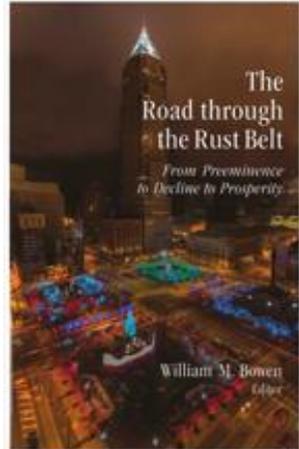

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the Rust Belt**

**From Preeminence
to Decline to Prosperity**

William M. Bowen
Editor

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10

Reasons for Misgivings about Local Economic Development Initiatives

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Local and regional economic development efforts consisting of public subsidies for business and public support for promoting increased local consumption are based on the “market failure” approach. Such activities are attempts to correct the operation of nonfunctioning private markets. This approach, while still widely touted and utilized, also presents questions as to its effectiveness, especially in Rust Belt cities.

From the time of the Industrial Revolution through the middle of the twentieth century, the enormous capital investments made in cities such as Pittsburgh, Cleveland, Buffalo, Cincinnati, Milwaukee, St. Louis, and Detroit helped the industries within them to become pre-eminently competitive.¹ High levels of immigration, to supply their demands for largely blue-collar labor, were another contributing factor. As a result, these and similar cities became globally dominant industrial powerhouses. Fabulous wealth was created. But as the end of the twentieth century unfolded, knowledge and technology advanced, and the world economy changed.

Today these same places have earned reputations as lackluster, Rust Belt cities with serious problems. Large numbers of talented people have, for the past several decades, steadily out-migrated from them for better opportunities elsewhere, leaving behind obsolete production facilities built for early to mid twentieth century manufacturing, a public infrastructure in poor condition, relatively high taxes, and a strongly unionized workforce.² The large and now deteriorating investments in capital and infrastructure have become increasingly difficult to

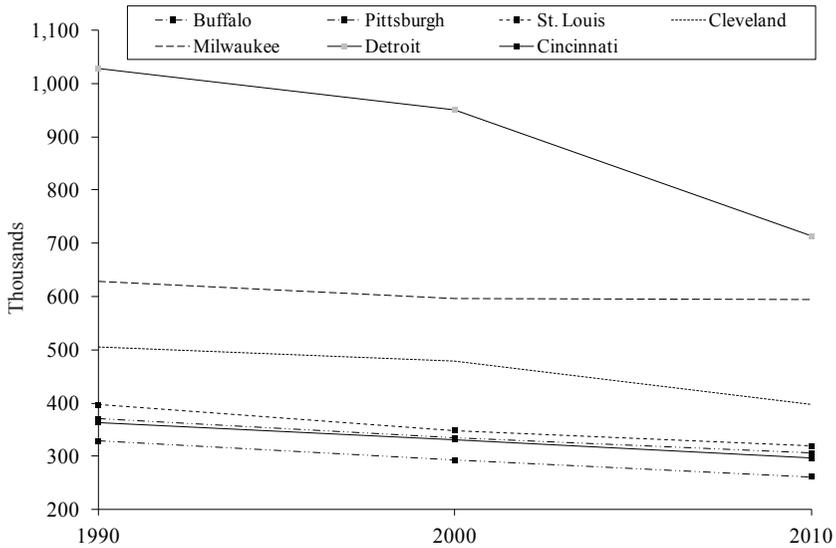
maintain with continuously declining populations and correspondingly smaller tax bases. Population loss has also brought reduced capacity for local and county government agencies to provide public services, as well as lessened representation in national-level political decision processes. Figure 10.1 shows the population decline over recent decades.

The public and to some degree nonprofit sectors in these cities have responded to the deterioration in part by enacting a range of local economic-development initiatives. These include public or quasi-public interventions into local markets through various forms of incentives and subsidies designed to change the respective city's local economic growth paths. They include industrial parks, tax abatements, enterprise zones, aquariums, artist incubators, river walks, casinos, festival marketplaces, and many others. There are many examples of these initiatives.

In Cuyahoga County, Ohio (home of Cleveland), for instance, the three county commissioners decided in 2007 to expend well in excess of \$465 million of taxpayer money for a privately owned and operated "Medical Mart" (Nichols 2009). The decision was ostensibly predicated on the promise of a one-stop shop in which major medical vendors, such as GE, Phillips, and Siemens, would have floor space upon which to sell medical products to hospitals and doctors from around the world visiting Cleveland and looking to buy the latest in medical technology and cutting-edge equipment. A powerful local coalition of advocates alleged that this would attract a steady stream of conferences and conventions, bringing hundreds of thousands of physicians and hospital administrators to the city each year, creating a huge number of new jobs, generating major new local revenues, and otherwise revitalizing the region.

Insofar as public deliberation occurred at all, it was not widespread or robust. It did not include anything vaguely resembling judicious consideration of the expected value of returns to the public coffers from the expenditure, much less of the research showing that municipal outlays for purposes of attracting conventions in the past have not always yielded positive results for local economies (Fenich 1992; Hovinen 2002; Isler 2008; Laslo and Judd 2004; Noll and Zimbalist 1997; Sanders 2004, 2005). To support the mart, the county commissioners, in closed meetings purportedly held to protect the owner operator's trade secrets, without a vote of the county's citizens, and without a publicly available cost-benefit analysis, decided to fund the Medi-

Figure 10.1 Changing Population in Selected Rust Belt Cities, 1990–2010



SOURCE: U.S. Census Bureau (1990, 2000, 2010).

cal Mart from a 20-year \$0.0025 sales tax on every dollar spent in the county.

Similarly, throughout the industrial Midwest and beyond, elected and other urban authorities have supported and committed public funds to construct and operate major sports-related and other facilities that would supposedly raise the respective city’s growth paths. Examples include stadiums, arenas, and training centers in Buffalo, Cincinnati, Cleveland, Detroit, Milwaukee, Pittsburgh, and St. Louis. Virtually all were designed and built using public funds, but privately owned and operated, ostensibly to stem decline and renew prosperity by creating jobs (Noll and Zimbalist 1997). The costs of constructing and running these facilities have been funded primarily through broad-based general taxes.³ Specific illustrations of initiatives justified by local economic development objectives include the America’s Center Convention Complex in St. Louis, the Detroit Creative Business Accelerator, the Detroit Economic Growth Corporation for Business Retention and Attraction, the Team Northeast Ohio (NEO) Minority Business Attraction Initiative

in Cleveland, the National Underground Railroad Freedom Center and the Queensgate Terminals in Cincinnati, the Forest Hills Community Development Corporation in Pittsburgh, and the Niagara Convention Center in Buffalo, among many others.

