Economic Development Programs for States In the 1990s

By Tim R. Smith and William F. Fox

State economic development programs have traditionally tried to create jobs by recruiting large manufacturing businesses from other states or countries. Such programs first appeared in the 1930s, when southern states successfully used tax incentives and subsidies to attract textile manufacturers from the Northeast. Since then, manufacturers have remained the primary targets for state economic development efforts. Such programs brought big economic development prizes to some states in the 1980s, at times netting high payoffs. Notable examples in the 1980s were the Nissan and Saturn manufacturing plants attracted by Tennessee, and the Toyota plant won by Kentucky. However, the overall effectiveness of traditional recruitment programs in creating jobs is increasingly being called into question.

Programs aimed at helping indigenous, or homegrown, businesses will likely be more appropriate than traditional recruitment programs for the 1990s. Some states have already begun to move their economic development programs away from recruiting manufacturers toward encouraging business startups, fostering expansion of existing businesses, and preventing business failures. Today, most jobs are created by small indigenous nonmanufacturing businesses. Thus, states that continue to focus on recruiting heavy industry may overlook more promising economic development strategies.

The first section of this article describes the broad range of traditional state recruitment programs that states believe will create jobs. The second section examines how well traditional recruitment programs have met the goal of creating jobs. The third section outlines strategies for refocusing existing programs and adopting new programs aimed at indigenous businesses. The article concludes that states stand a better chance of boosting employment if they more

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aggressively shift the focus of their efforts from recruiting large manufacturing businesses to providing a more favorable economic environment for all businesses.

I. Traditional Economic Development Programs

Programs designed to attract businesses from other states and countries—especially large manufacturing plants—form the mainstay of most efforts to promote economic development. The emphasis on recruitment surfaced soon after World War II, as manufacturing employment grew and states generally believed that large manufacturing businesses provided the best source of new jobs.[1] Manufacturing employment swelled from 15.5 million in 1947 to 20.2 million in 1969. In addition, employment levels shifted substantially across states, as branch plants of northern-based manufacturing firms started up or relocated in southern states. Combined, these new employment opportunities in manufacturing fortified states' belief that the best job creation strategy was to recruit manufacturing businesses. Today, many states have been left with a legacy of traditional recruitment programs aimed at attracting manufacturing businesses.[2]

Reducing business taxes

The most common traditional recruitment technique involves reducing or limiting business taxes. State policymakers believe lower business taxes will increase profits, thereby attracting new businesses and new jobs. Business tax reduction usually takes one of four forms. Each form allows businesses to retain more profits.

In the first form, states can lower tax rates to limit business taxes and let businesses keep a larger share of their profits. State taxes that most directly affect businesses are corporate income, sales and use, and property taxes. While nearly all states impose these taxes on businesses, they do so at widely different rates.[3]

Second, states can offer tax credits to lower business tax liabilities. Tax credits allow the tax reduction to be directed to industries a state deems important to its economic future. Arkansas, Nebraska, and Indiana, for example, encourage job creation by granting corporate income tax credits for each new manufacturing job. Arkansas offers a tax credit for motion picture expenditures, and Mississippi offers tax credits for job creation in some high-technology industries.

Third, states can limit the base upon which business taxes are levied. By narrowing the tax base, a state tries to reduce business tax liabilities for a given tax rate, increasing the chances that businesses in the state will be profitable. For example, many states provide sales tax exemptions for manufacturing equipment.[4] In this way, the sales tax base is narrowed by excluding a business-related item from the tax base. Another example is that states can allow deductions to the corporate income tax, so as to limit the base of this tax. States also can offer businesses property tax abatement, or forgiveness, on the real property associated with new manufacturing facilities. Abatements of this kind often apply to particular industries or geographic areas.

Fourth, states can negotiate tax reductions for certain individual businesses. These tax concessions are normally used to attract new businesses or to prevent businesses from leaving a state. For example, property tax concessions helped attract the Nissan plant in Smyrna, Tennessee. And recent changes in Nebraska's tax law were aimed at attracting and retaining manufacturing businesses.

Other programs

States can use several other programs to attract businesses in addition to tax reduction. These other programs further illustrate the magnitude of traditional recruitment programs.

Credit programs to recruit businesses. States provide many forms of financing to recruit businesses in the hope of creating jobs. These programs normally attempt to reduce the cost of financing manufacturing facilities. For example, Kentucky and Mississippi offer direct loans and loan guarantees for industrial buildings and equipment. Kentucky agreed to pay interest on funds borrowed to finance the recent Toyota plant. Some states issue industrial development bonds, and most states allow local governments to issue them. These bonds exempt bondholders from paying federal income tax on the bonds' interest, although such exemptions have been limited by recent changes in federal tax law.

