
DEVELOPMENT POLICY COMPETITION AND POSITIVE SUM GROWTH: INCENTIVE COMPETITION AND ITS ALTERNATIVES

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Abstract

This essay directly challenges the assumption that development competition is undesirable by examining how development policy can enhance social welfare. I address the desirability of development competition by demonstrating that the efficiency of development efforts depends upon the types of development programs employed and the context in which governments compete. After discussing the role of government policy competition in general, I examine incentive competition. I argue that, while development competition can lead to zero-sum outcomes, the zero-sum result is a special case. From this perspective, the social benefits resulting from development competition depend on the characteristics of the economic development market. I next examine three alternatives to conventional development strategies: institutional development, human capital development, and social capital development. After describing each of these approaches I argue that they have the potential to create positive sum gains for the states and communities that employ them.

Introduction

For public administration, the 1990s was the decade of competition and markets. Municipal service contracting, voucher programs, and quasi-markets among local governments each captured the attention, and in many cases, the favor of academics and public officials. The perception that competition among government promotes efficiency is now widely held (Lowery 1997; Ostrom, Bish, Ostrom, 1988). Curiously left behind in this rush to embrace the application of

markets to government is the competition among states and cities to attract economic development. Competition for development has attracted criticism rather than praise from most quarters. Neil Pierce contends:

From the left, from the center, and from the right, from scholars, economists, and think tanks, the word is the same: There's little gain but immense peril in America's state-eat-state civil war over buying jobs with taxpayers money. The sooner the subsidies to footloose industries stop, the better off we will be (Peirce, 1991).

Critics of markets perceive competition to be destructive. AFSCME describes state and local development programs as corporate welfare. "The current state of economic development is that it pits one government against another and in the process, it hurts government, hurts public employees, hurts taxpayers, and hurts existing business" (Howard, 1994: p.15).

Many economists have joined in the condemnation of government competition for economic development. The hostility of economists state and local development programs is based on the notion that it constitutes an inefficient government intervention into private markets. Local development incentives distort the location decision by inducing business to choose a site that would not minimize production costs. This produces a geographic distribution of new capital investments that is less efficient for the national economy (Burstein and Rolnick, 1995). In 1995, over 100 economists issued a press release calling for an end to targeted business incentive programs (Fisher and Peters, 1998).

The literature on state and local development in political science and public administration acknowledges that development programs can enhance economic welfare, but again, more attention has been directed to their limitations. Development activities may direct public resources to activities that are ineffective or promote narrow special interests. State and local development activities are often portrayed as resulting in zero-sum or even negative sum competition. Such conclusions beg the question of when if ever might state and local development competition be justified as socially efficient.

While acknowledging that in practice development policy may often have undesirable consequences, I seek to show that when governments compete, state and local development policy can enhance social welfare. This essay address the desirability of development competition by demonstrating that the efficiency of development efforts depends upon the types of development programs employed and the context in which governments compete. After discussing the role of government policy competition in general, I examine incentive competition. I argue that, while development competition can and does sometimes lead to zero-sum outcomes, the zero-sum result is a special case. From this perspective, the social benefits resulting from development competition depend on the characteristics of the economic development market.

I next turn to an examination of the approaches state and local governments use to enhance economic development. Three alternatives to conventional development strategies are identified: institutional development, human capital development, and social capital development. After describing each of these approaches I argue that they have the potential to create positive sum gains for the states and communities that employ them.

Development Competition and the Benefits of Growth

Economists typically assume that development competition distorts market decisions. The approach presented here rejects this assumption. The consequences of development and investment decisions are not confined to those directly engaging in these transaction. The social benefits and costs of growth constitute externalities that are excluded from private investment decisions. This can lead to a mis-allocation of new development in the absence of government intervention. By internalizing these social externalities, state and local development programs have the potential to enhance social welfare.

