions. Companies are not required to hire any and all persons referred by JobNet, but are required to consider those referred as job candidates, and hire if qualified for the available position. JobNet will work with employers to screen who will be referred to particular job openings. The Development Commission claims that in the 1990-91 fiscal year, JobNet led to the placement in jobs of over 500 persons, 83 percent of low or moderate income.[37]

Employer-oriented training: Durham Technical Institute, North Carolina. Durham Technical Institute is part of North Carolina's community college system, which since the early 1960s has been oriented towards providing customized training to new companies locating in the state. Today, Durham Technical Institute continues to provide customized training for new and expanding companies. The Institute works closely with companies to screen prospective trainees, and the company decides who gets hired based on their training performance. But because the Institute also runs the local Job Training Partnership Act (the federally-funded training program for disadvantaged and displaced workers) and welfare-to-work programs, the Institute can bring some of the Durham area's disadvantaged population into customized training and jobs. Durham Technical Institute's customized training activities are heavily subsidized by the state; a company would only pay for the equipment for training and pay trainees a stipend, while the Institute pays all other training costs.

In addition to training for new hires, the Durham Training Institute provides customized training for upgrading skills, targeting this program towards rural small businesses. Designing customized training often raises issues about the company's technology and management, so the Institute also provides management assistance. Some of this management assistance is delivered through the Small Business Development Center operated by the Institute.[38]

Manufacturing Assistance Center: Cleveland Advanced Manufacturing Program. CAMP was set up in 1984 by Cleveland Tomorrow, a group of CEOs in the Cleveland area. CAMP includes Cleveland State University's Advanced Manufacturing Center, which provides engineering assessments to help local manufacturers, principally medium size manufacturers, solve problems with advanced technology. CAMP also includes Cuyahoga Community College's Great Lakes Manufacturing Technology Center, which help small and medium sized manufacturing companies improve their business practices and technology. Cuyahoga Community College also provides training and education programs in areas such as total quality management and CAD/CAM. CAMP is funded at about $14 million per year. Federal funds (principally from the National Institute of Standards and Technology for the Great Lakes MTC) support about a third of CAMP's budget, and state funds from the Edison Technology Center program support about one-fifth of CAMP's budget.[39]

Export Assistance: SEDA-Council of Governments. SEDA-COG is a regional economic development organization serving 11 counties in central Pennsylvania. Since 1984, SEDA-COG has run an export assistance program, which has been recognized by the U.S. Economic Development Administration as a national model. The program's two person staff provides one-on-one technical assistance in exporting to 30-60 small and medium sized firms per month. Firms are helped in developing an export plan, obtaining export financing, dealing with export regulations, and locating foreign customers. SEDA-COG claims that over 50 local firms report impacts of this export assistance and that local export sales have increased from $2 million to $46 million.[40]

Technology development: Technology Development and Education Corporation, Pittsburgh. TDEC, created in 1991, is a private non-profit which operates the Southwestern Pennsylvania Industrial Resource Center, funded by the state government. The Center provides customized engineering and consulting assistance to small and medium sized manufacturers, reviewing a firm's operations and suggesting needed improvements. Assessment services are provided at a nominal cost to the firm; implementation consulting assistance is 75 percent funded by fees paid by the assisted firm, and 25 percent funded by the state grant provided to the Center. Pennsylvania currently requires a firm receiving subsidized state financing to show that it is a "quality firm"; this test can be passed by the firm working with a local IRC on a quality improvement program. In addition to one-on-one assistance, the Southwestern Pennsylvania IRC coordinates a network of metalworking firms, encouraging them to cooperate to improve competitiveness.[41]

Microbusiness development: MICRO, Tucson, Arizona. The Micro Industry Credit Rural Organization (MICRO), started in 1986, is a non-profit organization providing financial assistance and advice to microbusinesses. This assistance is targeted to microbusinesses owned by Hispanics and women in Southwest Arizona and Southeastern California. In each local area in which MICRO operates, it sets up microindustry associations that microbusinesses are required to join for support and advice before receiving a MICRO loan. For more technical business assistance, MICRO refers microenterprises to local Small Business Development Centers or Senior Corps of Retired Executives programs. MICRO's revolving loan fund provides microenterprises with loans from $500 to $10,000. Eligible microenterprises must have previously had no commercial credit. MICRO loans have a short payback period, but assisted businesses can receive additional credit after paying back their first loan. From 1986 to 1992, MICRO made over 800 loans. Assisted microenterprises are concentrated in the areas of crafts, seamstresses, and some specialty food products.[42]

Entrepreneurial Training: Detroit Self-Employment Project. Started in 1990, the Detroit Self-Employment Project was developed by the Corporation for Enterprise Development, a national economic development "think tank." The Project is funded by Michigan's Department of Social Services, and operated by Wayne State University. The Project provides entrepreneurial training to self-selected AFDC recipients, using both courses and one-on-one assistance. AFDC recipients interested in entrepreneurship are helped to develop a business and marketing plan, trained in record keeping and financial management, and given leads on getting financing. One hundred ninety-nine applicants have completed the program and 101 have started their own businesses.[43]