Use of local economic development initiatives characteristically involves the exercise of public authority and the taxing power to claim some portion of the total local resource base for declared purposes of economic and job growth. The policies are supposed to affect consumer or firm behavior, or both. Generally, they involve tax abatements or public expenditures for the stated goals of providing public benefits within the urban or regional economic system.⁴ They comprise a range of public subsidies and direct cash aid for businesses, such as financial incentives for branch plant recruitment, capital market programs, information and education, export assistance, and centers for business-related research. The approaches include property and income taxes that are reduced or credited to selected private interests. They also consist of public financial support for purposes of increasing levels of local consumption spending on items such as publicly financed tourism and art facilities, casinos, and outdoor recreation activities. All constitute one form or another of a “nonmarket allocation mechanism” (Arrow 1985).

In the following pages we focus specifically on the market failure rationale for these and similar local economic development initiatives (Bartik 1990). In this line of reasoning, economic development initiatives are justified in terms of standard neoclassical microeconomics by the effort to restore economic efficiency. The rationale for them assumes that they will have the effect of correcting impediments to the formation or operation of private markets. Such obstacles are widely considered to include external costs and benefits, imperfect information and the existence of various monopolies, such as public utilities. On Bartik’s (1990) account, they also consist of involuntary unemployment and underemployment, imperfect capital markets attributable to suboptimal regulation, distorted fiscal benefits, improperly set social discount rates, underinvestment in human capital, imperfections in knowledge and information markets, and spillovers from research and development activities. Each of these forms of market failure has its own corresponding means of policy evaluation. The presence of any of them within a regional market could justify the use of an economic

development initiative. Several forms of market failure may also occur simultaneously, in circumstances of multiple market failure.

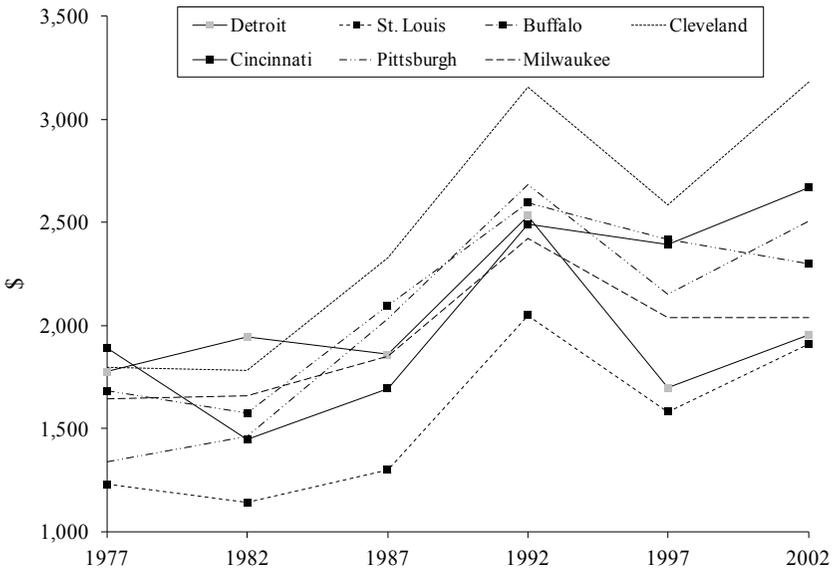
We first consider some reasons to have reservations with this approach, specifically based on principles espoused by members of the Austrian school of economics (Hayek 1944; Ikeda 2004; O'Toole 2004; Sautet 2004). As the following pages describe, Austrian economic theory stipulates that competition in free markets is virtually the only real way to create local prosperity. Then we consider further reasons for such reservations based on the theory of the second best (Wolf 1979). The theory of the second best stipulates that, under conditions of multiple market failure, the outcomes of economic development initiatives are inherently unpredictable. Finally, we assess the implications of these considerations for the use of local economic development initiatives to renew prosperity in midwestern industrial cities today.

AUSTRIAN CRITIQUES OF LOCAL ECONOMIC DEVELOPMENT INITIATIVES

The Austrian critiques of local economic development initiatives differ markedly from popular knee-jerk misgivings about the growth in public spending and taxation that have occurred over the past decades (Tanzi and Schuknecht 2000). This is not to say that these popular concerns have no basis in fact. The growth in public spending and taxation is real, but the Austrian misgivings are in no way knee-jerk. One way to look at the trends within Rust Belt cities is in terms of change in per-capita locally generated general revenue.⁵ Figures 10.2 and 10.3 illustrate these trends for the final decades of the twentieth century vis-a-vis selected cities from this group. Figure 10.2 indicates that per-capita locally generated general revenues incrementally have increased for time period 1977–2002. Figure 10.3 shows similar trends on a constant income basis, adjusted for the cost of living.⁶ It may be noted that while Detroit is out of sync with the trends in the other cities, it is the only one that has recently gone bankrupt.

