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Federal Policy Towards State and Local Economic Development in the 1990s

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Federal Policy Towards State and Local Economic Development in the 1990s

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FEDERAL POLICY TOWARDS STATE AND LOCAL ECONOMIC DEVELOPMENT IN THE 1990S

Upjohn Institute Staff Working Paper 93-17

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FEDERAL POLICY TOWARDS STATE AND LOCAL ECONOMIC DEVELOPMENT IN THE 1990s

Abstract

This paper suggests new federal policies towards state and local economic development assistance to business. I argue that there is some evidence that these programs can be effective in encouraging business growth and helping the unemployed. But state and local governments do not have the right incentives to adequately pursue national goals through economic development programs. State and local governments are not inclined to do quality evaluations of their programs and tend to favor business attraction programs over programs that might increase U.S. business productivity. In addition, it is unclear whether economic development efforts are most vigorously pursued by economically depressed areas, in which the national social benefits of economic development are the greatest. A new federal policy towards economic development should provide partial federal support for state and local economic development programs that encourage business productivity. The funding should be coupled with requirements for rigorous outside evaluation, comparing the performance of assisted and unassisted firms. Finally, our system of fiscal federalism should be reformed to provide greater resources for economically depressed areas. This assistance will allow these areas to be more economically competitive.

FEDERAL POLICY TOWARDS STATE AND LOCAL ECONOMIC DEVELOPMENT IN THE 1990S

I. *Introduction*

This chapter suggests new federal policies towards state and local economic development programs. By "economic development programs," I mean government-subsidized programs that provide customized assistance to individual business firms in order to increase their productivity, output, or employment. This assistance to individual firms may be financial, such as property tax abatements. This assistance may also be in the form of special public services, such as information for firms on how to modernize. Some economic development programs may be provided by "private" entities such as local Chambers of Commerce or local colleges, but some government subsidy is still involved.

From an economic perspective, federal intervention in state and local economic development programs might be warranted for two reasons. First, if one area's programs create external benefits or costs for other areas, the area on its own might not pursue an economically "efficient" level of program activity. Economic development programs that create external benefits for other areas should be encouraged by federal policy, while those that create external costs should be discouraged. Second, state and local governments on their own cannot deal adequately with income distribution implications of economic development programs. State and local governments on their own will have trouble redistributing income from rich to poor, because rich individuals and firms can move to avoid the redistribution. Federal intervention might be needed to ensure that state and local economic development programs promote national objectives for income distribution.

Most economists probably feel that state and local economic development programs at best have no national benefit and at worst are against the national interest. State and local economic development programs are thought to be a zero-sum game. One area's benefits from gaining jobs are matched by other areas' costs from losing jobs. This redistribution of jobs may decrease economic efficiency by distorting business location decisions. Furthermore, this competition for jobs may worsen the income distribution by lowering business taxes. Federal policy might seek to discourage such destructive competition for jobs.

My argument in this chapter is that some economic development programs could promote the national interest and therefore improvements in these programs should be encouraged by federal policy. Some economic development programs may increase national productivity. Even programs that redistribute jobs may promote the national interest if they provide jobs in depressed areas, which need jobs the most. Federal policy should subsidize such economic development programs if their effects on productivity and depressed areas can be demonstrated through rigorous evaluations.

II. *Current Trends in State and Local Economic Development Policy*

After describing the various types of economic development programs, I briefly summarize the history of state and local economic development efforts, and current trends in these programs.

Description of Programs

Table 1 outlines various commonly used types of state and local economic development programs. From the perspective of most state and local policymakers, the primary goals of these programs are to increase employment and the tax base in their jurisdiction, and lower the unemployment of local residents. Improving business productivity is a far less important goal to most state and local policymakers.

Recent History of Economic Development Programs

The modern history of state and local economic development programs starts with the efforts of Southern states, beginning with Mississippi in the 1930s, to aggressively recruit manufacturing branch plants from the North (Cobb, 1982). State and local economic development programs were significantly expanded in the 1970s and 1980s. This expansion was motivated by the recessions and industrial restructuring episodes that took place in different regions during this time period (Clarke, 1986).