Industrial Networks–Northern Economic Initiatives Corporation, Marquette, Michigan. NEICorp was originally set up by Northern Michigan University to encourage entrepreneurial activity in the Upper Peninsula, and is now an independent non-profit economic development agency. NEICorp coordinates Upper Peninsula industrial networks in three industries: Furniture Manufacturing, Maple Syrup, and Fine Crafts. The firms in each network cooperate on activities such as sharing the costs of hiring consultants, and jointly shipping and marketing their products. NEICorp also runs a local SBDC to provide technical assistance to small businesses, a Manufacturing Services program for firms with more than 20 employees, and a customized training program for manufacturers. NEICorp has recently brought in the South Shore Bank, a community development bank in Chicago, to run the North Coast BIDCO (Business and Industrial Development Corporation), financed by the State of Michigan and various foundations, to provide longer-term quasi-equity financing to small and medium sized businesses, along with some management assistance. NEICorp's activities are financed by a combination of state money, federal money, foundations, industry and business fees, and Northern Michigan University.[44]

Capital: Michigan's Capital Access Program. The Michigan CAP program is designed to increase the access of riskier but sound business ventures, principally those of small and medium sized businesses, to bank financing. Michigan CAP is a state program, but local banks decide which loans are made under the program.

For a CAP loan, the bank and business borrower each contribute some percentage of the loan value into a loan loss reserve fund for each bank. The percentage contribution of each party to the loan can vary from 1.5 percent to 3.5 percent. The state contributes 1.5 times the combined bank/borrower contribution into the bank's loan loss reserve fund. CAP loans are more expensive than normal loans to the borrower. The borrower pays a premium into the loan loss reserve fund, and most banks pass on their reserve fund premium costs to the borrower. Because CAP loans are more expensive, borrowers will not use such financing unless conventional financing is unavailable.

Banks can take more risk under CAP because losses are covered up to the total amount in the bank's loan loss reserve fund. For example, if a bank and its CAP loan recipients on average each contributed two percent of the value of the loans, with the state contributing six percent , the bank can run CAP with a ten percent loss rate and still make money. Banks' conventional small business lending seeks a loss rate under one percent. But CAP discourages excessive bank risk-taking because the bank is fully liable if losses exceed its reserve fund.

Since its inception in 1986, Michigan's CAP program has supported over 1,800 business loans, and has involved over 50 banks. Programs modelled after CAP have been more recently set up in other states and cities, including the cities of Akron, Milwaukee, and New York.[45]

Enterprise Zones: Evansville, Indiana. The Evansville enterprise zone was designated by Indiana in 1984. The principal tax incentive of Indiana's enterprise zone law is an exemption of business inventories in the zone from the property tax. Enterprise zone firms must pay a percentage of their tax benefits into local Urban Enterprise Associations serving the zone. In Evansville's case, this contribution is 20 percent of the tax benefits. Evansville's UEA has used these funds to set up computer education programs and to construct a daycare center. Jobs in Evansville's enterprise zone have expanded from 4,000 to 7,000 jobs.[46]

Evaluation

Even while local economic development programs have become more aggressive, diverse, and sophisticated, there is little information on their effectiveness. Evaluations of local economic development programs are rarely initiated by local officials.

Some local economic development programs are recognized "success stories." For example, the 1987 National League of Cities survey of 322 city economic development professionals ranked Baltimore and Boston as the most successful economic development cities.[47] This ranking is not due to any study showing that Baltimore and Boston have better economic development programs. Baltimore and Boston's high rankings probably occurred because both cities have sponsored large downtown development projects (Faneuil Hall Marketplace in Boston, the Inner Harbor redevelopment projects in Baltimore).

The local economic development "evaluations" that are done seem designed to claim credit for economic growth, rather than to find out what program approaches really work. As one economic development practitioner put it, the approach of many economic development organizations is to "shoot anything that flies, claim anything that falls."[48]

However, there are acceptable techniques for evaluating economic development programs. Most of these rely on surveys of assisted firms, asking them to rate the quality and effectiveness of the assistance they received. Other evaluations compare the economic performance of assisted and unassisted firms. The findings of these studies will be included in the next section of this chapter, which will consider useful guiding principles for city economic development policies.

3. What Principles Should Guide Local Economic Development Policies?

This section contains a discussion of principles for local economic development policies. What principles should help set the <u>goals</u>, <u>organization</u>, and <u>methods</u> used by local economic development policymakers? How should local policymakers <u>evaluate</u> economic development programs?

<u>GOALS</u>

Guiding Principle 1: <u>Creating More Jobs in a "Broadly Defined Market" Has Significant Benefits</u>.