Infrastructure. States often build infrastructure to attract manufacturers and jobs from other states. The most common public infrastructure investments are highways and water and sewerage systems. While infrastructure improvements and expansions are usually provided for all residents and businesses, states increasingly are building or improving infrastructure to attract individual manufacturers (Fox and Smith 1990). For example, Tennessee provided highway upgrades to improve access to both the Saturn and Nissan plants.

Education and training. Many states try to attract businesses by improving the skills of their labor force. Education and training programs increase the profitability of businesses by increasing the productivity of workers and reducing labor costs. Traditionally, education and training have been tailored to meet the needs of manufacturing businesses. For example, Tennessee provided $11 million to Nissan and $30 million to Saturn to help workers develop job-specific skills for the new plants. Similar training programs were designed in Michigan for Mazda, in Illinois for Diamond Star Motors, and in Kentucky for Toyota (Milward and Newman 1990). Most training of this kind occurs at state universities and vocational technical schools, although Tennessee also helped send many Nissan employees to Japan for training.

State promotion. All states promote themselves as good places to do business. States commonly advertise their most attractive attributes and economic development programs through newspapers, videos, and trade shows. In addition, state economic development departments frequently help businesses comply with the myriad of government regulations. They also provide information to project development teams on possible sites for locating within the state. The audience for state promotion efforts such as these includes businesses in other countries (Smith 1989). For example, 39 states have opened trade offices in Japan.

II. Traditional Recruitment: The Best Strategy for Creating Jobs?

The breadth of these programs shows how strongly states rely on the traditional recruitment strategy. Such efforts may have been appropriate when U.S. manufacturing employment was growing. More recently, however, some policymakers have begun to question whether the traditional recruitment strategy can create jobs.

The number of jobs created by the traditional recruitment strategy depends on how well recruitment programs attract large manufacturing businesses and how many jobs these businesses bring with them. Before deciding whether the traditional strategy creates jobs effectively, two questions must be asked.[5] First, *do recruitment programs attract businesses?* Surveys and empirical studies suggest that, at best, recruitment programs have a small effect on business location decisions. Second, *are large manufacturing businesses good sources of new jobs?* Employment trends and evidence about the contribution of large businesses to job growth suggest that large manufacturing businesses are no longer a major source of new jobs. Consequently, policymakers are asking a third question, *are there better sources for new jobs?*

Do recruitment programs attract businesses?

Researchers have relied on two types of studies to determine whether recruitment programs are effective in inducing businesses to relocate. The two types of studies are surveys of factors important in the location decisions of individual plants, and empirical studies of the relationship between various government programs and economic growth.

Most surveys of business location decisions conclude that public programs are much less important to the location decision than such factors as labor costs and access to markets. Surveys are generally designed to ask corporate participants in recent branch plant decisions to reveal the most important factors in their location decisions. For example, Schmenner (1982) concludes from results of several comprehensive surveys that taxes affect only those location decisions where all other factors are equal. He also concludes that while high taxes might deter businesses from locating at a particular site, low taxes are not likely to attract businesses. Furthermore, because personal taxes affect the quality of life in an area, they are likely to have a larger effect than do business taxes on business location.

Schmenner bolstered his conclusion that taxes play a minor role in location decisions by surveying 410 of the Fortune 500 companies. In this survey, firms identified factors considered essential in the choice of a state or region in which to start or relocate a branch plant. Low taxes and available government financing were essential location factors to only 1 percent of branch plant openings and to none of the relocating plants. To find out what factors were most important, firms were asked to identify which factors helped tip the scales in favor of a particular site. Such factors were regarded as desirable but not essential in choosing a location. Nearly 75 percent of the respondents cited a favorable labor climate, and 60 percent cited low land costs. But only 35 percent of the respondents cited low taxes, and only 25 percent cited government help with infrastructure and labor training.[6] From this survey information, Schmenner concludes that most firms locate branch plants without much regard to specific recruitment programs.

Empirical studies also suggest that traditional recruitment activities have only a small effect on business location decisions. Although focusing on the effects of taxes, these studies evaluate the effects of other programs as well.[7]

Carlton (1982) examined the effects of taxes and recruitment programs on employment at new branch plants of manufacturing firms. He also considered the effects of such other location factors as prices for labor and energy on where plants located.[8] The study found that neither taxes nor other types of incentives were significant location factors. Energy prices, particularly the price of electricity, were important, though. In addition, firm size, the availability of engineers and other workers in the local market, and the concentration of employment in an area were important location factors for at least one of the industries.