During the 1970s and 1980s, state and local economic development programs also expanded the types of firms and the types of activities that were assisted. Prior to the 1970s, state and local economic development programs were almost exclusively oriented towards attracting new branch plants with financial incentives. In the 1970s and 1980s, newer, so-called "Second Wave" programs also targeted new start-up businesses, small businesses, and existing businesses. These "Second Wave" programs also tended to include more special

services to businesses. These "Second Wave" programs did not supersede the "First Wave" branch plant recruitment efforts. Most of the money that state and local governments put into economic development programs has probably always gone to tax subsidies to new branch plants.[1]

During the late 1980s and early 1990s, state and local economic development programs have been cut back. Many state and local governments have had budgetary problems due to the 1990-91 recession. Cutting back economic development programs has sometimes been politically attractive, in part because of the limited evidence on the effectiveness of state and local economic development programs, and in part because these programs only directly benefit a relatively small number of businesses.

Despite recent cutbacks, state and local economic development programs are here to stay. Voters expect Governors and Mayors to "do something" about the economy. Even if some programs are eliminated to balance budgets, Governors and Mayors often recreate similar programs later on, to at least demonstrate their symbolic commitment to improving the economy.

Recent Ideological Developments: The Third Wave

In the last few years, some activists have promoted a new approach to economic development labelled the "Third Wave." The "Third Wave" concept is that rather than having government directly provide economic development services to small and existing businesses, the government should encourage private sector providers, ideally operating in a competitive market, to provide such economic development services. Under the Third Wave approach, the government would still be involved with economic development, because it would provide some subsidies and guidance to these private or quasi-private economic development service providers. But government would only pay a portion rather than 100% of the cost of providing economic development services.[2]

One example of a "Third Wave" program is Michigan's Capital Access Program. The "Capital Access" program is an alternative to a traditional economic development business loan program, in which the government directly makes loans or guarantees bank loans. Under the Capital Access program, a small business borrower and a participating bank each pay a fee of between 1.5% and 3.5% of the value of the loan. The state government matches the total contribution of the borrower and bank (i.e., pays in between 3% and 7% of the loan's value). These funds go into a loan loss reserve fund for each bank. A bank's losses from program loans are covered its individual loan loss reserve fund, but losses beyond the bank's reserve fund are the bank's responsibility. The program is intended to give bank's incentives to make above-normal risk loans, but not too risky. Banks should not want to make normal loans under this program because of the extra fees involved that are not recovered unless there is a default. On the other hand, banks should not want to make too many risky loans because of the bank's exposure if its fund should be exhausted.

Table 1

A Typology of Common
State and Local Economic Development Programs

"First Wave" 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

"Second 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

Note: this table is adapted from Table 1.1 in Bartik (1991).

The Third Wave approach has been created and promoted by the Corporation for Enterprise Development (CfED), a Washington-based think tank. Some of those associated with CfED also have close ties with the moderate "neoliberal" faction of the Democratic party and the Clinton Administration. For example, Doug Ross, formerly President of CfED, wrote two chapters on economic development in the Progressive Policy Institute's December 1992 book, *Mandate for Change*, that gives policy advice to the Clinton Administration (Ross, 1992). The Progressive Policy Institute is the think tank of the Democratic Leadership Council, a group of moderate Democrats formerly headed by Clinton. David Osborne, an advisor to Clinton, has also been closely associated with CfED. Osborne is a journalist whose 1988 book on state and local economic development policy, *Laboratories of Democracy*, highlighted CfED's contribution (Osborne, 1988). Osborne more recently has written a bestselling book (*Reinventing Government*) on reforming how all government services are delivered (Osborne and Gaebler, 1992).

