STATE ECONOMIC DEVELOPMENT POLICIES AND NATIONAL ECONOMIC GROWTH

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INTRODUCTION

In recent years the role of the states in economic policy-making has been subject to considerable discussion. Faced with local economic downturns, many previously affluent regions have taken the policy offensive in the battles for jobs and economic growth. While pressing forward with economic development programs which vary from indirect subsidization through tax breaks to direct incentives in new and risky enterprises, state and local governments have seemingly been indifferent to questions and doubts regarding the effectiveness, legitimacy, and wisdom of these endeavors.

These questions and doubts are directly confronted in this article by the thesis that state-level economic policy-making has been central to the strength of the national economy of the United States over the past decade. Put briefly, during the 1980s if not longer, state governments filled the vacuum left by a national government that intentionally avoided an explicit industrial policy such as those used in other nations and as advocated by several well-known analysts. By stimulating economic activity within their respective jurisdictions, states and their subdivisions provided (and continue to provide) the stimulus that carried the United States through a major national economic downturn and years of sustained growth.

Underlying this assertion are two premises which seem to contradict conventional wisdom. First is the premise that states possess the capability to influence positively the operations of the national economy. A great deal of criticism has been directed against state and local economic development activities on the grounds that, while they might sustain or accelerate existing positive market trends, they are inevitably ineffective in initiating national economic growth. In this sense, state-level policies are regarded as accidentally felicitous at best and politically self-serving at worst.

Second is the premise that state and local economic development activities have an overall positive impact on the American economy. The popular view holds that state and local governments increase the inefficiency of the U.S. economy by engaging in "zero sum" competition for jobs and capital investment. Even among those who believe the states can be and have been effective in their economic development activities, the belief is widespread that such success is counterproductive to the health of the national economy. In a most blatant expression of this position, Kinsley (1984:18) argued as follows:

> Certainly very little new business is generated by the nation as a whole by letting corporations play the state legislatures off against one another. In fact, the process undoubtedly makes our economy less efficient and less productive by adding artificial considerations to business investment decisions. A company that ought to be locating a new plant near its suppliers or near its markets will instead plunk it down in whatever state is temporarily ahead of the game of incentive leap frog.

Besides confirming the positive role of the states, the primary reason for rejecting the views of Kinsley and others is the possibility for developing a national economic policy that integrates the actions of the various states with federal programs. If, as is contended in the first two sections of this article, states and localities have played a key role in the recent recovery, it is not difficult to imagine, as the authors discuss in the last section of this article, a national economy which harnesses the economic energy of state governments.

POLICY EFFECTIVENESS

The argument against state economic policy-making is based upon a belief that the actions of state and local governments are ineffectual, are prone to generate market inefficiencies, and have little to do with critical decisions made by private sector decision-makers (Barker, 1983). As a framework for analyzing the role of states in the economy, states can be seen as using various policy tools to affect the size of private sector markets, the structure of market competition, the degree of business exposure to market risks and liabilities, and the resources available for private sector development (Dubnick and Holt, 1985).

The size of markets is influenced by state governments through efforts to expand the number of potential customers for business products and services. State governments also have considerable impact on the degree of business competition in the American economy through their capacity to manipulate market structure variables. This is seen most often in public/private ventures and state level economic regulation, particularly among banks, utilities, common carriers, and the licensed "trades" and professions.

Additionally, states have taken advantage of their legal capacity to adjust the risks and liabilities faced by private sector companies. Guaranteed loans is a common way for states to accomplish some reduction in the risks faced by a variety of businesses. Finally, state government's most important leverage point in the marketplace has been the provision of financial and other resources that directly encourage private investment. Most states supply eligible private firms with tax incentives and investment loans. In addition to traditional financial incentives, education and worker training programs, enterprise zones, "incubator" locations, and other types of special economic development districts are increasingly common.

Previous research has relied on two methods to evaluate the effectiveness of state development policies: survey analysis of executives' plant siting decisions and econometric analysis of changes in state economic growth. Evidence from both of these sources provides support for the position that state policies have significant marginal impacts on market resources and patterns of economic growth.

SURVEY EVIDENCE

Analysis of the factors which business leaders rank as most important in decisions regarding where to locate new facilities or to relocate old ones has been the most popular method of assessing the effectiveness of state development policy. The consensus of early studies of siting decisions was that state and local government actions have almost no influence on locational preferences. Nevertheless, the generalizability of the findings of these early firm location surveys is questionable. Virtually all of the studies, which found government development policies to have little effect, were based upon surveys of the largest 1000 corporations in the U.S. These companies, however, constitute less than one percent of the businesses operating in the U.S. (Humberger, 1983).