Bartik (1985) also found that recruitment efforts exert only a small influence on branch plant locations. He examined the effects of several factors on the location of 1,607 manufacturing branch plants from 1972 to 1978, including unemployment insurance, workers' compensation, corporate income, and property tax rates. Bartik's findings suggest that the corporate income tax rate influences where businesses locate. However, he estimates that a 10 percent increase in a state's corporate income tax rate would deter only 2 to 3 percent of businesses. Moreover, other tax rates tend not to be significant factors in location decisions.

Bartik's study also points out that several other factors influence branch plant location. For example, more roads lead to more plant locations, suggesting that state infrastructure programs are important. Higher unionization of labor in a state leads to fewer plant locations, while a high degree of existing manufacturing activity attracts more plants.

Fox and Murray (1990) provide limited evidence linking taxes and other recruitment programs to the location or startup of businesses. Their study examined the location effects of taxes and a broader set of recruitment programs on 68,520 businesses relocating or starting up in Tennessee from 1980 to 1986. All industries were represented in the study. The study found that high taxes were generally more important to small businesses than to large businesses. Taxes were not important in the location choices of businesses with more than 50 employees. The study also revealed that high sales tax rates discouraged manufacturers of durable goods. Furthermore, a highly educated work force and ready access to interstate highways help attract business.

Overall, empirical studies of business location suggest that recruitment activities have little or no effect on business location decisions. Empirical evidence thus reinforces survey results suggesting that such factors as access to markets, unionization, and a high concentration of similar businesses in an area are more important determinants of location decisions.

Are large manufacturing businesses good sources of new jobs?

The traditional recruitment strategy assumes that large manufacturing businesses can provide a lot of new jobs. But are these businesses good sources of new jobs?

Recruiting manufacturing businesses is not likely to be an effective job creation strategy. Manufacturing employment has experienced no net growth of employment since 1969. Furthermore, manufacturing's share of total employment has declined throughout the postwar period (Chart 1). Manufacturing accounted for 35.4 percent of total employment in 1947, 28.7 percent in 1969, and only 18.1 percent in 1989.[9]

Although manufacturing employment has not increased since 1969, some states have continued to recruit manufacturing businesses—primarily large manufacturing plants—from other states. However, the evidence shows that U.S. firms seldom relocate or start up branch plants. Schmenner's survey showed that startups of new branch plants of large firms in his sample accounted for an average of only about 15,900 new jobs in each state from 1970 to 1979.[10] Moreover, only 445 branch plants relocated during the period, an average of less than one relocation per state each year—and only 61 of these plants relocated across state borders. Consequently, noticeable job growth in a state is not likely to stem from relocations, and only limited growth is likely to stem from new branch sites.

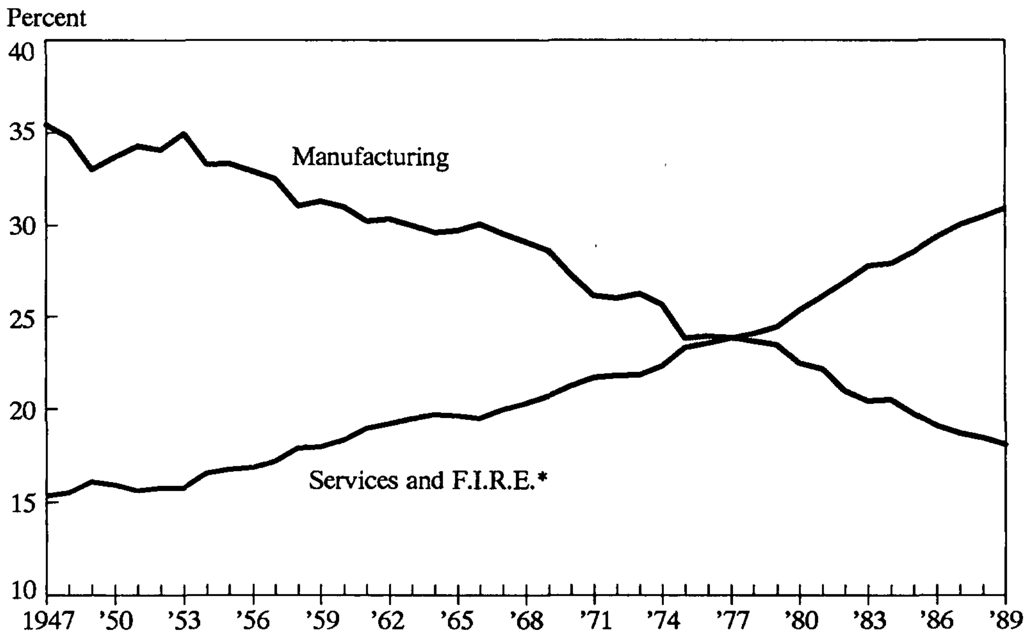
Are there better sources for new jobs?