The Third Wave has arisen in response to disappointment over the political and practical feasibility of "Second Wave" programs in which governments directly provide services to small and existing businesses. "Second Wave" programs suffer from four interrelated problems: insufficient size to have significant effects, fragmented services, lack of accountability, and lack of business support. It is politically difficult to ever expand "Second Wave" programs, in which governments pay 100% of the costs of providing services to selected businesses, to a sufficient size to significantly affect a state or metropolitan area's economic growth. Services provided are fragmented. One government office helping with exporting, another with modernization, and a third with job training. As with most government services, objective evaluations of the performance of Second Wave programs are rare. No market test prevents a bad program from continuing. Business support for "Second Wave" programs is weak. Most businesses have no interest in going to some government agency for advice. Without business support, Second Wave programs are vulnerable to changes in political fashion and budgetary problems in state and local governments.

The Third Wave approach in theory solves these problems. By working through private or quasi-private organizations, Third Wave programs are supposed to be able to provide more flexible and better integrated services to businesses. Private and quasi-private organizations also are supposed to elicit more business support. Because the government subsidy for services is considerably less than 100%, a given government budget for economic development can potentially provide services to more firms. Furthermore, because part of the costs of economic development services are borne by business clients, there is at least some minimum accountability. Businesses will not pay fees for services unless they feel they are of some value.

Third Wave advocates frequently cite European examples. Economic development services in Europe are reportedly provided by trade associations and other private or quasi-private entities. Economic development services provided by these private organizations are more integrated, in that the same organization will help a firm with any problems impeding the firm's competitiveness. These private service providers in Europe receive some government subsidies.

But most of their funding comes from client fees. Finally, these economic development services are provided on a much larger scale in Europe than in the U.S. (Nothdurft, 1992).

The "Third Wave" approach has not been extensively implemented in the United States. Michigan's Capital Access Program is one example of a Third Wave program. Oregon is providing some support for "flexible networks" in which firms in an industry cooperate in doing R&D, job training, production, or marketing. Oregon is providing training to various private "network brokers" who will help set up networks. Oregon is also providing small seed grants to cover part of the initial costs of setting up such networks.[3]

III. *Current Evidence on the Effectiveness of State and Local Economic Development Programs*

Most economists would argue that state and local economic development programs make little sense. The argument against these programs has three parts. First, state and local policies are argued to have little effect on business activity. Second, even if state and local economic development programs could increase local jobs, in-migration of labor would quickly offset any new jobs, bringing unemployment back up to its original level. Third, even if local residents did get labor market benefits from more local jobs, from a national perspective this is a zero-sum game. The benefits from job gains in one area are matched by the costs from job losses in other areas.

These arguments against state and local economic development programs imply that the federal government might want to discourage these programs. State and local competition for jobs will lower business taxes and increase subsidies to business. Because business owners are above-average in income, these lower business fiscal burdens make the overall federal-state-local fiscal system more regressive. In addition, if economic development programs do affect business location decisions, but produce little national social benefits, then these programs can be argued to induce business to make less efficient location decisions.

My recent book, *Who Benefits From State and Local Economic Development Policies?*, argues that a case can be made for state and local economic development programs (Bartik, 1991). These programs may be able to achieve their goals and provide net benefits for the nation. My argument is not that every economic development program would pass a benefit-cost test. But the basic strategy of these programs—assisting firms in order to provide jobs or to improve productivity—is sensible.

My book addresses all three arguments made against state and local economic development programs. I argue that state and local policies can affect local growth, that local growth benefits local residents, and that state and local economic development may benefit the nation.

On the first argument, that state and local policies cannot affect local economic development, the conventional wisdom among researchers has shifted. At one time there was little evidence that state and local policies affected local growth. But recently, many empirical studies have suggested that state and local taxes and public services do have significant effects on local growth. Of 57 studies since 1979 that have examined state and local taxes and local growth, 70% have found at least one statistically significant and negative effect of taxes. The average long-run elasticity of state and local business activity with respect to state and local business taxes in these recent studies is -.25. (Bartik, 1991, p. 40).