The Austrian critiques also differ from scholarly misgivings about local economic development initiatives that stem from the mixed and largely inconclusive results of analysis from the applied social science

Figure 10.2 Locally Generated General General Revenue per Capita in Selected Rust Belt Cities, 1977–2002

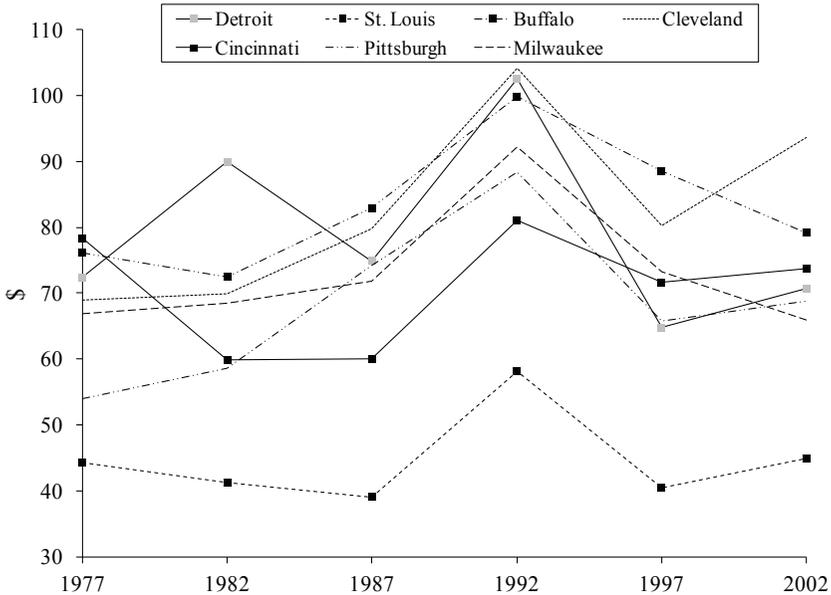


NOTE: Tax revenues are shown in 2002 dollars, which are adjusted at a constantly inflated rate of base year 2002. Data for all cities are based on county-level information for the county containing the central city. A linear regression through these data fit well and have positive slopes. The slopes and R^2 statistics are (\$290.09, 0.7612), (\$215.19, 0.6771), (\$244.23, 0.7116), (\$174.69, 0.6378), (\$23.53, 0.0219), (\$105.03, 0.4520), and (\$156.33, 0.6015) for Cleveland, Cincinnati, Pittsburgh, Buffalo, Detroit, Milwaukee, and St. Louis, respectively.

SOURCE: Population numbers are from the U.S. Census Bureau for 1977, 1982, 1987, 1992, 1997, and 2002; locally generated general tax revenues are from Annual Survey of Governments of the U.S. Census Bureau, which are produced by Inter-university Consortium for Political and Social Research (ICPSR) and available at <http://www.icpsr.umich.edu>.

research community. Some of this social science research shows that local economic development initiatives have had at least some short-term positive effects (Bartik 1991; Reese and Ye 2011). Other studies find that economic development initiatives have either not induced the promised improvements, did not have any discernible effects at all, or led to less economic prosperity (Hissong 2003; Ikeda and Staley 2004; Peters and Fisher 2003, 2004; Reese and Ye 2011; Swetkis 2009).

Figure 10.3 Locally Generated General Revenue per Thousand Dollars of Personal Income in Selected Rust Belt Cities, 1977–2002



NOTE: General revenues and personal income are all adjusted to constant 2002 dollars using the Consumer Price Index (CPI). All cities are based on county-level data for the county containing the central city. Locally generated general revenues per \$1,000 of personal income represent the financial burden of county residents to pay taxes. Though the regression lines in Figure 10.3 do not all fit as well as do the lines in Figure 10.2, with the exception of Detroit the slopes on the regression lines for all of the cities remain positive. The slopes and R^2 statistics are (\$5.10, 0.4835), (\$0.96, 0.0398), (\$3.13, 0.2303), (\$2.30, 0.1895), (-\$1.62, 0.0453), (\$0.84, 0.0254), and (\$0.59, 0.0246) for Cleveland, Cincinnati, Pittsburgh, Buffalo, Detroit, Milwaukee, and St. Louis, respectively.

SOURCE: Locally generated general revenues are from the Annual Survey of Governments of the U.S. Census Bureau produced by ICPSR, which is available at <http://www.icpsr.umich.edu>; personal income is from the Bureau of Economic Analysis for time period 1977–2002 and is available at <http://www.bea.gov/regional/index.htm>.

The Austrian critiques instead are based conceptually in disputes over the realism of the assumptions made in neoclassical microeconomics, particularly the supposition that decision makers are rational and in possession of complete information (Caplan 1999). Austrian economic theorists specifically reject the realism of any assumption that market decision makers can ever act on the basis of anything remotely similar to omniscience about their situations. Instead, these theorists maintain that all decisions that create wealth and prosperity, or not, including those involving local economic development initiatives, are made by ordinary people. Accordingly, these people are fallible. They possess imperfect knowledge, and seldom if ever make fully rational choices. Their characteristics are those of *Homo sapiens*, not *homo economicus*. When in positions of authority to make public initiative decisions, they are at times seriously threatened by moral hazards, misaligned incentives, special interest groups, and political influences.

The Concept of Catallaxy

Much of the Austrian critique centers on the concept of catallaxy. This term describes the origin of wealth and prosperity, stipulating specifically that they must emanate at least in part from spontaneously arising circumstances beyond the capacity of any given finite set of human decision makers to design. The concept is rooted in Frederick Hayek's philosophy of social order (Hayek 1944, 1945, 1976a,b).

Hayek assumed the order that we as humans find in the world is given to it at least in part by our own minds (Gray 1982). Humans, he thought, are active and organic, albeit "constrained" choosers of purposes and means to achieve them (Sowell 1987). We make our choices and earn our living in the world not so much on the basis of primarily abstract or theoretical knowledge as on the basis of practical knowledge. Hayek used "special knowledge of circumstances" to refer to the knowledge with which we do this. Accordingly, special knowledge of circumstances is the understanding of concrete situations, local conditions, people, and opportunities. It has both abstract and practical dimensions. It is abstract in that all of it is explicitly or otherwise predicated upon assumptions, some of which are explicit but most are tacit, for instance, about human nature, language, and reasoning, through the relationships among elements of sensory perceptions. At the same time,

such knowledge is practical in that it is embodied in habits of thought, perception, and behavior that allow us to act so as to survive, adapt to our ever-changing circumstances, and achieve our purposes.⁷ At its best, this knowledge allows us to act so as to create wealth and prosperity, primarily through market exchanges.