"More jobs" is the number one goal of most local economic development organizations. The empirical evidence supports placing a high priority on more jobs <u>for the overall local labor market</u> . The local labor market is an area that encompasses most local commuting flows, such as a metropolitan area. Increasing the total jobs in a local labor market significantly increases the earnings of local workers and the unemployed. Empirical research shows that an increase of ten percent in a metropolitan area's employment will increase average real earnings per person by around four percent.[49] Half of this increase in real earnings occurs because local residents who otherwise would be out of the labor force get jobs. The other half of the increase in real earnings occurs because growth allows some individuals to be promoted to better paying occupations.[50]

The benefits of local employment growth are greater, in percentage terms, for lower income persons, less educated persons, and blacks. For example, an increase in metropolitan area employment has about twice as great a percentage effect on the income of families in the bottom income quintile (the poorest one-fifth of all families) as it does for the average family.[51] As a result, faster employment growth in a metropolitan area significantly reduces local poverty.[52]

How can suburban employment growth help central city residents, when many city residents do not have access to these jobs? But only some metropolitan residents need have commuting access for an increase in jobs anywhere within a metropolitan area to affect all metropolitan residents. For example, if new suburban jobs go to suburbanites who formerly commuted to the central city, the resulting central city job vacancies may benefit central city residents. There is enough commuting between different communities within a metropolitan area that the entire metropolitan area shares similar, if not identical, labor market fortunes. Where jobs are located within a metropolitan area does make some difference,[53] but not as much as the health of the overall local labor market.

The benefits of more jobs are greater in local labor markets with high unemployment and sluggish growth. Such distressed areas will have a less mobile population and are probably less attractive to in-migrants. Additional jobs are more likely to increase the employment rates of current residents and are less likely to go to in-migrants.

In addition, the social benefits of employing the average unemployed person are greater in a high unemployment area than in a low unemployment area. In a low unemployment area, most persons who perceive a high benefit to employment will have a job. The remaining unemployed will on average only perceive modest benefits to becoming employed–the wage rate will not much exceed the value they place on their alternative uses of the time while unemployed, in childcare, work around the house, continued job search, or leisure. In a high unemployment area, many individuals who are desperate for a job, in that their wages would vastly exceed the value of their time while unemployed, may be unable to find a job.

Guiding Principle 2: Increasing the Total Numbers of Jobs in a Local Labor Market Requires Strengthening the Local Export Base or Substituting for Imports.

Increasing the total jobs in a metropolitan area is achieved by either (1) increasing the number or sales of firms that sell to business or residents outside of the metropolitan area ("expanding the export base"), or (2) inducing local businesses or residents to substitute purchases of local goods or services for goods or services produced elsewhere ("import substitution"). Not every increase in jobs in a local firm will expand total jobs in a metropolitan area. If a firm sells locally, and its expansion does not lead to import substitution or lower costs for export-base firms, its expansion will lead to the contraction of other local firms.

Expanding jobs in an area's export base firms will have "multiplier effects" on employment in other local firms. Some of the increased sales of export based firms are spent on local workers' salaries and local supplies. Local suppliers and workers in turn spend some of their additional funds on local goods and services, creating still more jobs. These multiplier effects of respending are not infinite because some of the additional money "leaks out" of the local economy, and is instead spent on goods and services produced elsewhere, or goes into savings or taxes.

How multipliers vary for expansions in different firms can be calculated with an econometric model of the metropolitan area economy and information on the firm's characteristics. The local multiplier effects of an increase in jobs in an export base firm will be greater the greater the firm's wages or the firm's ties to local suppliers. Higher wages mean a greater boost to local retail demand.

Local policymakers should question their consultants when they cite export base multipliers of greater than two, that is when they claim that one more job in an export base firm results in more than one additional job in other local firms. Only unusual circumstances will produce multipliers greater than three. Multipliers as low as 1.2 for low wage export-base firms with weak local supplier links would not be unusual.

Export base firms include many industries and business types. Export based firms include most manufacturing firms, with the exception of locally oriented industries such as printing. Export based firms include service industries such as some computer software companies, research and development laboratories, law firms with a national clientele, banks with a national or regional market, etc. Export based firms include corporate headquarters for firms with a market outside the metropolitan area. Export based firms also include tourist industries; new money is brought into the local economy by outsiders visiting and buying. Within most industries, larger companies are more likely than small companies to be export base firms, but there are many exceptions to this tendency.

More total local jobs can also be created if local businesses and consumers substitute purchases from local firms for purchases from outside firms ("import substitution"). If local businesses or consumers use more local suppliers, each dollar brought in from outside circulates more intensively within the local economy, creating additional local jobs. For import substitution to be sustainable, the use of local suppliers must be based on cost or quality advantages. If the use of local suppliers is based on civic boosterism, it is likely to quickly fade after the "buy local" campaign is over. If the use of local suppliers is based upon laws or regulations to encourage the use of local suppliers, such policies may make local firms less competitive in the export market because of their use of uncompetitive suppliers.

Guiding Principle 3: Encouraging "Higher Quality" Jobs–Jobs With Higher Wage Premiums, More On-the-Job-Training, Greater Advancement Opportunities–Has Significant Labor Market Benefits for Local Residents.

Economic research shows that different industries pay quite different wages, often differing by 15 percent or more, for workers with similar education, age, and other characteristics.[54] Within a given industry, different firms pay different wages–often differing by ten percent–controlling for worker characteristics.[55] Firms also differ greatly in their policies towards worker training, and innovative workplace practices such as work teams, quality circles, and total quality management.[56]

A local area can improve economic opportunities for its workers by shifting the local mix of firms and industries towards those offering better wages, working conditions, and opportunities for advancement. The local mix could be shifted towards higher quality jobs by targeting economic development policies towards such firms. Support for worker training, to be discussed further below, might also encourage firms to offer higher quality jobs.