Furthermore, of 30 recent studies that have included state and local public service variables, 60% have found at least one statistically significant and positive effect of public services (Bartik, 1991, p. 47). Three recent studies have considered the net effect of a state increasing taxes to increase its level of public services (Helms, 1985; Bartik, 1989; Munnell, 1990). All three conclude that the net effect of such a policy change on state growth would be positive.

But these studies consider general state and local fiscal policies. There is little direct evidence on whether economic development policies, which provide customized assistance to specific firms, significantly affect economic development. Because general state and local tax policies affect overall business growth, tax or other financial incentives for specific firms probably on average have positive effects on firm location and growth decisions. This extrapolation of the research literature becomes increasingly questionable as we consider tax incentives for more and more narrowly defined types of business growth. For example, enterprise zones might have so many social and economic problems that a marginal tax incentive might have little effect on investment in zone areas. Finally, we cannot reasonably extrapolate the results of general studies of state and local public spending and growth to programs that provide new types of public services to specific firms, such as modernization and export assistance.

There have been some evaluations of state and local economic development programs. Most of these evaluations are based on "soft" evidence, such as client surveys. Such surveys, although useful to program managers, will not convince skeptics that these programs work. We need to know what would have occurred without the program's assistance. This requires data comparing the performance of those assisted by the program with those unassisted by the program. For economic development programs that target assistance on specific firms, we need to compare assisted with unassisted firms. For enterprise zone programs or other programs which target geographic areas, we need to compare assisted with unassisted areas.

To my knowledge, there are only two studies that have provide such hard evidence on economic development programs. A study by Harry Holzer and others found that Michigan's former program of state subsidies for firm's job training in new technology resulted in statistically significant and large reductions in scrappage rates in assisted firms versus unassisted firms (Holzer et al, forthcoming). A study by Leslie Papke found that enterprise zone areas in Indiana

had greater inventory growth and less unemployment claims than comparable non-zone areas (Papke, 1991).

Still, although there is little hard evidence showing that specific economic development programs work, the significant effects on local economic growth of state and local tax and public service policies indicates that state and local policies could potentially affect economic development. Such effects of state and local policies should not be surprising. With transportation and communication costs becoming less important, many businesses are increasingly footloose. Minor differences in local economic environments could affect business expansion and location decisions.

On the second argument, whether local economic growth helps local residents, chapters 4 through 7 of my book present extensive evidence that an increase in a metropolitan area's employment has significant long-run effects on the employment rates and earnings of local residents. Consider a 1% increase in a metropolitan area's employment compared to what it otherwise would be; that is, suppose the metropolitan area's employment growth is 1% higher one year than it otherwise would have been, after which it resumes its previous growth path. I estimate that this change would reduce local unemployment rates in the long run by 6/100ths of 1%, increase labor force participation rates by 14/100ths of 1%, allow the average resident to move up to an occupation with wage rates higher by 2/10ths of 1%, and increase the average resident's real earnings by 4/10ths of 1%.[4]

These long-run effects on local residents' economic well-being, due to a short-run local labor demand shock, are a form of labor market "hysteresis." "Hysteresis" is physics jargon recently used by labor economists to describe a labor market whose long-run equilibrium depends on its history. Hysteresis effects of local labor demand shocks could occur because short-run demand shocks increase residents' long-run human capital. Because of stronger local labor demand, residents who otherwise would not be employed are able to get a job in the short-run. As a result, they gain skills, confidence, and a better reputation in the labor market, all of which are forms of "human capital." Even after sufficient time has passed for in-migrants to come in, local residents are still more competitive in the labor market than they otherwise would be.[5]

The zero sum game argument is the strongest argument against state and local economic development policies. I argue in chapter 8 of my book that this competition may produce net national benefits, but hard empirical evidence for this position is scant. Net national benefits of state and local economic development programs might occur for two reasons. First, many state and local economic development programs aim at increasing business productivity. If these programs are "efficient"—the dollar value of the productivity improvements exceeds the program cost—then the nation benefits. Productivity-enhancing economic development programs will attract resources to that local area, and away from other local areas. But reallocating resources towards higher productivity activities is economically efficient.