The Limitations of Decision Makers

Because special knowledge of circumstances is always at least in part attributable to the active ordering structures of our own minds, it is at best limited and idiographic. Social and economic reality, Hayek contended, is far too complex to be comprehended by a single mind. While any one person or group may possess enough knowledge to successfully provide answers for the full range of questions that can be asked within the context of a given set of assumptions, only a limited range of questions may be asked from within that same set. The knowledge required to make sound decisions about how to improve prosperity for an entire urban economic system exists only in widely disbursed form among all of the members of that system, each of whom knows his or her own situation and purposes better than does anyone else. This information greatly exceeds that available to any single political authority or business leader, economic development planning committee, or government agency.

Accordingly, no decision maker, group of decision makers, or agency involved with a local economic development initiative can possibly be sufficiently well informed and rational to be able to calculate and coordinate all the variables that contribute to the creation of wealth and prosperity in an urban economic system. Therefore, it is not feasible for them to reliably predict the full range of outcomes from any such initiative. When social norms nevertheless routinely accept the use of local economic development initiatives as substitutes for market decisions, the likely effects include excessively large and unaccountable local governments, untrustworthy urban governance processes, waste of resources, retardation of the creation of wealth and the renewal of prosperity, and disrespect for the preferences, if not individual liberties, of those who are either unwilling or unable to exert political influence on the allocation decisions.

The Importance of the Market

The concept of catallaxy suggests that, in capitalistic markets, social and economic order and prosperity emerge from the chaos of myriads of human decisions in “the mutual adjustment of many individual economies in a market” (Hayek 1976b, pp. 108–109). Prosperity arises spontaneously through the coordinated interactions and mutual adjustments of multitudes of unfettered market exchanges, each of which occurs on the basis of price signals and the partial knowledge of the participants, not as a result of economic development initiatives. To be sure, some participants are more knowledgeable than others, and some are more resourceful. But none conduct their exchanges within the context of a fully integrated and orchestrated social system known as “the market,” especially not one that produces any sort of definable public interest or overall product that local economic development authorities might optimize in the manner of a linear program. The idea that the purpose of an urban economy is to maximize one form or another of a social objective function or total social product, such as the number of new jobs, and that local economic development decision makers can make reliable decisions to improve or increase it is simply a misconception.

Following this line of reasoning, the idea that economic development decision makers know enough to somehow maximize a social objective function for the whole of an urban economy, or even at the margin to nudge things in their intended direction, is little more than hubris. The limitations on their knowledge imply that they could never conceive, much less design and orchestrate, the array of exchange most conducive to prosperity within a city of any size with anywhere near the degree of balance and nuance as can the market. Instead, the greatest feasible degree of decentralized, bottom-up decision making will lead to the greatest increases in prosperity. To reliably design and deliver a mechanism for changing a midwestern industrial city’s economic path, authorities would have to know not only the entire range of relevant facts and relations, but also how all individuals would mutually accommodate each other as a result of its implementation. Even the very best theories of social planning, human behavior, and economics are not adequate for the requisite tasks.

Implications for the Role of Government

The concept of catallaxy also has implications for the institutions used to govern local market behavior, especially in terms of democratic values and individual rights. Hayek, in particular, was concerned about the reach of governmental power into economic affairs. He maintained that, when governmental power is held and exercised by those who do not recognize or care about the limitations of their own knowledge, or by those who are intent primarily on further enhancing their own power and authority, one of the likely effects is to unduly restrict individual freedoms and effectively violate the rights of others. The use of local economic development initiatives to change urban economic growth paths may thus at times conflict with the core values of freedom, equality, and private property on which the potential renewal of prosperity must be judged. Anyone who has gone before a zoning commission or an architectural review board, or who has attempted to change the mind of a determined county commissioner understands and knows that local governments can wield sweeping and at times even seemingly tyrannical powers.⁸

In the case of Cleveland's Medical Mart, by 2011, after project cost escalations of over \$150 million, and after construction had started, it became evident that the concept had failed to attract large, multinational or national vendors who wanted to display their products. Instead, it was announced that the mart would house primarily local vendors, including hospitals, universities, and firms in the information technology, security system, and aromatherapy business (Campbell 2011). The stated purpose also morphed from the attraction of hundreds of thousands of doctors and hospital administrators from outside the region, looking to purchase high-tech medical devices, to a largely locally oriented center for continuing medical education (Campbell 2011; Gomez 2011). Rather than housing major national medical supply firms, the main tenants were local and included small medical businesses, universities, and other medical interests from the area, not outside vendors that would attract a steady stream of medical conventions.

In summary, the Austrian critiques argue that local economic development initiatives are no substitute for the verdicts of unfettered capitalist markets. There is moreover every reason to believe that private

investors placing their own money at risk will make better decisions than will economic development authorities. Thus, if a medical mart, convention center, stadium, or other local initiative is predicted to generate net positive revenues for an urban economy, let private markets make the full investment and reap the full profits, or take the full losses it brings. Only unfettered markets can rationally coordinate the demand and supply of land, labor, capital, and technology so as to create widespread prosperity. Had the \$465 million or more tax dollars spent on the Cleveland Medical Mart otherwise not been taxed, and had the funds instead remained in free markets, those dollars would have been used in other ways, some of which might have generated genuine prosperity for a range of the region's citizens.

LOCAL ECONOMIC DEVELOPMENT INITIATIVES AND THE THEORY OF THE SECOND BEST

On these conceptual foundations, Austrian economic theorists argue that, of all feasible alternatives thus far conceived, the activity of voluntary exchange in unfettered capitalist markets alone has the greatest potential to generate widespread wealth and prosperity. This process is hampered by substituting the purposes and conceptions of imperfectly informed and cognitively limited economic development authorities for those of the vastly larger number of firms and individuals who would otherwise participate with the same resources in free markets. Insofar as such policies are rationalized by market failures attributable to imperfect knowledge and information, they may not be so much a solution to economic decline as a contributing cause of it.

Markets fail for reasons other than imperfect information and sometimes for more than one reason at a time. Monopolies, for instance, are widely considered to constitute a source of market failure, as are non-rival and nonexcludable goods and services, market transactions involving costs and benefits that accrue to third parties not directly involved in the transaction, and transactions costs that are so high that markets are not economically viable and therefore do not exist (Arrow 1985; Bator 1985). Setting aside for the moment all considerations about imperfect knowledge, it is widely recognized that when instances of any one of

these other forms of market failure occur, increases in prosperity cannot be properly incentivized by unfettered capitalist market activity alone. The concept of catallaxy as a basis for a critique of local economic development initiatives applies only to those market failures caused specifically by imperfect knowledge and information; it has very little if any direct bearing upon any of these other sources of market failure.