Market economics charges 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, private markets produce social externalities when all the relevant costs and benefits of development are not included in private investment decisions. Location choices for new development often produce positive or negative externalities for the community to which development is directed. In this context, government inducements to development may internalize externalities such as the value of tax base improvements, additional jobs, higher wages, and consumer goods on the one hand, or congestion, pollution, and inflation on the other. By incorporating salient social costs or benefits into private investment calculus, development policies may in fact enhance the social efficiency of private development decisions.

Social welfare can be enhanced by governments' ability to purchase changes in economic growth that match the expressed preferences of citizens for the social externalities associated with more rapid or less rapid development. Of course, tax dollars are not directly exchanged for economic welfare gains; increased income and employment are indirect consequences of private investments. Governments can induce changes in community welfare that result from economic growth by stimulating or impeding private development.

In addition, many of the direct benefits of development policies go to residents and other businesses not just the targeted firms. For example the \$130 million incentive package South Carolina offered to attract BMW included public infrastructure improvements and \$50 million for expansion of the Greenville-Spartanburg airport (Fisher and Peters, 1998). Governments provide developmental services and inducements to private firms in exchange for commitments of employment and investment. The benefits of growth, and thus the willingness to pay for economic development, vary and in some instances will be less than the perceived costs. Comparative empirical analysis has consistently demonstrated that development policy varies substantially across states and communities and that this variation is strongly associated with economic conditions (Rubin and Rubin, 1987; Bowman, 1988; Sharp, 1991; Feiock and Clingermayer, 1992; Tao and Feiock, 1999).

Consequences of Competition

This perspective sheds new light on several criticisms of state and local government development competition. It is because of the

economic, social, and psychic cost of mobility are so high and attachments to place are so strong that there is a willingness to pay to bring economic opportunities to a location rather than move ones residence to realize these gains. Even though American labor is highly mobile, some groups of people, especially older, less-skilled, or minority workers are relatively immobile (Fisher and Peters, 1998). Moreover, even for skilled, younger, and non-minority workers, mobility is quite limited in the short run. On the other hand, new investment capital approaches perfect mobility as funds can be electronically transferred around the globe in seconds.

Criticism of development competition is often directed to the types of policy instruments that are used in this competition. In particular, the use of targeted subsidies or tax incentives that are directed to specific firms has been criticized. Fisher and Peters (1998) contend there is no such thing as a “non-targeted” policy. Development policy runs on a continuum from one-time deals tailored to a particular firm that is the object of a bidding war, to broad scale policies available to all. Even programs available to all are valued by some more than others. Absent government or market failures (Feiock, 1998b), communities can promote their economic interest by pursuing a level of development at which the marginal value of growth to the median taxpayer equals the marginal cost. In doing so they can take into account the opportunity cost of using any other particular instrument.

Zero-Sum Competition

One of the most often voiced criticisms of the market for economic development is that it results in zero-sum competition. The zero-sum argument is not applicable if development actions can create, rather than just move investments around. As I describe in the concluding section, some development policy instruments seek to build human capital and reduce transaction costs of private exchange. Such approaches create rather than shift development resources. Even if we assume no additional investment is created, competition among governments for economic development with targeted incentives does not necessarily lead to zero-sum results. Instead, the zero-sum outcome can be viewed as a special case. This can be illustrated by examining the limitations of the zero-sum logic as it is applied from a regional, national, and international perspective (Feiock, Dubnick and Mitchell, 1993).

For purposes of argument, assume a growing economy within multiple regions. One or more of these regions is characterized by high unemployment and low growth, while the remaining regions have more robust growth and close to full employment. We assume that all economic development incentive costs are borne by the state or local government offering the development subsidy and that governments are free to compete for industry by offering these economic development incentives. If a jurisdiction in an economically disadvantaged region offers a development incentive, the effort might then be observed and imitated by other governments in the region. Because a jurisdiction offering the incentive must cover all its costs, not every state or local government will have an equal interest in engaging in this activity. Those jurisdictions experiencing the most severe economic problems will have the greatest willingness to pay for increased development because the positive externalities resulting from new investment will be high, reflecting the marginal social benefit of additional growth in those communities. Competition for business will be concentrated in the regions with low economic growth and the costs of development policies result in self-limiting competition.