If productivity-enhancing economic development programs have productivity benefits that exceed their costs, some market failure must have prevented these efficiency gains from being realized. Such market failure seems plausible. These productivity-enhancing programs mainly focus on providing firms with information on modernization, job training, exporting, and business planning. Private markets in such information may be inefficient. The information consumers—owners or managers of small and medium-sized businesses—will often be unable to evaluate the quality of private information providers, depressing the demand for such information.[6]

The weak point in this counter-argument is the lack of adequate evaluation studies, as pointed out previously. We have little evidence that real-world information providing programs increase productivity more than they cost.

A second rationale for net national benefits of state and local economic development programs is that these programs may redistribute economic activity towards economically depressed areas. High unemployment areas probably need jobs more than low unemployment areas. The average reservation wages of unemployed workers are lower relative to market wages in high unemployment areas than in low unemployment areas, because individuals in low unemployment areas with low reservation wages would have already found jobs.[7] The social benefit from new jobs are the wages paid minus the reservation wages of the workers who get the jobs. Thus, the social benefits from new jobs are likely to be greater in high unemployment than low unemployment areas.

In addition, redistributing jobs towards high unemployment areas may allow lower national unemployment without higher inflation. The usual assumption is that changes in unemployment have little effect on inflation at high unemployment rates, and large effects at low unemployment rates. Redistributing labor demand from low unemployment to high unemployment local labor markets would considerably reduce inflationary pressures in low unemployment labor markets, while having little effect on inflation in the high unemployment labor markets. The lower overall national inflationary pressures resulting from this redistribution gives fiscal and monetary policymakers greater leeway to allow lower national unemployment rates without causing accelerating inflation.

The key problem with this rationale for net national benefits of state and local economic development programs is that it is unclear whether high unemployment areas most vigorously pursue these programs. If state and local politicians are rationally pursuing their jurisdictions' best interests, one would expect some tendency in this direction, because high unemployment areas are likely to benefit most from economic development programs. But politicians may have many other motivations than their jurisdictions' best interests.

IV. *Possible Rationales and Mechanisms for Federal Intervention in State and Local Economic Development*

The two traditional economic rationales for federal intervention in state and local affairs are "externalities" caused by state and local policy, and equity concerns. State and local governments will pursue too little of activities that provide external benefits to other areas, and too much of activities that cause external costs. State and local governments' pursuit of equity will be overly constrained by the fear that wealthy individuals and businesses may move out to escape the redistribution, and poor individuals may move in to take advantage of the redistribution.

Based on these two rationales for federal intervention, I argue that federal intervention in state and local economic development is justified in three areas, listed in order of increasing cost and political difficulty:

* Encouraging better evaluation of economic development programs,
* Providing partial subsidies for economic development programs that seek to increase business productivity, and
* Restructuring our system of fiscal federalism to encourage economic development in depressed areas.

Evaluation

Federal support for evaluation of state and local economic development programs is justified because one state's evaluations provide external benefits to other state and local areas. Because state and local areas do not take into account these external benefits, state and local areas will underfund evaluations. In addition, there are political reasons for state and local governments to underfund evaluation. Negative evaluations might cause political problems, and voters may distrust positive evaluations. Local residents might prefer some sort of outside influence over evaluation procedures to ensure that the evaluations have some reasonable objectivity.

How might evaluations of economic development programs be best conducted? For programs that assist selected firms, a quality evaluation requires comparison of the performance of assisted versus unassisted firms. Evaluations of the effects of programs on a firm's employment growth can be conducted relatively cheaply by using data from state's unemployment insurance files ("ES-202 data"), which reports the employment and payroll of all businesses paying unemployment insurance in the state.[8] Measures of the effects of the program on other goals, such as productivity, sales, exports, etc., would require surveys of assisted and unassisted firms. In either case, some statistical techniques would be needed to estimate the effects of the program on firms, holding all else constant. This could be done by matching assisted firms with similar unassisted firms, or using regression techniques to control for differences across firms.