Less widely acknowledged, however, is that in instances when more than one market failure occurs simultaneously, actions taken to improve some of the conditions will not necessarily improve the efficiency of the urban economy as a whole. Indeed, exactly this point—that under conditions of multiple market failure the use of any sort of public policy intervention will not necessarily improve the efficiency of an economic system as a whole—was made formally in the general theory of the second best (Lipsey and Lancaster 1956; Wolf 1988).

The theory of the second best stipulates that the existence of an efficient market is not possible in the absence of the simultaneous fulfillment of a set of preconditions, all of which are jointly required to ensure that every participant in the market is a price taker. These preconditions specifically include zero entry and exit barriers, perfect information, perfect factor mobility, zero transactions cost, nonincreasing returns to scale, and homogeneous products across suppliers (Stigler 1957). Each precondition is necessary, because for a market to be efficient it must be impossible for any given participant to influence prices in the market. If any one of the preconditions is not fulfilled, some market participants are apt to become price makers, and market failure is likely to occur. Moreover, if in any given market more than one of the preconditions is not fulfilled, multiple market failure occurs. In turn, when the existence of an efficient market is not possible, the best remaining outcome is the “second best.”

The theory of the second best has the important negative corollary that the public policy implications of multiple market failure are inherently ambiguous (Wolf 1979). That is, under conditions of multiple market failure it cannot be determined a priori exactly what the second-best outcome would look like or how to attain it. Moreover, a situation in which more, but not all, of the preconditions necessary for fully efficient markets are satisfied is not necessarily better than one in which fewer are satisfied. The removal of any one of the constituent failures through a local economic development initiative may affect

overall urban economic efficiency by raising it, lowering it, or leaving it unchanged. But according to the theory of the second best there is no theoretically sound and reliable way to tell which. The only thing certain is that the result will vary on a situation-by-situation basis. Local economic development initiatives under multiple market failure conditions may be as likely to have a deleterious effect on the efficiency of the overall urban economy as they are to have a positive one.

This line of reasoning begs the question: do midwestern industrial urban economic systems contain multiple market failures? Certainly, pioneering urban economist Wilbur Thompson (1968) thought so, as have numerous subsequent urban scholars.⁹ As an illustration, land use decisions in any given urban market are apt to be subject to a combination of market failures. Some of these failures are attributable to collective action problems (Foster 2011).¹⁰ Others are due to discrimination in local housing markets (Herbert and Belsky 2008) and labor markets (Brueckner and Zenou 2003), to externalities in local housing markets (Dietz and Haurin 2003; Ewing 2008; Odland 1985), to capital market imperfections and positive external effects on the local educational systems (De Fraja 2002), to congestion on nearby roads (Arnott and Small 1994; Downs 1962; Timilsina and Dulal 2011), to urban air pollution (Kahn 2006), and to high information and transactions costs in financial systems (Levine 1997), among countless other challenges.

Both the concept of catallaxy and the theory of the second best thus lead to a similar general conclusion: the existence of market failure does not guarantee that local economic development initiatives designed and implemented to correct such a problem will succeed. Decisions to use local economic development initiatives in midwestern industrial cities may or may not lead to outcomes that include greater prosperity. The outcomes of using any given local economic development initiative can be assessed only approximately and ideographically on the basis of each individual case, and only using carefully designed and analyzed empirical evidence.

THE GOVERNMENT-FAILURE APPROACH TO LOCAL ECONOMIC DEVELOPMENT

Uncertainty and unpredictability are not only basic characteristics of markets but also fundamental aspects of government failure. By definition, this failure occurs in situations in which government has “created inefficiencies because it should not have intervened in the first place or when it could have solved a given problem or set of problems more efficiently” (Winston 2006, pp. 2–3). Government failure has to our knowledge not been widely considered in the local economic development literature. With this type of failure, the goal of increased prosperity would have been better served by analysis and application of fundamental economic principles of free markets rather than by leaving decisions to the tacit knowledge of circumstance possessed by local economic development authorities.

Both Austrian economic theory and the theory of the second best lead to the inference that local economic development initiatives cannot as a rule be counted upon to reduce waste or to stimulate wealth creation for average citizens. Nor can they be relied on to improve efficiency in the allocation of resources beyond the level that would otherwise have been feasible had the resources remained circulating in the market. Accordingly, this provides a theoretical framework within which misgivings about these initiatives are rational, logical, and consistent with evidence. The basic consideration is that the full range of outcomes is and must remain uncertain and unpredictable until well after the go-no-go decision is made with respect to any given local economic development initiative.

Intervention May Not Be the Answer

It is of significance to note that in any situation in which a market failure is shown to exist, its presence alone does not necessarily imply that intervention into the market can improve the situation. For one reason, market failures may correct themselves. For another reason, governments can fail, too. This could occur, for instance, in circumstances in which the decision to use a nonmarket allocation mechanism is based upon flawed or incomplete knowledge and shortsightedness,

or when the relevant economic development authority, regardless of any conscious intentions, is subjected to the influences of local growth coalitions or other powerful special interests.

Logically, to be consistent with the market failure approach to economic development, decision makers deliberating a proposed initiative must first establish that a market failure exists. But this is not enough to rationally justify the use of a proposed local economic development initiative. The decision makers must also ensure that all expected benefits of the proposal are at least equal to all the expected costs.

The existence of a market failure means that properly functioning price signals are absent. In this situation, markets left alone will not yield the most efficient use of resources, and therefore will not generate the greatest feasible levels of prosperity. Demonstration of the existence of a market failure is necessary for a local economic development initiative to be rational, because in situations in which there is no market failure, reliance upon the unfettered market without government intervention is the most likely way to create new wealth or prosperity. At the same time, the existence of market failure is not a sufficient condition for such an initiative to be rationally justified because of government failure. Much as the absence of the preconditions for an efficient market accounts for market failure, so the absence of the preconditions for sound public sector decision making accounts for government failure. These preconditions include knowledge and information necessary for economic calculation on behalf of economic development authorities, appropriate incentives, adequately conceptualized decision processes, no unanticipated behavioral responses, and no abuses of political power.¹¹

If while considering a local economic development initiative decision makers fail to thoroughly consider both market failure and government failure, they cannot possibly tell in advance of its implementation whether or not the costs of the initiative will or will not exceed the corresponding benefits (Bartik 1997; Peters and Fisher 2004).