The availability of economic development incentives to business in the declining regions results in an increase in the net inflow of capital to those regions. More capital will become available for economic expansion as new firms are attracted by the availability of labor and government financial inducements. The increase in investment in a depressed region resulting from development competition benefits the entire region. This net addition of capital to the region means that it is possible for all of the competing jurisdictions to win. From the perspective of the individual community the results described above may look to be zero-sum. Governments in a depressed region will sometimes compete for the same businesses and believe their efforts "cancel each other out." Each local government may be unaware that the impact of competition is the alteration of capital flows among regions. What has escaped recognition by students of development policy is that this competition results in more winners than if local governments in depressed regions had colluded and agreed not to compete.

If a region's economic development problems will be solved more rapidly when governments with economic problems compete with each

other, this begs the question of whether the benefits to depressed regions come at the expense of the high growth regions in a zero-sum trade-off. Negative effects on growing regions are not inevitable and in many cases will be minimal. In a growing economy, economic opportunities can expand in one area without causing contraction in another. Moreover, total jobs or income may not decline in any region because marginal shifts in the interregional flow of capital may only effect the rate of expansion in these 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 regions and into growing regions means the economies of jurisdictions in growing regions would not have to expand as fast to maintain high employment levels. Because the allocation of new investment is more sensitive to development actions than relocation of existing resources and facilities, 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 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 surplus labor in the declining 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. From an international perspective, the benefits of development policy competition are even more apparent. Development policy competition that reduces the costs of producing goods in the United States and increases the competitiveness of U.S. producers.

Recent studies provide evidence that state and local economic development policy can be both efficient, in the sense of achieving positive-sum economic gains, and progressive in that disadvantaged groups disproportionately benefit (Bartik, 1991). A critical assumption of analysis that supports these conclusions is that economic development programs are supplied by communities suffering economic distress because there is high demand for more rapid growth. If incentive offerings are not related to economic demand, then they will result in an inefficient allocation of growth.

Political systems which respond to economic hardship by providing development incentives can produce economic outcomes that are both efficient and progressive. On the other hand, if growth promotion is a response to political incentives, rather than economic conditions, communities not experiencing economic problems pursue growth using development incentives, thus creating allocational as well as economic inefficiencies by directing benefits primarily to land and capital interests.

Alternative Approaches to Economic Development

Dissatisfactions with incentive based development approaches has stimulated interest in several new approaches to fostering economic development. These include efforts to restructure institutions and property rights, human capital development through education and training initiatives, and efforts to develop a culture of trust, cooperation, and motivation through civic involvements (i.e., social capital).

Institutional Development

Subnational governments play an important role in defining the rights, rules, organizations and institutions that structure the state and local economies (Brace, 1993). This includes government action affecting property rights, governance, finance, operational rules and regulations. State and local governments play the primary role in determining the allocation of property rights and the institutions and rules that structure the local economy (North, 1991; Brace, 1993).

The complex system of state economic development requires efforts to build governmental capacity and the infrastructures for private development. Building from the foundation of earlier work, we see how state and local government action may impact the performance of economies in many ways (Eisinger, 1988; Fosler, 1992; Trogen and Feiock, 1996).

Peter Eisinger's (1988) model of the entrepreneurial state suggests that public investments in developing markets and technology can increase the productivity of local industry. Such efforts require enhanced policy and administrative capacities by state and local governments. Government interventions increase the productivity of

industry and create new demand for local products by identifying emerging industries which would prosper in the state and developing new markets for state products. In addition, state and local policy can increase the productivity of state industries by both the promotion of new technologies, and the provision of venture capital for new technologies which are too risky for private investors to finance, support for research and development, venture capital programs as well as export promotion.

Investments in institutional structures that lower private transaction costs can enhance growth. State capacity is difficult to define both conceptually and operationally. One dimension of institutional structure with important development consequences is the form and organization of state and local development activities. For example, many states have set up state sponsored industrial development authorities. Such authorities indicate an ongoing state intervention in the state business climate rather than piecemeal intervention resulting from legislation (Trogen, 1999).