If large manufacturing businesses are not good sources of new jobs, where can policymakers turn? Evidence suggests that other types of businesses offer greater promise for job creation.

Several nonmanufacturing industries offer greater potential for future development programs. For example, the finance, insurance, and real estate (FIRE) sector and the services sector have grown rapidly since World War II. From 1947 to 1989, FIRE employment grew at a 3.3 percent rate and services employment grew at a compound annual rate of 4.1 percent. As a result, the share of employment in these two sectors grew significantly (Chart 1). By 1989, there were 26.9 million jobs in the services sector and 6.8 million in the FIRE sector. These and other nonmanufacturing industries thus hold promise for employment growth in many states.[11]

Further evidence suggests that economic development strategies focusing on large new businesses will ignore the richest sources of potential new jobs—new small businesses or

Chart 1
Employment Shares
(Percent of total U.S. nonagricultural employment)



*Finance, insurance, and real estate.

Source: U.S. Department of Labor.

expansions of existing businesses. Evidence on the types of businesses most responsible for job creation is scant because most business location studies mix the effects of new firms with the expansion, contraction, or closing of existing firms. And national data on business entries do not exist. However, comprehensive data are available on business entries in Tennessee for the years 1979 through 1986. These data illustrate that the majority of job creation in Tennessee occurred in new small businesses or expansions of existing businesses (Fox and others 1987, and Fox and Murray forthcoming).

The Tennessee data on business entries suggest that small businesses account for most new firms and the new jobs that come with them.[12] Only 100 businesses with more than 200 employees—0.16 percent of all new businesses—started or relocated in the state from 1980 to 1985.[13] On the other hand, 56,228 firms with 20 or fewer employees started or relocated in the state. Although precise data on employment at these new small businesses are not available, their overwhelmingly larger number suggests their employment impact far exceeded that of large businesses.

The data also suggest that most employment gains occur through expansions rather than new locations or startups. Employment gains at expanding firms accounted for six times more new jobs than new startups from 1979 to 1986 in Tennessee, a state known for its success in recruiting large manufacturing businesses. And 60 percent of national manufacturing gains in the

1970s were due to plant expansions (Schmenner 1982). The Tennessee data on business entries and national employment trends thus suggest that large manufacturing businesses are not likely to be a strong source of new jobs for most states. Therefore, traditional recruitment strategies overlook indigenous businesses and their greater potential to create jobs.

III. New Directions for Economic Development Programs

The potential of indigenous businesses—especially small businesses—to create jobs suggests that states should focus on building a strong economic environment to help these businesses grow. To carry out such a strategy, states should shift the focus of traditional programs from recruiting large manufacturing businesses to fostering the growth of smaller indigenous businesses. States also should consider a new class of programs designed to enhance the environment for entrepreneurs, existing businesses, and small firms. Such a strategy, though not proven, is more likely to be successful than traditional recruitment programs.

Redirecting business recruitment programs

State economic development programs are likely to generate more jobs if they are redirected to include indigenous businesses. These efforts stand a better chance of creating significant numbers of new jobs if all businesses, not just large manufacturers, can reap benefits from these programs. That is, the programs are more likely to succeed if they are made available to the businesses that hold the most promise for job growth in the 1990s, namely, small nonmanufacturing businesses.

One way states can aim economic development programs toward a broader range of businesses is by viewing these programs as ways to improve a state's overall economic environment. In this way, development programs can build on states' strengths and overcome their weaknesses to provide a healthier setting for businesses. In other words, if a state creates a favorable economic environment, it increases the likelihood that new businesses will start and existing businesses will prosper. In addition, states might also benefit from business relocation because a favorable economic environment increases the likelihood that businesses will move from states with less favorable economic environments.

Although states should de-emphasize recruitment, their development strategies could retain some recruitment efforts. Some states have attracted wholesale, computer, and banking businesses. Other states continue to target specific manufacturing industries. For example, some farm states have aimed their economic development efforts at food processing industries (Barkema, Drabenstott, and Stanley 1990). But these recruitment efforts should be modest and aimed at carefully identified targets that are particularly promising to individual states.

