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Boon or Boondoggle? The Debate Over State and Local Economic Development Policies

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Boon or Boondoggle?

The Debate Over State and Local Economic Development Policies

Over the past 20 years, governors and mayors have assumed responsibility for economic development. While many regions have experienced high unemployment and declining real wages, federal action to deal with these economic problems has been constrained by budget deficits and a conservative political philosophy, and state and local governments have had to act. Almost every state and metropolitan area has expanded the size and scope of economic development programs. More money is being spent on subsidies to new branch plants than ever before, and even conservative states have intervened in the private market by subsidizing business research and industrial modernization, and by providing capital and business training to small business and entrepreneurs.

To most politicians, economic development means more jobs. More jobs are expected to bring many benefits: lower unemployment, higher wages, greater property values, increased profits for local businesses, more tax revenues, and reelection for the politician who can take credit for these boons. Politicians usually emphasize most the benefit of providing jobs for the unemployed.

But critics argue persuasively that state and local economic development policies cannot achieve these benefits. According to the critics, economic development policies do not help the unemployed and the poor, but mostly benefit capitalists and the propertied. The indictment against state and local economic development policies has three parts. First, the policies are argued to have little effect on the growth of a small region such as a state or metropolitan area. Second, even if these policies could affect job growth, so many in-migrants would be attracted that the local unemployment rate would quickly return to its original level.

Third, even if local growth lowered unemployment in one area, from a national perspective these benefits would be offset by increased unemployment in other areas.

This book presents evidence to counter these criticisms of state and local economic development policies. It argues that economic development policies can significantly affect the growth of a state or metropolitan area, that increases in the growth of a local economy can benefit its unemployed, and that state and local economic development policies can benefit the overall national economy.

While the argument relies, in part, on my interpretation of previous research, I also present new empirical research on how metropolitan growth affects the unemployed, workers, and property owners. That research shows that faster growth of a metropolitan area has significant long-run effects on its unemployment rate. Furthermore, faster growth leads to significant occupational upgrading to better jobs, particularly for minority and less-educated persons. Growth of a metropolitan area also increases its property values. But overall, the benefits of faster growth are probably distributed in a progressive manner, that is, the real incomes of low-income persons increase by a greater percentage than those of upper-income persons.

This is not to imply that cutting business taxes to spur economic development is always the right policy. Public services to business also affect the economic growth of a local area. Depending on the circumstances, the labor market benefits of local economic growth may be outweighed by the costs of environmental damage due to growth and the costs of government resources devoted to economic development programs.

Focus on Local Economies

To avoid confusion at the outset, my arguments for the potential benefits of state and local economic development programs are meant to be applied to programs that seek to affect growth for an entire small economic region, such as a state or a metropolitan area.¹ Programs aimed at individual towns or suburbs within a metropolitan area raise

different issues. Metropolitan areas, or states, can legitimately be thought of as economic regions, because they have quasi-independent labor and housing markets. The trend in local economic development policy is towards metropolitan cooperation. In addition, states are increasingly prominent in organizing and financing economic development policy at all levels of government. Thus, the book addresses the types of state and local economic development policy that dominate the scene today and are likely to be even more important in the future.

What is Economic Development Policy?

Another source of confusion could be what is meant by “economic development policy.” Growth and structural change in the economy of a state or local area are arguably affected by every government action, from the quality of public schools to the regulation of optometrists. Economic development policies discussed here, however, are those that provide *direct* assistance to businesses. Direct economic development policies assist businesses with cash, such as tax subsidies, for example, or with services, such as training individuals in how to develop a business plan for a new enterprise. Policies such as those related to public schools that *indirectly* affect economic development have broader purposes and are best evaluated from a broader perspective. This book focuses on direct economic development policies because their claimed success in promoting economic growth is their main rationale. Furthermore, economic development policies that assist businesses directly are politically controversial. Liberals are concerned that these policies give too much profit to business, while conservatives are concerned that these policies give too much power to government.

Table 1.1 lists the main types of direct economic development policies being pursued by state and local governments. These policies can be grouped into two types. Traditional economic development policies seek to provide financial and other incentives for businesses to locate and expand in an area. Most incentives are provided through the area’s tax system and are targeted at attracting new manufacturing branch plants.