The Need for Benefit-Cost Analysis

One of the best known ways to protect against situations in which the costs of an initiative exceed the benefits is through careful benefit-cost analysis. Benefit-cost analysis is an underutilized framework for

the planning and appraisal of policies and projects (Little and Mirrlees 1996). While there is little doubt that this type of analysis is imperfect, if it is done properly it nevertheless makes the bases for decisions systematic and explicit. It thus forces decision makers to think clearly and carefully about their choices and to make the rationale for them transparent and subject to wide public scrutiny and discussion. This occurs through prescribing a set of steps by which decision makers carefully consider all of the possible consequences or outcomes of a decision, evaluate them, and determine whether the total benefits promise to outweigh the total costs, and for whom.

Decision makers would, for example, explicitly define the objectives of a proposed local economic development initiative, specify the alternative approaches to achieving the growth objectives, and estimate the costs associated with the entire range of outcomes from each of the alternative approaches, including all of the capital, operating, and intangible factors, such as dislocations, aesthetic alterations, etc. The benefits would include any improvements in the efficiency of the urban economic system, as well as changes in valuation of existing facilities or businesses due to shifts in markets. A proposed initiative would be undertaken only if its benefits are at least as great as its costs.

In this light it is notable that neither massive out-migration from cities nor the presence of too few jobs to support a population within a city in and of itself constitutes evidence of market failure. Rather, even in the presence of out-migration, markets may be working perfectly. People and firms may simply be moving to avail themselves of greater satisfactions, opportunities, or profits at other locations. People tend to migrate their residences to places at which, all else equal, the amenities are better, the quality of life is higher, or the present value of increased income in the new region is greater than the increased cost of living in that area. Similarly, firms may migrate out of an urban core area to avail themselves of greater potential profits attributable to changes in production, communication, or transportation technology; relative prices of factor inputs; or large-scale shifts in the location of service-consuming populations. Observed out-migration only constitutes evidence of market failure when it can be shown that in its absence some people would be better off without anyone else being made worse off, and that this is not happening on its own. Thus, Pfister (1985) labeled the use of local public policy to stem urban out-migration "pathological."

UNFATHOMABLE AND UNCERTAIN ASPECTS OF LOCAL ECONOMIC DEVELOPMENT INITIATIVES

Some of the decline in twentieth-century midwestern industrial cities has undoubtedly been attributable to macro-scale economic and geographical change, driven by recent advances in technologies and over which urban policymakers have little or no control. Insofar as these large-scale shifts were the primary cause of such decline, there is no apparent a priori reason to suppose that market failures exist. And insofar as no market failures exist, there is no good, theoretically sound reason to think that the use of economic development initiatives will in any significant way stem further decline. Indeed, two causes of decline that cannot be altered through local economic development initiatives come immediately to mind.

Changing Preferences Enabled by Technology

The first is that technological progress has made it increasingly possible for people to realize their seemingly innate preferences for living in places with relatively mild winters and under more satisfactory conditions. As noted by Andrew Thomas in Chapter 7, beginning shortly after air conditioning became widely accessible, the population of the United States has been steadily migrating from the Northeast and Midwest to the South and West (Rappaport 2003). These preferences, and the associated large-scale migration, have also been enabled by the changing composition of industry from heavy manufacturing to services, since service industries are freer than manufacturing to locate throughout the country. Also, the preferences of relatively affluent residents to live under more satisfactory conditions, in conjunction with comparatively inexpensive transportation, have led them to suburbs and beyond, where the infrastructure and schools are in better condition, commercial corridors are available, housing stock is adequate, and many of the problems of the inner city can be left behind. At least insofar as the recent decline of twentieth-century midwestern industrial cities has been driven by behaviors based on innate preferences and enabled by technology, the use of local economic development initiatives is not likely to make much difference.

Globalization

The second is globalization. Technological advancements, together with relaxation of legal and other institutional restrictions on international trade, have forced firms in midwestern industrial cities to compete today as never before with businesses in other cities around the country and the world (Amendola and Gaffard 1988; Antonelli 2001, 2003; Atkinson and Stiglitz 1969; Geroski 1995; North 1991; Scotchmer 2004; Searle 2005). First and foremost among these cities are those in China, as is described by Chieh-Chen Bowen earlier in this book. Among other things, newly globalized competition means that midwestern industrial cities are inextricably affected by inclusion in or exclusion from global networks of information and financial control (Cohen 1981; Friedmann 1986; Friedmann and Wolff 1982; Neal 2011; Sassen 1996). The levels of wealth and prosperity within these cities have thus arguably become closely linked to, if not completely determined by, their positions in these networks.¹²

Moreover, firms in these cities must vie with companies in places that have lower labor, energy, environmental compliance, and other costs of production. They must thus compete within the context of vast worldwide disparities in factors such as savings rates and rates of return on capital investments, population size, wages, levels of migration, natural endowments, regulatory environments, and investment in research, development and education, all of which in part determine the success of rivals. Firms in midwestern industrial cities are in many ways at a competitive disadvantage relative to similar businesses located in other areas around the world. To the extent that the relative decline in the preeminence of these cities has been attributable to globalization, the use of local economic development initiatives cannot be reasonably expected to significantly ameliorate the corresponding urban problems.