In addition to increasing wages and improving working conditions, better quality jobs encourage increased labor force participation. For example, in several studies, Bartik finds that a shift in a metropolitan area's industrial mix towards a mix with a one percent greater average "wage premium" increased the average annual hours worked per person by over one percent.[57]

Guiding Principle 4: Local Economic Development Organizations Should Consider How to Increase the Modest Proportion of New Local Jobs That Go to Local Residents, Particularly Disadvantaged Local Residents.

Local public officials are generally unaware how large a proportion of new jobs go to in-migrants rather than the original local residents. Empirical research on how local employment growth affects migration suggests that in the short-run (less than five years), 30-50 percent of new jobs go to in-migrants; in the long-run (more than five years), 60-90 percent of new jobs go to in-migrants.[58]

Is it legitimate for local public officials to be concerned about whether new jobs benefit their original constituents versus in-migrants? Because the original residents pay much of the costs of economic development programs, they might legitimately demand that policies seek to increase their benefits. In addition, there are benefits to providing jobs in local economies for which people have a strong "sense of place."[59] Studies indicate that people are on average willing to give up 10-20 percent of their income to remain in their original local area.[60] Finally, as discussed below, there may be some fiscal benefits to avoiding the public service costs of more in-migration.

It is not simple to tell the relative benefits for in-migrants and the original residents from a particular economic development policy or project. For example, suppose that some economic development deal encourages a branch plant to relocate into a metropolitan area. Suppose further that the relocated plant brings along with it all of its existing workers; this is particularly plausible if the plant pays high wages. Such a plant will still provide some benefits for local workers. First, the relocated plant will have some multiplier effects, which will expand employment opportunities for local residents in local suppliers and retailers. These multiplier effects will be particularly large because of the plant's high wages. Second, even if the relocated plant's workers originally came along with the plant, there will be some turnover over time, opening up job vacancies for the original residents. The employment benefits from this relocated plant may be lower than average, but they will not be zero.

Simply requiring new businesses to do local hiring might discourage new business locations. This concern explains why aggressive city policies to push local hiring, such as Portland's JobNet program, are the exception rather than the rule. Programs that make local hiring more attractive, through customized training, may be more feasible.

Guiding Principle 5: Job Growth's Fiscal Benefits Are Often Elusive Because of the Costs of New Infrastructure, But Job Retention Often Has Fiscal Benefits Because It Uses Existing Infrastructure.

Two key principles should be kept in mind in assessing the fiscal effects of economic development. First, the fiscal impact depends on the marginal costs and revenues of the additional local jobs and population that occur because of the economic development program. The marginal costs and revenue from one new job or person are usually quite different from the average costs or revenue associated with jobs and people already in the metropolitan area. Second, any evaluation must consider the capital costs of new infrastructure, not just operating costs.

It is important to understand the conditions under which economic development can be fiscally unprofitable. Local tax systems are set up so that average tax revenues cover average costs. Additional jobs and people generally result in similar tax revenues per job or person as do existing jobs and people, unless special development subsidies or impact fees are used. Marginal public service costs associated with additional jobs and people are, however, often much greater than the average costs.

In part, marginal costs usually exceed average costs because retrofitting infrastructure to handle higher demand is expensive. Doubling the capacity of a road or water or sewer plant that already exists will usually more than double the acquisition costs.

In a recent book on impact fees, Alan Alshuler and Jose Gomez-Ibanez indicate the potential infrastructure costs associated with new development and the complexities associated with analyzing those costs.[61] They summarize two studies done of the fiscal impact of new development on Montgomery County, Maryland, which provides most local public services in the county and collects most local taxes. A 1969 study assumed that the costs of new infrastructure would equal the average debt costs and maintenance costs currently paid for existing infrastructure. However this assumes that debt and maintenance costs on required net new public capital would be no higher than the costs on old infrastructure. According to this study, most taxable new business activity, without accompanying Montgomery County growth in households, produces two to six times as much revenue as its public service costs. Even if all new employees lived in the county, the 1969 report concluded that new development would be fiscally profitable for hotels or office complexes. Office complexes were estimated to produce $1.29 in local revenue for every dollar in additional public service cost they require.

A 1989 study looked only at large office parks, one of the most fiscally profitable new development types in the 1969 study, and concentrated on the costs of additional highways to serve a new office complex. Unlike the 1969 study, this study looked at the actual cost of adding new highway capacity and found that the additional county revenues per office worker per year of $410 would barely exceed the $347 per worker per year that the additional highway capacity would cost. Altshuler and Gomez-Ibanez comment that "with such a slim margin, little tax revenue was left over to fund other county services that the office building might require (such as sewer, water, solid waste, police protection, or fire protection), let alone those required by the households of employees. If this result held for office parks, the most profitable form of development under the 1969 analysis, it doubtlessly was even more true of other types of businesses or residential developments."[62]

The fiscal impact on a local government appears quite favorable when we are considering an economic development policy aimed at preventing a local economy from declining in employment or population. Local economic decline will tend to lead to a proportionate decline in public revenues. But infrastructure costs will not decline. The infrastructure is already in place and has in part already been financed. It is usually infeasible to abandon much existing infrastructure, and this would only save maintenance costs. Thus, by avoiding the losses associated with economic decline, economic development policies that help retain jobs and people produce a fiscal benefit.