Table 1.1
A Typology of State and Local Economic Development Policies
that Directly Aid Businesses

Traditional Economic Development Policies
(Primarily Targeted at Branch Plant Recruitment)

Marketing Area As Branch Plant Location

Industrial development advertising
Marketing trips to corporate headquarters
Provision of site information to prospects

Financial Incentives

Industrial revenue bonds
Property tax abatements
Other tax relief
Provision of land at below-market prices
Direct state loans

Nonfinancial Incentives to Branch Plants

Customized industrial training
Expedited provision of site-specific infrastructure
Help with regulatory problems

“New Wave” Economic Development Policies
(Primarily Targeted at Small or Existing Businesses)

Capital Market Programs

Predominantly government-financed loan or equity programs
Government support for predominantly privately financed loan or equity programs

Information/Education for Small Business

Small business ombudsman/information office
Community college classes in starting a business
Small business development centers
Entrepreneurial training programs
Small business incubators

Research and High Technology

Centers of excellence in business-related research at public universities
Research-oriented industrial parks
Applied research grants
Technology transfer programs/industrial extension services

Export Assistance

Information/training in how to export
Trade missions
Export financing

What I call “new wave” economic development policies are an eclectic group of policies that became popular in many states during the late 1970s and early 1980s. These policies encourage various forms of innovation, such as applied research, industrial modernization, entrepreneurship, and business expansion into export markets. They also have in common a willingness to involve government much more with business decisions. Rather than just providing cash, they would have government provide services to businesses to help them determine their best market or technology.

Several prominent books on state and local economic development policies describe the many new wave policies and debate whether the new wave approach or the traditional approach is better.² While that debate is important, my focus in this book is on whether the general approach of assisting business for economic development purposes is likely to cause changes in business behavior that benefit other groups in society, and if so, who those groups are. All of the direct economic development policies have in common an attempt to reduce some sort of business costs, broadly defined. This even is true for new wave policies. For example, export information programs reduce the cost to businesses of acquiring information on markets in other countries; entrepreneurial training programs reduce the costs to potential entrepreneurs of developing a business and financing plan; applied research grants reduce the costs to high technology companies of developing an innovative product. Furthermore, the issue of the overall desirability of business assistance for economic development logically needs to be resolved before the issue of which type of business assistance is most effective. If the entire philosophy behind direct economic development policies is flawed—if these policies can only benefit the assisted businesses, or can only benefit property owners—then the debate over different types of policies is pointless.

Jobs Versus Other Goals of Economic Development Policies

The analysis of this study emphasizes one particular goal of direct economic development policies, the goal of more jobs for the state or local area. Some direct economic development policies have additional goals as well. For example, many of the new wave economic development policies also aim at encouraging innovation.

Job creation is the primary goal for all direct economic development policies, traditional or new wave, from the perspective of politicians and voters. Governor Mario Cuomo of New York expressed the opinion of many state and local political leaders and voters when he said that “while there are no panaceas, nothing comes closer than one simple word: jobs.”³ Advocates of new wave economic development policies may tout their innovation benefits, but the policies will face political death if they fail to increase job growth.⁴

Despite all the publicity given new wave economic development policies, the evidence suggests that more resources are devoted to traditional policies whose primary goal is more jobs for the state or local area. Data from the National Association of State Development Agencies indicate that expenditures by state development agencies totaled about \$1.5 billion in 1990 (National Association of State Development Agencies, 1990). Much of this agency spending is devoted to traditional rather than new wave programs. A State of Minnesota survey suggests that state spending on high technology economic development totaled \$550 million in 1988 (Minnesota Office of Science and Technology, 1988). Some of this spending appears to be for university basic research, and there is overlap between the NASDA and Minnesota figures. But even if there were no overlap, and all of this \$2 billion was devoted to new wave programs, these expenditures are dwarfed by the various tax subsidies, or “tax expenditures,” that state and local governments give to business for economic development purposes. For example, in the State of Michigan alone, over \$150 million annually is foregone from property tax abatements granted to businesses.⁵ For just one manufacturing branch plant (albeit a large one), the General Motors

Saturn plant, Tennessee state and local governments provided subsidies with a net present value of \$144 million, mostly in the form of property tax abatements.⁶ Furthermore, in addition to these tax expenditures that are clearly linked to specific economic development projects, many of the recent tax reforms in the states have reduced business tax rates and provided business tax credits and deductions, largely on the rationale that these changes would help the business climate and promote economic development.⁷ The “tax expenditures” caused by these development-oriented tax reforms vastly exceed what states spend on venture capital, entrepreneurial training, or other new wave economic development policies.