In more recent research, factors identified as salient in national searches for an appropriate region have been found less important once the decision is made to locate within a specific region. After costs of production have been accounted for, state and local tax differentials or development policies become important factors in the location decision (Huncker, 1974; Mulkey and Dillman, 1976; Wasylenko, 1981).

Another limitation to this body of research is that the attention given to relocations of firms is disproportionate to their minor contribution to new investment within states. Although plant location decisions are one indicator of resource allocation, tax schedules and the extraordinary costs of opening, closing, and moving plants may render siting relatively resistant to development incentives. Because capital is more mobile than physical structures or machinery, incremental shifts of new capital from one state to another, which would facilitate plant expansion, may be much more sensitive to changes in marginal costs resulting from development policy than are plant sitings.

Recent analysis of the effects of development incentives on the chemical industry demonstrate that, while the influence of incentives on relocation of facilities was negligible, changes in the interstate distribution of jobs and investments were strongly related to the development incentive efforts of states (Rowland and Feiock, 1989).

State policies have consequences for the expansion of existing facilities and the location of branch operations. While state economic policies directed to business may not be a major factor in decisions to establish branch plants, they are of more importance in deciding where to locate a branch operation once the decision to branch has been made (Wasylenko, 1985).

Schmenner's (1981) analysis of newly sited plants found that the desire for low taxes was the most important factor explaining regional location choices. In sum, the most recent research calls into question previous conclusions that state policy is inconsequential to location choices and identifies specific instances where state actions are salient.

ECONOMETRIC EVIDENCE

Econometric analysis facilitates identification of the overall impact of public policies on economic growth, not just the direct impact of specific firms' decisions. Industrial development resulting directly from incentives to business may stimulate additional spin-off investment in the community through industrial linkage and agglomeration economies. Furthermore, state governments may derive benefits from development policies even if the businesses that locate in that jurisdiction would have done so without the inducement. "Programs which subsidize real estate or structural capital will increase the intensity of land use and will thus tend to increase employment at the site in question" (McDonald, 1983:335).

State policies may also influence development through changing the overall business climate of the state. Survey evidence suggests that perceptions of a jurisdiction's desirability as a location for investments are influenced substantially by the number of incentives provided for industry, not merely the direct impact of specific incentives on profitability (Kale, 1984). *Industrial Development Magazine*, Fantus Corporation, Alexander Graham Corporation, and numerous business consulting firms regularly rate state business climates based upon the number of tax breaks and development incentives provided for industry.

To examine the direct and indirect effects of state development policy efforts, it is necessary to estimate an econometric model of state economic performance. In the last decade, a number of cross-sectional models of state economic growth have been estimated. While the results vary somewhat depending on the specification and functional form of the models, most analyses identified positive effects of state economic performance resulting from state development activity.

Plaut and Pluta (1983) examined changes in manufacturing employment and investment in the states between 1967-72 and 1972-77. Their model included market accessibility, labor, wages, unionizaton, energy, land, and climate in addition to taxes and measures of state development policy activity. They found both taxes and development policy to be predictors of changes in manufacturing employment. Similarly, Newman (1983) found corporate tax rates and right-to-work laws related to growth.

Digby (1983) modeled manufacturing employment growth as a function of wages, unionization, economic base, climate, and past economic growth (agglomeration economies). Adding the adoption of various state development programs to the equations significantly increased the explained variance. For example, right-to-work laws and state training programs increased explained variance eight percent. Local studies have also found incentive policies to have positive effects on manufacturing investment, employment, and the number of firms (Feiock, 1988).

While only a few longitudinal analyses have been undertaken, this evidence also suggests that state policy can alter patterns of economic performance. An analysis of a pooled cross-sectional time series of per capita manufacturing investment by state from 1966 to 1978 found that lagged state tax variables negatively affect business investment (Benson and Johnson, 1986). In fact, the majority of recent cross-sectional and longitudinal econometric analyses provide evidence to disconfirm the conventional wisdom that state development policies have little or no effect on employment and investment (Vedder, 1981).