Consider the Montgomery County example. If Montgomery County was a declining rather than growing county, an economic development policy that attracted an additional office park might not require additional highway capacity. The office park's revenues per worker would be about the same, but most of the public service costs in the 1989 study would be irrelevant.

Guiding Principle 6: <u>Economic Development Policies That Increase Market Efficiency Provide Public Benefits Beyond Increasing Net Local Jobs</u>.

Inefficient markets supplying business with capital, training, and information may impede some businesses from starting-up, expanding, modernizing, or surviving. These problems are particularly important for small and medium sized businesses, and minority and women-owned businesses.

Many of the economic development programs already mentioned provide services to address these problems with the business development process. Such services, if they have a value to business that exceed their costs, can be socially beneficial even if they do not affect overall net local job growth because they can help provide better quality goods and services.

For example, suppose that a local group provides training to help minorities and women start new restaurants. Suppose these new restaurants are able to out-compete other local restaurants and drive them out of business. Even if total local employment is unchanged, the local restaurant sector will be offering a better product. <u>If</u> the greater productivity of the new restaurants exceeds the costs of training the new restauranteurs, then local consumers are better off.

ORGANIZATION

Guiding Principle 7: Economic development organizations must encourage participation by both the public and private sectors.

Economic development programs cannot be totally publicly-run because effective economic development requires private resources, credibility, and expertise. Public resources for economic development are limited, so these resources must be used to leverage private resources. For example, compared to 100 percent government-financed business loans, programs such as the Capital Access Program that encourage private lending can support more lending with a given government budget. As another example, charging fees to business for providing advice on business modernization, as is done by Industrial Resource Centers in Pennsylvania, allows more firms to be helped with limited public dollars. Moreover, compared to government agencies, economic development organizations with a private veneer may be viewed by some small businesses as more credible service providers. As one staff person of an Industrial Resource Center put it, "If I showed up with a business card saying "I'm from the state and I'm here to help you", I'd get tossed out on my ear."[63]

But local economic development cannot be totally privately-run and financed because the rationale for economic development programs is that the private market on its own inadequately supports some business development. If the public is to subsidize economic development, there must be some public monitoring to ensure that such subsidies achieve their social goals.

Thus, regardless of whether an area's lead economic development organization is public or private, an effective economic development process must enlist the money and expertise of both the public and private sectors.

Guiding Principle 8: Economic development is best pursued on a local labor market scale.

The labor market benefits of job growth or wage increases in one local community occur across the entire local labor market. Because a community's policies will not fully reflect these spillover benefits, individual communities may sometimes be insufficiently oriented towards economic development policies that create jobs and enhance wages.

The fiscal effects of development in one community also spillover the entire local labor market. In many cases these fiscal effects on nearby communities will be negative. The community siting the new business development will receive additional business property taxes, whereas the roads and schools needed by workers in the new jobs may be paid for by other communities. Uncoordinated policies pursued by many small units of government will be excessively competitive for business real estate development.

Thus, the fragmented structure of most metropolitan areas, with many competing jurisdictions and little coordination, may distort how economic development is approached. This fragmented structure explains why economic development is often seen as a series of real estate deals rather than as a way of improving labor market opportunities. Local governments may end up subsidizing real estate development more than they subsidize human capital development.

The local labor market is also the level at which the key resources for achieving economic development must be pulled together. Labor is the most important business input. Labor costs and quality available to a business are largely determined by the metropolitan area, not the business's neighborhood or community. To alter labor costs or quality, economic development programs must target the overall local labor market. Local suppliers to an export-base firm will also be located throughout the metropolitan area, not just in the community in which the export firm is located. Policies to improve supplier competitiveness must target the entire local labor market area.

METHODS

Guiding Principle 9: Marketing, streamlining regulations, and business problem-solving can often be cheap ways of making development happen.

The "sales" and "business development" activities that dominate the time of local economic developers are plausibly cost-effective. Because such interactions with firms are idiosyncratic, there is little research on their effectiveness. But sales and business development activities focused on information and problem-solving, not financial subsidies, are relatively cheap, and government intervention in this area has some rationale.

These activities involve providing information on the local community to business prospects, and helping resolve problems that businesses have with local government regulations, taxes, and services. Providing basic information to businesses requires relatively modest expenditures on economic development staff. Providing information, particularly information on government regulations, services, and taxes, is a legitimate public activity. Private information markets are imperfect, and public or quasi-public agencies have some comparative advantages in obtaining and providing such information. Trying to resolve problems that "customers," including business customers, have with government activities, without compromising public goals, is one way of making government more effective and responsive.

"Business development" becomes more questionable when it turns into public real estate development: government using zoning and condemnation to redevelop land. Absent a public subsidy, such government-based proceedings can be seen as one way of overcoming the problem of the "holdout landowner": the one landowner in an area who refuses to go along, at a reasonable price, with an overall area plan. Unfortunately, many government-sponsored redevelopment projects use large public subsidies–the Faneuil Hall development project in Boston for example–and such large subsidies are more open to question.