Do State and Local Economic Development Policies Affect Growth?

Financial subsidies . . . are rarely a significant concern in wise business-location decisions and usually amount to little more than a government giveaway and burden on taxpayers, including corporate taxpayers forced to subsidize their competitors. (Page 36 in *Leadership for Dynamic State Economics*, Committee for Economic Development, 1986)

The first issue in analyzing state and local economic development policies is whether these policies have any significant effect on the job growth of an area. If they fail to increase job growth in the areas that adopt them, they cannot help the unemployed.

Many policy researchers have denounced the traditional economic development policies of tax and financial subsidies as ineffective in promoting state or metropolitan area job growth. The usual theoretical argument for this position is that state and local taxes are too small a percentage of business costs to affect business growth decisions. The usual empirical argument for this position relies on both surveys of business firms and econometric studies of the determinants of state or metropolitan area job growth. Surveys of business firms often show a low ranking of state and local taxes as a location determinant. Furthermore, until

recent years, the overwhelming majority of econometric studies could find no significant statistical relationship between state and local business growth and state and local business taxes.

The theoretical argument that state and local business taxes are too small to affect business location is unpersuasive. Many states and metropolitan areas will be close substitutes from a business perspective, offering similar access to markets and supplies. Even small production cost differentials could prove decisive for a particular business location decision.

The problem with surveys of location determinants is that the questions asked are difficult to interpret. These surveys ask the business to list the most important, or essential, or crucial determinants of its current location choice. What “important” means in this context is difficult to define. What we really want to know is whether a different location would have been chosen if state and local business taxes had been 5 percent higher, or 10 percent higher. Answering this question requires a quantitative weighing of this site’s advantages versus alternative sites, and most businesses would be unable or unwilling to provide such precise answers to a survey.

Recent econometric evidence indicates that variations in state and local business taxes do have effects on state or metropolitan area growth that are likely to be considered significant by most policymakers. Difficult methodological problems plague the estimation of how taxes affect state and metropolitan area growth. No existing study escapes all these problems. But compared to earlier studies in this area, recent studies generally use better data and methodologies. Recent studies mostly agree that state and local business taxes affect the growth of an area, and even agree on the approximate magnitude of the effect.

Major public services that benefit business, such as improvement in public infrastructure, are also estimated to spur state or metropolitan area growth in many of the newer studies of business location. An economic development policy of business tax cuts may fail to increase jobs in a state or metropolitan area if it leads to a deterioration of public services to business. An economic development policy of tax increases may succeed in increasing jobs if it significantly improves public services to business. Policymakers must consider both tax and public

service effects on business if they are to successfully increase their area's job growth.

New wave regional economic development policies go beyond providing financial subsidies or general public services to providing specific services to small business and entrepreneurs. Many policy researchers who denounce state and local tax breaks are much more hopeful about these types of policies. At present, there is no good evidence on whether new wave economic development policies are effective. If new wave services have a higher value to business than their cost, they could have a greater effect on the growth of a state or metropolitan area, per dollar of government effort, than the more traditional business tax breaks. The cost effectiveness of state and local economic development policies is crucial to whether the policies make sense for a particular state or locality.

Does Local Growth Help the Unemployed and Lower-Income Households?