ZERO-SUM COMPETITION

State development policy has been described by numerous commentators as a zero-sum game resulting in wasteful and unnecessary competition among areas for investment and jobs. For example, Beaumont and Hovey (1985:327) stated:

> Industrial development is fundamentally a zero-sum game. If this is true, it is argued, then all state and local policies do is to move a given amount of economic activity around the country without increasing the total amount of that activity. For example, five to nine million auto transmissions are produced in the United States in any given year. The number varies, but not for reasons related to state and local policies. While Louisiana may gain from attracting some of this production from Michigan, that state's gain may be equaled by Michigan's loss. If Michigan's policies draw this production back, the gain may be at Louisiana's loss. Thus, it is argued, no national gain comes from this activity.

Two assumptions underlie the zero-sum perspective: (1) development policies do not create new business and (2) development policies distort the efficiency of private investment decisions. Both of these assumptions appear tenuous. Further, even if these assumptions are correct, the zero-sum conclusion does not necessary follow.

The zero-sum view assumes that development policies seek only the redistribution of industry among spatial areas rather than the creation of new business or expansion of existing business. Many of the economic activities of state government are directed to market size, structure, and risk. Such actions promote the expansion and retention of existing industry or encourage entrepreneurship to create new business. This is especially important because most of the change in business activity among states is due to differences in rates of new firm creation and not relocation.

Wolman (1988:19) has pointed out that "policies that foster entrepreneurship and help bring firms that would not have existed into business are positive sum." By lowering the costs of doing business in a particular state, economic development policies facilitate formation of new enterprises and assist young businesses to survive and expand. Empirical evidence at the local level suggests that policies directed to new and small business are effective in stimulating manufacturing growth (Birch, 1979).

The second assumption is that any alteration of the distribution of private investments resulting from development policies is inefficient because these policies add "artificial" considerations to business investment decisions. Nevertheless, to the extent that private markets cannot reflect all the relevant costs and benefits of investment decisions, development incentives may internalize important externalities such as the value of additional jobs, higher wages or customer goods to a state. By incorporating salient social costs or benefits into private investment calculus, development policies may in fact improve efficiency.

In the next three sections it is argued that **the zero-sum outcome is a special case and not the general case**. This is accomplished by examining the problems involved in the zero-sum logic from regional, national, and international perspectives.

Regional Implications

For purpose of argument, assume existence of a growing economy with several regions. One or more regions are characterized by high unemployment (long-run labor surplus) while the remaining regions have close to full employment. Also assume that all economic development incentive costs are borne by the state offering the development subsidy and that all states are free to compete for industry by offering subsidies in the form of economic development incentives. If a state in a high unemployment region offers a development incentive, the effort might then be observed and initiated by other states.

Because the incentive is directed to increased employment and the state offering the subsidy must cover all its costs, not every state will have an equal interest in engaging in this activity. Those states experiencing the most severe unemployment problems will have the greatest incentive to offer development subsidies because the positive externalities resulting from new additional business will be high. That is, cities compete in a market for jobs in which the amount of incentives offered reflects the marginal social benefit of additional jobs (Blair and Wechsler, 1984).

Although such a market operates far from perfectly, the implication is that expensive state development incentives reflect the need for jobs and their positive externalities. For this reason competition for business will be concentrated in the regions with high unemployment.

While state development policy may not be sensitive to short-term changes in economic conditions, there is strong evidence of a negative relationship between economic conditions and economic development activity in state and local government. The economic positions of states as well as the costs of development policies result in self-limiting competition (Rubin and Rubin, 1987).

Availability of economic development incentives to business in a high unemployment region results in an increase in the net inflow of capital to the region. More capital will become available to expansion and new firms will be attracted by the availability of labor and government financial inducements.

The increase in capital in a depressed region resulting from development competition benefits the entire region. The net addition of capital to the region means that it is possible for **all** of the competing states to win.

From the perspective of the individual state, the results described above may look to be zero-sum. States in a depressed region will at times compete for the same businesses and will believe that their efforts "cancel each other out."

Each state in concentrating on being competitive may be unaware that the impact of competition is the alteration of capital flows between regions. What has escaped recognition is that this competition results in more winners than if states in depressed regions had colluded and agreed not to compete.

National Implications

In the above example, competition is not a zero-sum game for the region experiencing high unemployment. Moreover, the region's economic development problems will be solved more rapidly if states with a labor surplus compete with each other than agreeing not to. This begs the question of whether the benefits to the depressed region come at the expense of the high employment region in a zero-sum tradeoff.

Negative effects on regions with full employment are not inevitable and, in many cases, will be minimal. In a growing economy, job opportunities can expand in one area without causing contraction in another. The marginal shift in the interregional flow of capital may only affect the **rate** of job expansion in the regions. This means that total jobs or income may not decline in any of the regions.