Such statistical comparisons may be biased because assisted and unassisted firms probably have unobserved differences. These unobserved differences make it difficult to tell whether the estimated program "effects" are due to the program or the unobserved differences. Unobserved differences could be due to different types of firms being selected for assistance by program managers, or different types of firms self-selecting to apply for assistance. For example, if only bad firms apply for government assistance, assisted firms will grow slower than unassisted firms. In addition, if program managers try to help firms that are in trouble, then the program will appear to be associated with slower firm growth. Alternatively, one could argue that the more creative firms will figure out how to access state and local economic development programs, and that any observed better performance by assisted firms may be due to this greater creativity. In addition, perhaps program managers will select for assistance firms that are likely to do well, in order to make the program look more successful.

"Selection bias" in evaluating some "treatment" is an old problem in social science and medicine. The usual solution is to do a random assignment experiment in which potential clients are randomly assigned to a treatment group and a "control" group that is denied treatment. Random assignment implies that the expected differences between treatment and control groups will be zero except for the treatment. Outcome differences between the two groups are more likely to be due to the treatment itself.

In the present case, a traditional random assignment experiment would assign some firms to a treatment group that would receive economic development services, and other firms to a control group that would be denied services. Implementing such a procedure might cause political problems due to complaints from businesses denied services. A more politically feasible way of randomizing service delivery is to randomly select some firms for intensive marketing efforts for the economic development program. If these targeted marketing efforts are successful, these "treatment group" firms should become greater users of economic development services than firms that are not targeted for marketing efforts. These differentials in program usage between treatment and control groups can be used to get consistent estimates of the true effects of the treatment.

For economic development programs that target geographic areas—such as enterprise zones—a good evaluation requires comparing the performance of assisted and unassisted areas, holding all other factors constant. This can be done either by examining "control" unassisted areas that are matched to the assisted enterprise zone areas, or by using a regression model of the determinants of area economic development to hold other factors constant. Selection bias is also a problem with this evaluation procedure. Zone areas may differ from non-zone areas in unobserved ways. Zones may be selected by government officials either because they were expected to do poorly, or perhaps because they were seen as having unusual growth potential compared to other low-income neighborhoods. Zone applications may reflect desperation on the part of zone residents and their city's political leadership, or may reflect a creativity on the part of the zone and the city that could be associated with better long-term economic performance.

To eliminate the possibility of selection bias, the selection of enterprise zones should ideally be based in part on random factors. This is feasible to do this if enterprise zones are being tried on a pilot basis, as is proposed by the Clinton Administration: the Administration's February 1993 economic package proposed the creation of only 50 federal enterprise zones. To implement random assignment for this pilot program, the top 150 proposals could be randomly divided into 50 zone areas and 100 control areas. Survey data on businesses, residents, and property value and use should be collected in all 150 areas for at least five years after zone designation, and treatment and control group performance could then be compared.

If random assignment is deemed politically infeasible, a second-best method to evaluate the effect of the program is to compare designated zones' performance with the performance of unsuccessful zone applicants. If one has good information on the actual criteria and scoring procedure used to select zones, one should be able to model the selection procedure and correct for the selection bias.[9]

Productivity Programs

There is also a rationale for federal government support for state and local economic development programs that improve business productivity. Some of the benefits of an improvement in a firm's productivity are likely to be shifted forward as lower prices or higher quality to business or household customers for the firm's products. Many of these customers will be located in other areas. In addition, productivity improvements at a firm result in workers and managers having greater knowledge about how to be productive. Both people and ideas are quite mobile within the U.S. Hence, this greater knowledge about how to be productive at one firm is likely to eventually increase productivity at other firms throughout the U.S.