When jobs develop in a fast growing area, workers from other areas are attracted to fill the developing vacancies, thus preserving the same unemployment rate as before the growth surge. (John Logan and Harvey Molotch, Professors of Sociology at State University of New York at Albany and University of California—Santa Barbara, respectively, p. 89 in *Urban Fortunes: The Political Economy of Place*, 1987)

. . . the fortunes of numerous poor and unskilled urban residents of cities are often largely unaffected by even healthy expansion within local economies. (Page 5 in *Urban America in the Eighties*, Report of the Panel on Policies and Prospects for Metropolitan and Nonmetropolitan America, President's Commission for a National Agenda for the Eighties, 1980)

The next issue is whether the ability of state and local economic development policy to affect local growth makes any difference. Suppose some policy does increase job growth for a local economic region, such as a metropolitan area. The increase in local labor demand would

be expected to lead to some short-term reduction in local unemployment and upward pressure on real wages. But if labor mobility is rapid enough, the increase in local labor demand will be quickly matched by an increase in local labor supply. The unemployment rate will increase back to its original level, and the real wage will drop back to its original level.

Migration statistics indicate that the United States is a mobile enough society that labor market effects of faster local job growth could plausibly be very short-lived. For example, during a typical four-year period, over 13 percent of the population moves between metropolitan areas (Marston 1985). This mobility rate far exceeds the likely unemployment rate differentials across metropolitan areas. Only a small portion of this normal flow of migrants needs to respond to changes in relative job growth rates across metropolitan areas for the labor supply change to be well-matched to the labor demand change.

Even if local labor supply quickly responds to labor demand shifts, economic development policies would still provide the benefit of higher land values. Increased local demand and supply of labor would increase both business and residential demand for land. The price of existing houses and buildings would increase. Land would be bid away from other uses (e.g., agriculture or speculation) and devoted to new residential and commercial development to accommodate the new businesses and residents. Even with this increase in developed land supply, the price of existing land would remain at a permanently higher level, as existing land presumably has some locational advantages over the newly developed land. Unlike the case of labor, sufficient land cannot "migrate in" to a local area to force land prices back down to their original level.

The benefits of higher land values lack the political or ethical appeal of the benefits of lower unemployment. Land is disproportionately owned by upper-income groups, so land value benefits would be distributed "regressively": the percentage increase in real income would be greater for upper-income groups than for lower-income groups. If land value increases are the only benefits of state and local economic development policies, it is questionable whether anyone other than property owners should be required to pay for these policies. Furthermore, in this case economic development policies would be unable to help solve the social

problems of unemployment and poverty among minorities and other disadvantaged groups.

My argument for long-run labor market effects of local job growth is that what happens to people in the short run affects their long-run prospects. Suppose that an increase in local job growth leads, in the short run, to some currently unemployed residents getting jobs that they otherwise would not have obtained. These currently unemployed residents have a short-run advantage over potential in-migrants because in-migration does take some time to respond to shifts in labor demand. Because these current residents obtain jobs in the short run, they acquire skills that increase their employability and real wages in the long run, even after migration has had a chance to fully respond to the increased labor demand.

This dependence of a long-run equilibrium—in this case, the long-run equilibrium unemployment rate of individuals—on past history has been labeled *hysteresis*. Hysteresis was originally used in physics to describe how the electromagnetic characteristics of certain metals are permanently affected by the temporary application of certain magnetic forces.⁸ More recently, some economists have suggested that an economy's equilibrium unemployment rate may be permanently increased by a temporary recession, or lowered by a temporary boom. If this is true, then macroeconomic policies that affect the short-run performance of an economy may also affect its long-run performance. The issue of whether equilibrium unemployment exhibits hysteresis has implications much broader than simply who benefits from state and local economic development policies.

The new empirical results of this book support the hypothesis that labor markets are subject to hysteresis effects. The results are based on analysis of average unemployment rates, occupational wage rates, and housing and other prices for 25 metropolitan areas from 1972 to 1986, and on analysis of the labor market success of 44,000 adult males in 89 metropolitan areas from 1979 to 1986. The results, extensively presented in four chapters of the book, can be briefly summarized here. The data suggest that a once-and-for-all shock to a metropolitan area's employment—that is, a shock that temporarily affects the employment growth rate but permanently affects the employment level—lowers the

area's unemployment rate and raises labor force participation rates for at least eight years after the shock. Holding occupation constant, real wages are unchanged. Individuals with given education and experience are more likely to be promoted to higher-paying occupations in metropolitan economies that experience higher growth, however, and this upgrading in occupational status persists well after the temporary shock to growth has subsided. The effects of local growth on real earnings are highest for blacks and for less-educated workers. Local growth also raises property values; overall, however, it appears that faster local growth is likely to have a progressive impact on the income distribution. The percentage increase in real income is greatest for low-income groups, even accounting for the regressive distribution of the benefits from increased property values.