In addition, migration of labor "forced" by the lack of opportunities in depressed regions would be reduced. This reduced labor flow out of depressed states means that the economies of the growing regions would not have to expand as fast to maintain high employment levels. Because the interstate allocation of new facilities and expansion of existing facilities are more sensitive to development actions than relocation of existing resources, development competition can minimize negative effects on full employment regions by influencing the location of the net expansion of the nation's productive facilities.

The mobility of labor across states is a key factor in determining whether the zero-sum result is achieved. Given the self-limiting nature of development actions, only in the situation where there is no surplus of labor in the high employment region (growth of capital stock equals growth of labor supply) and labor mobility is high will a zero-sum outcome result. Even this result may not be undesirable for states in that policy competition reduces forced labor migration.

Since labor is less mobile than capital, economic gain for the nation would result from influencing the distribution of the new expansion of the economy. The lower the mobility of labor, the greater the likelihood of economy-wide gains from development competition. Positive-sum results for the economy as a whole are particularly likely where the surplus labor in the underemployment region is immobile. This positive-sum outcome is especially likely because family and cultural patterns, high costs of movement, and public support programs that are tied to places rather than people give rise to rigidities in the labor market.

International Implications

From an international perspective, the benefits of development policy competition are even more apparent. Even if state development policies are zero-sum from a national perspective, they have positive impacts from an international standpoint.

Development competition may have beneficial effects in reducing imports and increasing exports. By reducing business costs, state policies reduce the costs of manufacturing goods in the United States and increase the competitiveness of U.S. producers. State development competition increases the national efficiency of the U.S. and thereby assists export-based firms and improves the nation's position in the world economy (Beaumont and Hovey, 1985). This further limits the possibility of zero-sum outcomes.

FUTURE OF STATE ECONOMIC POLICY-MAKING

In 1933 Luther Gulick declared that the "American state is finished. I do not predict that states will go, but affirm that they have already gone" (quoted in Sanford, 1967:21). The extensive and growing number of economic activities of state governments outlined in this article would appear to prove Gulick's assessment incorrect.

The information provided in this article does not capture all of the ways states contribute to the viability of the economic systems of the United States but, nevertheless, it is a beginning for assessing the contributions of state economic policy. In conclusion, states have the capacity to play a critical role in economic policy-making and, in fact, are already playing that role to a greater extent than is realized.

American federalism presents challenges for integrated economic policy-making, but this fact alone is not a justification for dismissing the potential positive role of the states in national economic policy-making. There are, in fact, many reasons for taking states' actions into account in national policy-making. One reason is that the states are often responsible for implementing federal policies. It is well known that the national government has increased its role in social welfare, housing, education, highways, mass transit, and other domestic policy arenas in the last thirty years. However, it is often forgotten that the programs upon which the growth of federal activity is built are intergovernmental by nature. Intergovernmental strategies have proven viable and effective vehicles through which national policies and priorities can be achieved.

A second reason is that the states are already involved in the development of national economic policy. It was argued earlier that state development policy competition reduces the costs of manufucturing goods in the United State and increases the competitiveness of the United States producers by increasing national efficiency. Through a variety of means and mechanisms, states have become active participants in efforts to improve the U.S. position in the world economy.

A third reason for a more positive role for the states in national economic policy-making is the number of inconsistencies being produced by currently disjointed federal and state actions. For example, in many regulatory areas, state governments facilitate economic activity while the federal government attempts to frustrate business ventures.

Empirical research has discovered that economic competition leads states to provide subsidies and tax breaks intende to offset the costs of federal regulatory policy compliance. A national economic policy that takes state actions into account might reconcile or at least recognize the inconsistency of various policy actions.

A final reason for ensuring a more positive role for state economic policy is that such an effort is consistent with the Reagan and Bush administrations' policy of returning programs and powers back to the states. The transfer of federal programs and activities to state governments highlights the need for strategic matching of federal and state actions in pursuit of national economic goals.

In economic development there is little indication that the national government would step in to fill the gap left by the absence of state development initiatives. In fact, the federal government appears to be retreating from its involvement in encouraging urban economic development as witnessed by failure of national enterprises zone legislation, limits on industrial development bonds, reductions in the CDBG program, and elimination of the UDAG program.

By providing evidence that state policy is an effective tool for economic development and that state policy competition leads to positive-sum economic gains in most instances, it is hoped that the positive economic role of the states and their strategic relevance to national economic growth will be more appreciated.

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