It is somewhat easy to recognize and accept that historical and geographical drivers of change are of a scale that goes beyond anyone's complete comprehension. But we also tend to think that, even when focusing only on events within local urban economic systems in the Midwest, complete knowledge of the effects of many local economic development initiatives is beyond the capacity of the human mind. This argument is not only intuitive but it is consistent with considerable

research on human psychological limitations and capacities (Kahneman, Slovic, and Tversky 1982; Miller 1956; Simon 1974; Warfield 1988). Thus, we find ourselves inclined to suppose that the full range of the causes of some of the perceived problems in Rust Belt cities is simply unfathomable. Local economic development initiatives responding to these issues would, upon closer examination, be found to be attributable not so much to market failure as to the interests of political and economic regimes, in combination with cultural and institutional traditions in which the intrinsic limitations on human knowledge are not recognized. A moment's reflection will reveal that this is not trivial. It implies that problems of renewing prosperity are inseparable from political and economic aspects of society as well as from human psychological incapacities and biases that characterize virtually all other choices made under uncertainty. Decisions to use economic development policies are thus tied to the possibility of human error, not to mention undue political influence.

The Nature and Incidence of Benefits

Do local economic development initiatives lead to a greater abundance of resources and a fuller life for average people and whole urban populations, or only for a relatively small and exceptionally fortunate segment thereof? Given that public revenues are used to fund nonmarket allocation mechanisms, one might reasonably suppose that the taxpayers who bear the costs would have some legitimate claim to a commensurate portion of the rewards. What constitutes the basis upon which legitimate claims to these benefits does and should rest? What is the minimally tolerable share of the gains due to any given taxpayer? These and similar questions seem to us to be among the most difficult and complex in any serious consideration about using these mechanisms. Especially when the levels of public funding for economic development initiatives are relatively large, they will have positive effects on at least some segment of the local taxpaying population. But what if this includes primarily or only a relatively limited subset of the relevant taxpaying population, composed of, for instance, local landholders, real estate firms, and companies with business and other financial linkages to the particular funding channels through which the public expenditures are provided?

It is not always clear exactly who the beneficiaries of local economic development initiatives are and whether the incidence of the benefits reflects the incidence of costs. Proponents predictably assert that the initiatives are conducive to the renewal of prosperity, but it is rarely made clear how the validity of their assertions can be determined, and it is rarer still that net benefits over costs are actually demonstrated in a thorough and impartial manner through an independent benefit-cost analysis. Seldom are clear and compelling arguments made that the policies will lead to a greater abundance of resources and a fuller life for average people within an urban system. Moreover, use of local economic development initiatives is not always consistent with the spirit and principles of democratic governance, in which individual freedoms and rights are core values and great weight is placed on local institutions that exercise public authority, leadership, and representation of the interests of all citizens rather than only some (Selznick 1957, 1984).

Probably the most viable way to renew prosperity in midwestern industrial cities is to rely as fully as possible on capitalist markets to make allocation decisions. This is not to say that this approach would always be wise or equitable. Rather it is to say that such reliance draws to the greatest feasible extent on the use of prices for making allocations, puts the information in the hands of the dispersed individuals most directly impacted by the decisions, and puts the proper incentives on innovators and entrepreneurs competing in markets. It also provides feedback about success and failure. These are all powerful systemic factors in renewing prosperity. Moreover, it also puts individuals in situations in which their choices to participate or not in market exchanges are voluntary.

At times, uncritical use of local economic development initiatives has incurred huge costs in situations where no market failure has been demonstrated. At other times, when market failures have clearly existed, different approaches might have improved resource allocation in a much more efficient manner. This raises the practical difficulty of both identifying circumstances in which the use of local economic development initiatives will improve efficiency and distinguishing them from those in which it will not. Indeed, it may raise this difficulty beyond analytical tractability. Nevertheless, because resource allocations must be decided in some manner, and because the ways they are decided will with virtual certainty affect the renewal of prosperity in these cities, there is

no choice but to exercise a value judgment on the matter. Accordingly, our preference would be for less uncritical and unevaluated reliance on local economic development initiatives, and more performance of careful benefit-cost analysis. Our suspicion is that given such scrutiny, many of the policies would be very difficult to justify.

In light of these considerations we would propose that prosperity in midwestern industrial cities would be renewed most effectively by establishing local rules and institutional arrangements whereby all proposed new local economic development initiatives must be accompanied by statements indicating their purpose, evidence that their design will lead to the fulfillment of this purpose at acceptable cost, and a clear rationale for why such a policy should be employed. Rather than placing excessive reliance on local economic development initiatives to renew prosperity in midwestern industrial cities, we would generally favor directing public funds primarily toward efficiently supplying public goods and services and protecting the rights of individuals. Local governments should, in our view, consider investing fewer resources in economic development initiatives and more in areas such as establishing appropriate levels of centralization of authority in the public sector, achieving an adequate degree of collective trust in public authority, and defining and enforcing functional ownership arrangements and property markets. Efforts to renew prosperity in these cities should be directed toward creating and sustaining institutions that encourage the fullest possible range of initiative and responsibility on behalf of private economic agents acting in pursuit of their own individual purposes. Appropriate goals include developing and implementing institutional arrangements that provide individuals with the greatest possible discretion about how they will use their private property (and to hold them accountable for their choices), incentivizing the formation of competitive markets, ensuring low tax rates, and setting appropriate limitations on the use of nonmarket allocation mechanisms.

Insofar as local governments get involved in renewing prosperity past this point, the guiding principle should be to establish the conditions necessary for the operation of efficient markets. These conditions notably include adequate schools. Markets alone will not provide for the lower strata of society to acquire sufficient levels of the essential skills of reading, writing, and arithmetic. Without these competencies, a segment of the population in any urban economy will not be educated

enough to make sound political judgments as participants in local democratic governance processes. In turn, without a suitably functioning democratic system, autonomy, benevolence, trust, and free exchanges are more likely to cease; human relations are more apt to assume the sort of dominance/subordination relationships that characterize serfdom or slavery; and overall prosperity is more likely to decrease than to increase.

CONCLUSION

Both theory and empirical evidence indicate that markets can fail and that sometimes local economic development initiatives conceived and implemented in the name of correcting the malfunction actually improve efficiency. This poses a practical difficulty of evaluation in that, while the list of market failures is long, the roster of successful government interventions taken to correct them is somewhat shorter. Moreover, while the difference between these inventories can be discussed in abstract terms, the effect of government action taken in response to a market failure in any given situation can only be assessed with empirical evidence.