Guiding Principle 10: Providing financial subsidies to individual firms is likely to be expensive per job created, but may be useful if done in the right circumstances and if carefully designed to maximize benefits and minimize costs.

Providing tax abatements or other financial subsidies to the location, expansion, or retention of individual firms is probably expensive per job created or retained. This high cost per job is suggested by studies of the effects of overall local business tax rates. In a recent review, Bartik shows that on average a ten percent reduction in state and local business taxes increases local employment and business activity in the long-run by around three percent.[64] These tax effects are similar for different business location decisions. For example, studies of branch plant location decisions also find that ten percent lower state and lower business taxes increase the plants locating in a local economy by around three percent. These estimates assume that business tax reductions are financed by increased personal taxes, or decreased transfer payments to individuals. Some studies find that business tax reductions, if financed by reducing spending on local education or roads, may reduce a local economy's employment.[65]

These estimated tax effects imply that state and local governments would have to give up around $3,800 per year in business tax revenue to create or retain one additional job in a state or metropolitan area.[66] Business tax reductions do affect some business location decisions, providing additional tax revenue. But these tax reductions also go to business activity which would have occurred in the local economy without the subsidy. The lost revenue from this unaffected business activity more than offsets the gain in tax revenue from new business activity. In addition, a full fiscal calculation would need to consider population growth and public service costs.

One could argue that the high cost per job created of general state and local business tax reductions need not imply a high cost per job created of discretionary tax subsidies. A local policymaker with perfect knowledge of each company could avoid subsidizing companies that would have located in the local area anyway. But in the real world tax subsidies can rarely be targeted systematically. Once tax subsidies are provided one firm, the political pressure is overwhelming to provide subsidies to all firms. Furthermore, policymakers lack sufficient knowledge to avoid subsidizing companies that would have located in the local area anyway. A more reasonable assumption is that targeting subsidies is so difficult that discretionary tax subsidies have about the same cost per job created as general business tax reductions.

Tax differentials within a metropolitan area have larger effects. Some studies suggest that a ten percent reduction in business property taxes - e.g., from a two percent effective rate to a 1.8 percent effective rate–in one community in a metropolitan area, holding the property tax rates of other communities constant, may increase the business activity in that individual community by 20 percent.[67] Tax differentials within metropolitan areas have larger effects than tax differentials across metropolitan areas because individual communities within a metropolitan area are closer substitutes for one another, from the perspective of a business choosing a location, than different metropolitan areas are for one another.

These effects of tax differentials within metropolitan area are so large that it might appear that an individual community could gain both revenue and jobs from lowering business property tax rates. Such a strategy is in the long-run ineffective. Most of the community's new jobs will come from other communities within the metropolitan area. As a result, local labor demand will not be much affected. Furthermore, other communities in the metropolitan area will respond to one community's lower business taxes by adopting their own tax reductions. If all communities within a metropolitan area offer the same business tax reductions, then no individual community gains a competitive advantage over other communities in the metropolitan area. Jobs will be created in the metropolitan area from these business tax reductions, but at the high cost of $3,800 per year per job.

Is it worth providing tax subsidies or other financial subsidies to encourage job creation in a metropolitan area, given that such policies cost around $3,800 per year per job created? Such a policy may be sensible if pursued in the right local economic environment. In a high unemployment metropolitan area the typical unemployed person is likely to be so desperate for a job that the social benefits from their obtaining a job may exceed $3,800 per year.

Spending $3,800 per job may also make sense if the jobs provide particularly high wages or large amounts of on-the-job training, or are more likely to go to local residents. Although local policymakers cannot easily target subsidies on the firms most likely to be affected, it is more feasible to target subsidies on firms that pay higher wages and provide extensive training. In addition to the benefits for workers of higher wages, higher wage firms will have greater multiplier effects. Some economic development programs have adopted some targeting criteria based on job quality. For example, Pennsylvania requires that firms receiving financial subsidies from the state be certified to be "quality firms."

Subsidies can also be designed to encourage training and hiring of local residents. For example, many state and local education and training institutions, such as the Durham Technical Institute mentioned above, provide subsidies to new or expanding firms for training local workers.

Subsidies to attract new firms or encourage firm expansions are more cost-effective if more of the subsidy is upfront. The typical U.S. business has a short time horizon. For example, a recent survey of corporate executives indicated that they used a real interest rate of 12 percent–or an ordinary nominal interest rate of 16 percent when inflation is 4 percent per year–to discount future cash flows.[68] Such a high real interest rate means that local subsidies provided ten years in the future have little effect on corporate decisions. A more effective strategy provides subsidies up-front: larger, shorter term property tax abatements; immediate subsidies of training costs; providing low cost land or infrastructure to the new or expanded facility. This assumes that local residents and local governments should use real interest rates of less than 12 percent in making decisions. This assumption seems reasonable because local governments can usually borrow money at less than 12 percent over the inflation rate.

Another advantage of front-loaded economic development subsidies is that they force local leaders to deal with the costs of subsidies during their terms in office. Twenty-year property tax abatements pass on costs to political successors, which encourages irresponsible decisions.