Can State and Local Economic Development Policies Benefit the National Economy?

*I firmly believe that state government must resist the temptation to intervene directly in economic decisions of the marketplace. It is certainly true that the combination of reduced federal support for state and local programs and the devastating impact of our recent recessions has put enormous pressure on state governments to "do something." The reality, however, is that state actions have not always increased the country's net investment. On a national scale, the impact of state economic development initiatives on U.S. economic activity is dominated by monetary, fiscal, and trade decisions at the federal level. States, therefore, are merely competing at the margins with one another for their share of new investment. Little or no net gain for the United States as a whole is attained from these programs. (Ralph E. Bailey, chairman and chief executive officer, Conoco, Inc., memorandum of dissent on pages 88-89 of *Leadership for Dynamic State Economies*, Committee for Economic Development, 1986)*

The argument is often made, as Bailey does in the above quotation, that state and local economic development policies are, even at best, a zero-sum game from a national perspective. It is argued that even if

economic development policies succeed in increasing growth in one area, this growth is merely transferred from some other area, and overall national growth is unaffected. The lower unemployment and higher wages in one area are offset by the higher unemployment and lower wages in other areas.

My argument against this “zero-sum” game position is twofold. First, even if it were true that state and local economic development policies just reshuffled jobs among geographic areas, such reshuffling may benefit the nation. Individuals vary in the dollar value they place on getting a job, which determines how high a wage they will require in order to accept a job. For example, individuals may place a higher value on obtaining a job—that is, are willing to accept a very low wage—if they have few other income sources. Individuals may place a lower value on obtaining a job if they feel they make good use of their time outside the wage labor market, such as taking care of children. In low-unemployment areas, most individuals who place a high value on getting a job will get one fairly quickly. In high-unemployment areas, many individuals who place a high value on getting a job will remain unemployed for a long time. As a result, the average unemployed individual in high-unemployment areas will “need” a job more—in the sense of placing a higher dollar value on getting one—than the average unemployed individual in low-unemployment areas. High-unemployment areas will benefit more from an additional job than low-unemployment areas, as the social benefits from hiring the average unemployed person are higher.

The vigor with which states and governments pursue economic development probably reflects these differences in the social benefits of reducing unemployment. Common sense suggests that high-unemployment states and localities will face greater political pressures to expand economic development policies. The scanty empirical evidence suggests that high-unemployment areas respond to these pressures by more aggressively pursuing economic development. The competitive game of state and local economic development probably helps redistribute jobs to the most needy areas.

Second, state and local competition for jobs may increase national growth. Higher subsidies in many local areas for expanded business

output and employment may reduce the average national unemployment rate and increase output. In addition, the transfer of jobs from low-unemployment regions to high-unemployment regions may reduce inflationary pressures and allow national policymakers to achieve lower national unemployment and higher output without increasing inflation.

One potential negative effect of state and local competition for jobs is that the national distribution of income may become more regressive, that is, more income may go to the rich instead of the poor. Competition for jobs may lead to reduced taxes on business owners. Wealthy business owners may benefit. But policymakers should offset these benefits for the rich by making the federal tax system more progressive, rather than by attempting to eliminate competition for jobs.

Is the Glass Half-Full or Half-Empty?

The focus of this book is on how state and local economic development policies can potentially provide benefits. This focus is necessary because the prevailing intellectual assessment of these policies is too negative. It should not, however, be interpreted as a blanket endorsement of all state and local economic development policies.

Empirical evidence presented here suggests that the benefits and costs of state and local economic development policies will often be close. Net benefits of economic development policies are most likely to be positive in areas of high unemployment and for programs that have large effects on business location, expansion, and start-up decisions per dollar of government spending.