Programs for business creation and expansion

Programs for creating and nurturing businesses have already begun to capture the attention of some state policymakers. However, programs focusing on indigenous businesses are still less prevalent than traditional recruitment programs. These newer programs usually entail using public funds to encourage business startups and the expansion or retention of existing businesses. Because it is still too soon to evaluate the indigenous programs, states should proceed cautiously and carefully monitor the success of the programs they adopt. Each state can then choose a mix of programs that most improves its environment for business startups and expansions. Four main types of new programs are available to states: small business development centers, research and development programs, technology transfer programs, and credit programs for new businesses.

Small business development centers. Good management practices are important to the success of small businesses. States are helping small and startup businesses learn such practices as marketing, organization, and financial controls through small business development centers. Frequently associated with universities, these centers provide management consulting services to individual businesses. In addition, states often provide financial and training assistance or low-cost space to encourage small business startups. Some states—Indiana, Massachusetts, and Georgia, for example—have developed programs to help entrepreneurs identify investors. A key strategy in Oklahoma's five-year economic development plan is assisting entrepreneurs and small businesses.

Research and development programs. Although high-technology businesses will create a relatively small share of new jobs over the next decade, several states believe they can attract a substantial part of the growth if they can help develop emerging technologies. To do so, states increasingly are establishing partnerships between their universities and private businesses.[14] Often these businesses are started by faculty entrepreneurs who receive help in moving ideas from research laboratories to the market. Some state policymakers believe that closer partnerships between state universities and businesses can help identify cutting-edge research areas with market potential. Pennsylvania's Ben Franklin Partnership and Ohio's Thomas Edison Program are two well-known research and development partnership efforts. In addition, Tennessee has provided funds for research and new facilities for development of applications of biotechnology to help clean up environmental waste.

Technology transfer programs. States are increasingly providing direct technical assistance to businesses. Agricultural extension services at land grant universities have provided technical assistance to agriculture for well over a century, but manufacturing extension services are relatively new. Many states are now developing such services to deliver technology to manufacturing businesses, often using existing capabilities at state universities. For example, the University of Tennessee has developed the Center for Industrial Services over a period of several decades. This center provides teams of engineers to help improve manufacturing processes. Ohio State University has developed the Ohio Technology Transfer Organization (OTTO) to improve the flow of new technology to small businesses.[15]

Credit programs for new businesses. States have designed two new kinds of credit programs to provide financing to risky startup businesses. By doing so, states are filling a gap left by traditional financing mechanisms, which often exclude risky enterprises with a potential for large payoffs.

States have established *venture capital funds* to spur the startup or expansion of high-potential businesses with low probability of success. Such businesses have the potential to boost economic development through rapid growth, but may have difficulty securing private capital. Venture capital funds often take equity positions in a startup business, effectively tying repayment of the assistance to the success of the business. For example, Tennessee operates venture capital funds through a for-profit corporation at the University of Tennessee. Some states also set up clearing houses to match entrepreneurs with venture capital funds.

Another way states have stepped in to fill financing gaps for new businesses is through *business and industrial development companies* (BIDCOs). These new financial institutions are created by states to provide credit to new businesses that are more risky than businesses using conventional bank loans but less risky than businesses seeking venture capital funds. Public funds are used to attract private investors to start a BIDCO. Once established, the BIDCO operates as a private institution under state regulation to provide flexible financing to moderately risky businesses. Unlike commercial banks, BIDCOs can take an equity interest in the businesses they lend to or receive a share of profits to offset below-market interest. Moreover, BIDCOs provide more management assistance and get more involved in the day-to-day operations of businesses than banks. Michigan, a pioneer in the BIDCO programs, has established six BIDCOs.[16]

These examples of programs aimed at helping create and expand businesses suggest that states are already beginning to change the direction of their economic development programs. Although it is too soon to know if programs that focus on business creation and expansion will be more effective than traditional recruitment programs, new and existing businesses appear to hold untapped potential for state economic development.

IV. Conclusions

State economic development programs traditionally recruit large manufacturing businesses from other states or countries. Because recruitment efforts were successful in landing a few high-profile manufacturing plants in the 1980s, states have been reluctant to de-emphasize these traditional programs. But despite the visible prizes, empirical evidence suggests that recruitment efforts have very little effect on business location decisions. Moreover, if trends established during the past four decades continue, large manufacturing businesses will not provide a significant source of new jobs in the 1990s.

Most states stand a better chance of creating jobs if they emphasize an economic development strategy that builds a strong economic environment for indigenous businesses. Manufacturing industries will always be a source of jobs in some states due to transitions within the manufacturing sector, but smaller firms in services sectors hold greater overall promise for job creation. Traditional economic development programs need to be reoriented toward providing a sound economic environment for all businesses, especially indigenous businesses. In addition, new programs aimed at the startup, expansion, and retention of businesses will likely be more appropriate for the 1990s than traditional recruitment programs.