A disadvantage of front-loaded subsidies is the risk that a company will take the subsidy, and then quickly leave. A "runaway plant" is less likely for higher wage firms that make extensive investments in both human and physical capital, so this risk can be reduced by targeting subsidies towards higher wage firms. In addition, local policymakers can include "clawback" provisions to recover some of the subsidy if the firm leaves too soon. One way to implement clawbacks is to provide the upfront subsidy as a forgivable loan, which over time is converted to a grant if job creation goals are met.

Clawback provisions in economic development subsidies have been upheld by the courts, but only if such provisions are in writing and are explicit about the company's obligations. For example, the city of Duluth won a late 1980s court case against a company which had received an industrial revenue bond from the city. The IRB included a written agreement prohibiting the transfer of equipment purchased with the bonds. The company went ahead and transferred the equipment elsewhere. Duluth won an injunction prohibiting future transfers of equipment. On the other hand, the city of Yonkers lost an early 1980s suit to prevent a plant closing by the Otis Elevator company. The city had earlier provided below-market priced land to facilitate the plant's expansion. The city lost the suit because its agreement with the company did not specify the length of time that Otis had to remain in Yonkers.[69]

Guiding Principle 11: <u>Improving labor quality in a way that is responsive to business and worker needs can play a crucial role in local economic development</u>.

Improving local labor quality is crucial to firms because so much of business costs are labor costs. The issue is whether economic development policies targeting individual firms can be effective in improving local labor quality.

One study indicates that government grants for <u>customized job training</u>, when the job training is tied to a firm's technology upgrading efforts, can be effective in promoting improved productivity. Holzer and his colleagues found, in their study of a Michigan program giving grants for technology-related training, that product scrappage rates went down significantly more in assisted firms than in comparable unassisted firms. Product scrappage rates went down enough that the program's economic benefits probably exceeded the costs of the job training grants.[70]

Beyond the effects of customized worker training efforts on firm performance, there may be benefits to workers from providing more support to firms for training and upgrading their workforce. As argued by Paul Osterman in his book Employment Futures,[71] if firms have more financial support for worker training, and better information on effective training techniques, then firms have an incentive to change their technologies and human resource systems. Firms which receive more support for worker training may compete more on the basis of quality than on low wages, and may emphasize retaining their workers and worker upgrading rather than simply hiring and laying off in the open labor market as demand shifts. Such firms may provide workers with better wages, more job security, and greater upward mobility.

Subsidies for customized training should be focused on small and medium sized businesses, and on training that increases worker productivity in a variety of businesses. We know that small and medium sized businesses, due to financial constraints and higher worker turnover, are least likely to currently provide on-the-job training. Firms have less incentive to invest in training that will make workers more generally productive, because such training may make workers more attractive to other firms. Subsidies to large firms or for firm-specific training may subsidize training that the firm would have done anyway.

Guiding Principle 12: Programs can be designed that are effective in providing businesses with useful training and knowledge.

There is some evidence that programs that seek to provide businesses, particularly small and medium-sized businesses, with training and advice, can be effective in improving firm performance. Industrial extension services and small business development centers, which provide businesses with information on modernization, training, exporting, or business planning, seem to have sometimes been fairly effective. Several surveys have reported that a sizable proportion of the business clients of such programs felt that the program had beneficial effects on their employment, productivity, costs, or sales.[72]

Moreover, a recent study by Benus indicates that entrepreneurial training and start-up assistance to potential entrepreneurs can significantly increase the rate at which these entrepreneurs start up new businesses. Benus and his colleagues at Abt Associates studied U.S. Labor Department funded programs in the states of Washington and Massachusetts that provided interested unemployment insurance (UI) recipients with training and assistance in developing a business plan, and a lump-sum payment of their remaining UI entitlement upon achievement of certain specified business planning goals. In Massachusetts, 47 percent of the treatment group entered self-employment, compared to 29 percent of those in a control group; in Washington state, 52 percent of the treatment group entered self-employment, compared to 27 percent of the controls.[73]

A problem with programs providing business advice and training is how to achieve sufficient scale to have a large impact on the local economy. Charging fees, as has been done by Pennsylvania's Industrial Resource Centers, allows a given amount of public financing to support service to a larger number of firms. Another method is to facilitate the formation of industrial networks, as has been done by the Northern Economic Initiatives Corporation. Such groups of firms may share ideas on improving productivity, increasing exports, or improving worker training. By working simultaneously with a number of firms in an industrial network, a local economic development program can potentially have an enhanced effect on the local economy.

Guiding Principle 13: Capital programs run exclusively by government often lead to political and management difficulties.

The experience of the Capital Access Program in Michigan suggests that there is a market for medium risk business financing that is not fully served by our existing financial system, and that can be served with appropriately designed government assistance. The loss rate on Michigan's Capital Access Program is currently running about 2.9 percent. This compares with a typical bank loss rate on small business loans of less than one percent. The higher loss rate on CAP loans strongly suggests that most if not all of the business borrowers under this program would not have received conventional bank financing.[74] To fully justify the program, we would need to find social benefits of this program, for example in expanded employment opportunities, that justify the partial government subsidy under this program for the higher risk.