Organization of the Book

The remainder of the book presents these arguments in more detail. Chapter 2 reviews what previous research shows about how state and local public policies affect business growth.

Chapters 3 through 7 develop the broad theme of the book: how metropolitan growth affects different groups in the population. Chapter

3 presents the theory of likely distributional effects of local growth. Chapters 4, 5, and 6 present empirical estimates of the effects of metropolitan growth on unemployment rates and other measures of labor market activities, prices, and wages. Chapter 7 examines the overall effect of growth on real earnings, and uses these results to simulate the likely quantitative magnitude of the distributional and efficiency effects of local growth.

Chapter 8 considers whether state and local economic development efforts help the national economy. Chapter 9 concludes with a discussion of the broader implications of these results for macroeconomic policy, antipoverty policy, and the role of local areas in national policy.

NOTES

1. The theoretical analysis of the book may also apply to groupings of counties in nonmetropolitan areas that constitute true regional labor and housing markets. Virtually none of the empirical work of the book deals with these nonmetropolitan economic regions, however, so extrapolation of the findings to nonmetropolitan areas is more uncertain.
2. I refer here to such recent books as *Laboratories of Democracy*, by journalist David Osborne (1988), or *The Wealth of States*, by several policy analysts associated with the Council of State Planning and Policy Agencies (Vaughan, Pollard, and Dyer 1985). Both these books argue against traditional economic development policies and in favor of some new wave economic development policies. A more scholarly account of this debate is provided by political scientist Peter Eisinger, in his comprehensive book on state and local economic development, *The Rise of the Entrepreneurial State* (Eisinger 1988). Case studies of how this debate has been resolved so far in various states are provided in *The New Economic Role of American States*, edited by Scott Fosler of the Committee for Economic Development, a national business think tank (Fosler 1988).
3. Eisinger (1988), p. 10.
4. Vaughan, Pollard, and Dyer, in their book *The Wealth of States*, are certainly aware of the political importance of creating jobs. One of their arguments for a greater focus on new wave economic development policies is that such policies are more effective than traditional economic development policies in creating jobs in the long run: “. . . in the long run, employment opportunities and wealth will be greater under an entrepreneurial strategy than under any alternative approach to development” (Vaughan, Pollard, and Dyer 1985, p. 128). Osborne also makes similar arguments in his book: “Businesses that fail to innovate do not last long; regional economies in which innovation does not flourish quickly stagnate.” (Osborne 1988, p. 252).
5. These Michigan figures come from a report by the Citizens Research Council of Michigan (1986). Michigan is the only state I know of that keeps track of the volume of property tax abatements throughout the state.
6. These Tennessee figures come from a paper by Bartik, Becker, Lake, and Bush (1987). The figures are based on the in lieu of tax agreement between Maury County and Saturn, and on information from the Tennessee Department of Economic and Community Development on state expenditures on roads and job training for the Saturn plant. Stating the subsidy in present value terms is an appropriate way of emphasizing the large size of traditional economic development

subsidies. The present value of some flow over time of subsidies tells us what one-time subsidy, given today, would have the same value as that flow of subsidies. If all new manufacturing investment received the same present value subsidy as Saturn, the resulting flow of subsidies would be equivalent to spending \$3.4 billion annually on subsidies. Total manufacturing gross investment in 1985 was \$81.8 billion; \$144 million times 81.8/3.5 would yield a total present value of new subsidy commitments of \$3.4 billion. I should note that the Saturn subsidy was not particularly large for an auto plant; for example, the Kentucky subsidy to its Toyota plant was apparently much greater (Milward and Newman 1989).

7. Hal Hovey, editor of *State Policy Reports*, has stated that "state tax systems are evolving in the direction of [development-oriented] tax policies," which would eventually imply "eliminating *all* state and local taxes paid in operations, such as manufacturing, that have choices of where they locate and expand." (Hovey 1986, pp. 94-95). According to Steve Gold, former Director of Fiscal Studies of the National Conference of State Legislatures, "Interstate tax competition not only remains, but may intensify." (Gold 1988, p. 27).

8. Cross and Allan (1988) discuss the history of the hysteresis concept.