But much of the benefits of productivity improvements are local. The firm itself benefits the most from the productivity improvements and should always pay by far the largest share of the costs of productivity improvements. People and ideas are more mobile within local areas than across local areas, and hence state and local areas should pay part of the costs of programs that improve productivity. A mixed system of financing these programs, with the federal government, state and local governments, and business sharing the costs, seems most reasonable.

Although all aspects of business productivity improvements may have externalities that justify some government subsidy, only selected aspects of the productivity improvement process require assistance that is customized to the specific needs of the firm. It is this customized, firm-specific assistance that is delivered by economic development programs. Customized assistance makes a great deal of sense when firms need basic knowledge about how to improve their competitiveness. If a firm does not really know how to succeed in exporting, or what new technology might be able to do in the plant, or what job training can do for its workforce, then it can't even make rational decisions about what kind of productivity-enhancing investments to make. The basic information and training about productivity improvements that will be needed by each firm will vary a great deal from firm to firm, and so any attempt to provide such

information and training will need to be customized. Other aspects of the business productivity improvement process might be appropriately subsidized by government, but perhaps do not require customized assistance. Actually implementing a given investment in technology upgrading, or worker training should be encouraged by government because of the externalities it creates for others in the economy. But general tax credits for such investments seem more appropriate than firm specific grants.

We know little about how best to provide customized information to firms on how to improve their productivity. As mentioned above, there are few high quality evaluations of such services. We don't know whether such services in fact work. We don't know whether Third Wave advocates are correct that such services are best delivered by quasi-private groups rather than government.

Our ignorance argues for an experimental approach. Federal support should be provided for a wide range of models of providing customized services to businesses to help them figure out how to improve their competitiveness. This partial federal support, with a local match, and requirements for some financing by clients, should be coupled with rigorous evaluation requirements that would compared assisted with unassisted firms. Extra federal support should be provided for state or local areas that are willing to use random assignment methods for evaluation.

Helping Depressed Areas

A final area in which federal intervention in state and local economic development might be justified is helping the economic development of depressed local economies. As argued above, creating jobs in depressed areas may provide greater social benefits and allow a lower national unemployment rate.

A strong objection to federal aid to depressed local economies is that such a program is not politically sustainable on a large enough scale to make a difference. The argument is that any federal program must spread its benefits widely across states and Congressional districts to attract significant federal support over the long-run.

Helping depressed areas on a large scale might be easier to do as part of an overall reform of our system of fiscal federalism. A reform that provided significant aid to all state and local governments might be able to achieve significant targeting of resources on depressed areas within that program. For example, Alice Rivlin (former head of the Congressional Budget Office, now Deputy Director of OMB under President Clinton) suggested in her recent book, *Reviving the American Dream*, that the federal government should consider instituting a national value added tax that would be distributed on a per capita basis to the states (Rivlin, 1992). Canada has long had a system of federal aid to its provinces that seeks to promote greater equality in taxable resources per capita.

Whether such far-reaching reforms are politically possible in the U.S. is difficult to say. But statements about political feasibility often have a way of seeming inevitable until proven false. No one thought that a comprehensive tax reform package could pass the Congress until one actually did in 1986.

Where do enterprise zones fit into this idea of helping depressed areas? In my view, the biggest objection to enterprise zones is not that they won't work in the sense of attracting business investment. The research literature on business location indicates that location decisions within metropolitan areas are quite sensitive to tax and financial factors. The biggest objection to enterprise zones is that it is clear that in most cases enterprise zone areas are far too small to be considered distinct labor market areas. Hence, I have doubts about whether enterprise zones will actually help poor residents of ghettos much more than just creating the same number of jobs throughout the metropolitan area. Creating the same number of jobs throughout the metropolitan area would no doubt be cheaper. There is some literature suggesting that job access within a metropolitan area significantly affects employment rates (Ihlanfeldt, 1992; Holzer, 1991), but this conclusion is disputed by other research (Ellwood, 1986).