Unfortunately, economic development programs that address gaps in capital markets are frequently run as direct government loan programs. Direct government involvement creates management difficulties for government officials unaccustomed to making business loans. Moreover, officials making direct loans and investments face political pressures to make unsound loans to businesses with political connections. On the other hand, there may also be media and public pressure to avoid any loss whatsoever on the government's financing efforts.

Thus, programs providing direct government financing for businesses are difficult to run in a high quality manner over the long-run. Economic development programs that encourage private financial institutions to address gaps in capital markets, such as the Capital Access Program, may make more sense.

Guiding Principle 14: There is some evidence that well-staffed and targeted enterprise zones can attract jobs, but enterprise zones have inherent limitations as an approach to providing job opportunities.

The "enterprise zone" concept is a technique of geographically targeting economic development programs. Enterprise zones vary among states and cities in whether they emphasize tax breaks, infrastructure improvements, public services, or job training. What they have in common is that the subsidies are geographically pinpointed.

There is some evidence that enterprise zones in Indiana have reduced unemployment claims,[75] and in particular that the Evansville Indiana enterprise zone has helped increase employment in the zone.[76] Enterprise zone success seems greater in states that designate fewer zones.[77] Enterprise zone success is associated with having greater staffing effort to administer the zones.[78] The apparent success of Indiana's program may occur because Indiana's zones receive a percentage of the zone tax breaks to help support enterprise zone staff.

The limitation of the enterprise zone concept is that neighborhoods are not labor markets. Enterprise zones may be an important community development strategy, improving the physical appearance and morale of distressed neighborhoods. But we would not expect, in our mobile, commuting society, that many of the new jobs in enterprise zones would go to zone residents.

EVALUATION

Guiding Principle 15: The effectiveness of many economic development programs can be evaluated through relatively cheap surveys.

The many economic development programs that provide services to firms–information, training, advice, etc.–can be evaluated relatively cheaply by written surveys of the businesses that are clients of these programs. Clients of these programs do not have strong incentives to lie about their experience. But, surveys are unlikely to be effective for programs that provide tax subsidies, loans, or other financial subsidies to firms. Even if such programs had no effect on the firm's location decision, firms receiving such financial assistance might want to claim that the program had an effect, either because such a claim is legally necessary to receive assistance, or in order to keep the program alive for possible future use.

Surveys are likely to be more useful if they are as comparable as possible over time, and, to some extent, across different programs. If surveys ask comparable questions, then government managers can get some sense of how the quality of economic development services differs over time or across programs.

The Urban Institute has published a book, *Monitoring the Outcomes of Economic Development Programs*, that provides a comprehensive guide on how to conduct surveys of the business clients of state economic development programs, including suggested survey instruments, advice on how to distribute the survey, etc. The suggestions of this guide have been tested in evaluating economic development programs in the states of Minnesota and Maryland.[79]

4. Conclusion

Economic development is a diffuse area of policy for which only small amounts of public funds are available. Effective local management of economic development requires careful targeting of the limited public funds, leveraging of private resources, and cooperation of different groups in the local labor market area.

The policy implications of this chapter can be restated as follows:

- An important priority for limited public funds for economic development should be to encourage local educational and training institutions to be more responsive to the training needs of small and medium sized businesses in the area. Customized training funds should be focused on firms that seem most likely to offer higher quality job opportunities to local residents, and should be focused on training that is useful in a variety of jobs. Firms should pay for a portion of training costs.

- Another priority should be public support for quasi-private information and training services for small and medium sized firms and start-up firms, helping them determine how to export and modernize, and helping with management issues. Firms should be charged some fees for these services, in order to stretch limited public funds and provide an incentive for good service performance. Where possible, these services should seek to work with groups of firms to help them cooperate to solve some of their problems. The quality of these services should be regularly evaluated through surveys of business clients of these programs.

- Public support of business capital needs is best provided by encouraging private financial institutions to provide somewhat higher risk financing to small and medium sized businesses. Government can be a banker, but the hat does not fit well.

- Higher unemployment areas may legitimately be interested in providing tax and other financial subsidies for a variety of economic development projects. Such subsidies should be focused on export-base firms, import-competing firms, or their suppliers, and on higher wage firms. Subsidies should be provided upfront with clawback provisions if certain job creation goals are not met.

- To the extent possible, local governments should avoid destructive competition for business real estate projects with other nearby jurisdictions. If feasible, economic development efforts should be coordinated across the entire local labor market. The focus of local economic development efforts should be on stabilizing the local tax base and improving overall labor market opportunities for local residents.

Endnotes

1. Matt Kane and Peggy Sand, *Economic Development: What Works at the Local Level* (Washington, DC: National League of Cities, 1988), p. 4.

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The figure of $1,634 for state and local business taxes per private employee comes from three sources. Total state and local tax revenue in fiscal year 1989 was $469 billion (U.S. Bureau of the Census, *Government Finances*: 1988-89, Washington, DC: U.S. Government Printing Office, p. 21). The most recent estimate of the business share of state and local taxes is 31 percent. (U.S. Advisory Commission on Intergovernmental Relations, *Regional Growth: Interstate Tax Competition* (Report A-76, March 1981), Revised version of Table A-1, figures for 1977). Private nonagricultural employment in the United States averaged 89 million during fiscal year 1989 (U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, January 1991, p. S-10).

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