But data and evidence alone will not resolve some of the basic public policy issues raised in this chapter. On the one hand is a popular and widely accepted perspective that local fiscal policy should take an active role in renewing prosperity, such as through efforts to reverse out-migration from central cities, lower unemployment rates, stabilize economies, and generally to intervene in markets when doing so arguably leads to improved collective welfare. On the other is an Austrian economic perspective in which public fiscal policy cannot and should not as a rule intervene in the market, and the theory of the second best, according to which, under conditions of multiple market failure, the outcomes of such intervention are unpredictable. These divergent perspectives are not resolvable on the basis of available empirical evidence alone, due in large measure to the conceptual and theoretical nature of the differences between them. At the same time, until these disagreements are satisfactorily resolved, no a posteriori ways will be available to answer the question: what mix of public and private activities is most

likely to lead to renewed prosperity in midwestern industrial cities? The only remaining viable option is one of trial, error, data acquisition, analysis, and adjustment.

If the use of economic development initiatives is to be consistent with the spirit and principles of democratic governance, in which local institutions exercise public authority, leadership, and representation of the interests of all citizens rather than only some, these questions must be considered seriously and at length in public discourse. Decisions to use local economic development initiatives are thus not only about production and consumption, but also about ethics and values. Is the increment to economic output generated by a local economic development initiative worth more to society than what it displaces? How greatly does the population value democratic governance? These are but a couple of the wide range of ethical questions indissolubly tied up with the use of these policies. Thus, in our view, the problems involved are far too important and complex to be left only to economists of any ilk, largely because they involve a great deal more than what is typically considered to be “economic.”

Notes

1. While Buffalo may not be a midwestern city, it is clearly a Rust Belt city and is thus included in the chapter.
2. Walters (2010) argues that any satisfactory explanation of the decline of U.S. cities must start with the treatment of capital and the security of property rights within them, with particular emphasis on labor unions that reduce the returns to capital.
3. Considerable evidence indicates that the lion’s share of the benefits inure to the highly paid players and team owners, concession suppliers, some nearby local businesses, and businesses that buy season tickets as a means of increasing their own ticket sales. Despite gross overestimates of newly created job numbers contained in promotional studies heavily funded by affected cities or teams, such facilities are evidently built only with substantial net economic cost to the public (Zimbalist 2006).
4. Many tax incentives are really public spending in disguise (Toder 2002, p. 66), but it is easier to enact ineffective or unnecessary programs in the form of tax incentives than in the form of direct spending.
5. According to the definition used by the Census of Governments (2002), locally generated general revenues are divided into three categories: 1) local taxes, 2) charges, and 3) miscellaneous general revenues. Local taxes contain property, individual income, general sales and use, motor fuel, corporate income, other

selected sales, vehicle license, utility, and other taxes. Current charges include higher education, hospital, sewerage, and other current charges. Miscellaneous revenues include interest and other miscellaneous revenues. All were used for this study. We did not include taxes on utility revenues such as electricity, water, and other utility revenues, and insurance trust revenues. We calculated per-capita revenues by dividing locally generated total revenue in a county by that county's total population. Locally generated general revenue per \$1,000 of county personal income was calculated by dividing locally generated total revenues by total county personal income and multiplying that value by \$1,000. The data were from the U.S. Census Bureau and the Bureau of Economic Analysis.

6. According to U.S. Census Bureau data, the 31 percent population loss in Detroit between 1990 and 2010 was relatively greater than the population loss in any of the other cities (Buffalo, 17 percent; Pittsburgh, 17 percent; St. Louis, 20 percent; Cleveland, 22 percent; and Cincinnati, 18 percent). To the extent that this translated into correspondingly greater losses of property values and other components of locally generated general revenues in Detroit vis-à-vis these other cities, this would contribute to, if not completely account for, the slightly negative slope in Detroit's trend.
7. Hayek's conception of knowledge in its practical aspect is much akin to what we have variously heard referred to as "know how," "tacit knowledge," or "traditional knowledge."
8. The circumstances that reflect this concern are clearly illustrated in Bolick's (1993) description of the ways both liberals and conservatives miss the central point about individual liberties that the framers of the U.S. Constitution had in mind in the Bill of Rights as well as in the 9th and 14th Amendments. In providing this description he cites specific examples in which actions of local governments have wasted or misused tax dollars, imposed a particular set of social values on people who do not subscribe to those values, interfered with voluntary, nonharmful economic activities, violated private property rights, and rearranged "opportunities for the benefit of some and to the detriment of others" (p. 97).
9. Thompson (1968) argues that urban markets are in many ways profoundly distorted by widespread failure to rely sufficiently on price signals. He primarily considered collectively consumed public goods, merit goods, and payments to redistribute income.
10. Collective action problems occur when an individual's contribution to the attainment of a common interest is unlikely to have sufficient impact on the advancement of that interest to warrant the costs of political engagement. These problems tend to give way on the demand side to the capture of the governance process by special interests or rent seekers. On the supply side, they are associated with short-termism and the monopoly characteristics of the political market.
11. The logic of government failure from a decision-making point of view is spelled out clearly by Dörner (1996). It stems largely from unintended consequences that tend to occur as a result of failure or neglect on behalf of government decision makers to fully recognize and adequately consider the complexity involved in their decision situations. The general set of circumstances may be described as

follows. If two aspects of a given decision situation are interdependent, this means that they are correlated. So let us suppose aspects A and B within a given city's economic system are correlated. Let us further suppose that an economic development authority wants to alter B to change a city's growth path. B and C are known to have a causal relationship, and B can be manipulated and changed at will. This means that by altering the level of B, the official can alter the level of C, thereby changing the growth path. But if the decision maker is not aware of the correlation between A and B, in manipulating B to alter C she will also unknowingly alter A. The change in A is indirect, and may not be recognized until much later, if ever. However, the change in A is an unintended consequence of manipulating B to alter C. If the consequences of changing A are significant in some other aspect of the urban economic system, and perhaps even deleterious, the actions taken to change the growth path in one way may unintentionally create other, new problems, some of which are as serious if not more serious than the original one.

12. Neal (2011) finds that the direction of the causal relationship between a city's position in the global urban hierarchy and levels of employment goes from the position in the hierarchy to urban employment growth, not vice versa.

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