Having said that, it would still be of interest to create enterprise zones on an experimental basis, to test out the extent to which bringing jobs to ghettos can help the poor in metropolitan areas. As mentioned above, an experiment with random assignment of zone designation among the top applications should be tried. The experiment should include baseline surveys of the residents in the zones and the control areas, and should seek to follow the economic fortunes of these same individuals over time.

V. *Conclusion*

In summary, I would suggest the following federal initiatives in state and local economic development policy:

1. A federal grant program to intermediary organizations that would provide small and medium sized businesses with information on modernization, exporting, or training. The grant program would require a state or local government match, and some financing from client businesses. A wide variety of models for service delivery would be allowed under this program, ranging from pure government provision to quasi-private provision. All grants would require evaluations comparing assisted with unassisted businesses. Extra grant funds would be provided to programs that were willing to use some sort of random assignment experimentation methods in running the program.

2. A federal grant program for enterprise zones that would randomly choose zones among the best applications, and would evaluate the effects of the zones on the residents originally living in the zone, and on property values and property usage in the zone.

3. A federal grant program for evaluation of state and local economic development programs, in addition to those directly funded under items 1 and 2.

4. At some point in the 1990s, we will need to consider comprehensive reform of our system of fiscal federalism. Such reform should give poor areas significantly more access to revenue, so that they can be competitive in the economic development market, and provide minimally decent public services to their residents.

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Endnotes

1. It is difficult to conclusively prove this statement because few states keep good data on tax expenditures. But, as I discuss in my book (Bartik, 1991, pp. 6-7), total state development agency spending in 1990 was around $1.5 billion. In Michigan alone, property tax abatements are worth at least $150 million a year in lost revenue. Tax abatements and other tax subsidies for new branch plants probably vastly exceed state development agency spending, and exceed even more development agency spending for Second Wave programs.

2. This discussion of the "Third Wave" movement summarizes a number of articles by Third Wave advocates and critics, including Ross and Friedman (1990), Pilcher (1991), Dabson and Schweke (1992), Atkinson (1992), and Toft (1992).

3. Information on Oregon's programs is derived from remarks and handouts from Janet Jones (Manager, Key Industries Development, Oregon Economic Development Department) at the State and Local Economic Development Strategy Summit, University of Minnesota, State and Local Policy Program, Hubert Humphrey Institute, December 3-5, 1992.

4. This conclusion that shocks to local employment have long-run effects on residents' employment rates and wages has recently been challenged by Blanchard and Katz (1992). I analyze their claim in Bartik (forthcoming). My analysis indicates that if their model is modified to allow growth to more flexibly have long-run effects, than shocks to local employment do appear to have significant long-run effects on labor force participation rates.

5. Hysteresis models are discussed more fully in Cross, 1988, and in chapter 3 and appendix 3.1 of Bartik (1991).

6. Market failure rationales for regional economic development policies are discussed more fully in Bartik (1990).

7. The reservation wage of a person is the lowest wage at which they would be willing to accept a job. The conclusion that the average reservation wage of the unemployed drops as the unemployment rate goes up depends on the assumption that available jobs are more likely to be rationed, when labor supply exceeds labor demand, to persons with relatively low reservation wages. See appendix 8.1 of Bartik (1991). A study by Jones (1989) indicates that for every 1 percent increase in the local unemployment rate, the average reservation wage of the unemployed is reduced by 1.2 percent to 1.6 percent.

8. Use of ES-202 data in economic development program evaluation is discussed, along with many other issues in evaluating these programs, in the excellent book by Hatry et al (1990).

9. There is extensive controversy in the literature on evaluating job training programs on how robust and testable these corrections for selection bias are likely to be. For a negative view on selection bias corrections versus experimental methods, see Fraker and Maynard (1987) or

LaLonde (1986); for a positive view, see Heckman and Hotz (1989).