Certain forms, structures, and processes of state and local development, regulation, and management functions may reduce uncertainty in the business environment. These include the centralization of decision making, the definition of rights, enhanced state administrative capacity, and strategic planning initiatives. Organizational consolidation that concentrates both fiscal resources and bureaucratic expertise into a single agency may reduce private sector transaction costs associated with new investments. Recent work demonstrates state economic growth is enhanced as transaction costs are lessened by administrative arrangements which reduce uncertainty over rights in property (Feiok, 1998a, 1999). Regulatory programs in particular affect the certainty of property rights and the consequences of the certainty of property rights for development investment and economic growth. Regulatory arrangements that are clear, and predictable reduce market uncertainty. By reducing transaction costs government action can enhance market efficiency and foster economic development (Feiok and Stream, 1999).

The transaction costs that result from this uncertainty have important consequences for incentives to invest and produce because variations in regulatory directives that cannot be easily anticipated inhibit development. Stringent regulatory requirements, if they are

clear, stable and certain, may diminish firms' investment risk. This suggests that state and local governments with stringent regulation, but stable and certain patterns and processes of regulation may have some hope of enjoying both the social and environmental benefits resulting from regulation as well as a growing economy (Feiock and Stream, 1999).

Human Capital Investment

Recent work in economics has emphasized endogenous growth theories. From this perspective long term growth is a function of both technological and human capital development (Romer, 1986). In endogenous growth models an educated workforce plays a special role in determining the long term rate of technological innovation and long-run growth. Technological progress and productivity gains are greatest the larger the accumulation of human knowledge (Gould and Ruffin, 1993). The quality of education programs, education reforms, environmental quality, and public expenditures for education and other activities provide indicators of state and local investment in human and capital infrastructure for innovation.

Human capital investments such as education expenditures may be attractive to business and affluent citizens (Jones, 1990; Peterson, 1981). From this perspective, government provision of education and training can influence the return on factors of production. The provision of education reduces firm level production costs and increases the net return to these same productive factors. Lieberman and Marquette (1991) contend there are diminishing marginal returns from investments in education. They conclude that, having already established a basically competent workforce, additional state education spending does little to enhance growth or improve the productivity of workers.

Nevertheless, there is evidence to suggest that education expenditures are positively related to state and local economic performance. Jones and Vedlitz (1988) found higher education expenditures were related to changes in the number of firms; however, they did not find a significant relationship between education expenditures and changes in personal income (Jones and Vedlitz, 1988). More recent evidence confirms that support for higher education at the

state level has positive economic development consequences (Storm and Feiock, 1996, 1999)

Endogenous growth theory which emphasizes human capital development may help us discern why education expenditures might positively impact state and local economies. First, human capital theory posits that investments in education affect economic growth because education investments result in the improvement of the workplace which equates to higher income levels (Leslie and Brinkman, 1988; Miller, 1967). Bryan Jones (1990) provides state level evidence that state government expenditures for certain aspects of the physical and human infrastructure can promote economic growth. An educated workforce helps determine the rate of technological innovation and long-run growth (Gould and Ruffin, 1993).

In addition to the higher level skills needed for the types of occupations available in today's market, there is increased recognition that there is an economic return attached to education; in other words, educational attainment typically has tremendous economic significance for individuals (Miller, 1967). Education can also enhance the competitiveness of enterprises in the state by assisting in innovation and technology transfer. Recent economic shifts in the marketplace have made it necessary for higher education institutions to play a more prominent economic role in the development of new technologies and the commercialization of these technologies.

Social Capital Development

The work of James Coleman (1990) and Robert Putnam (1993) link the effective performance of economies and democratic governance to the presence of a strong norms of interpersonal trust and civic community. Relations of trust and consensual allocations of rights which establish norms can be viewed as resources for individuals (Coleman 1990: p. 300). Virtually all commercial and employment transactions contain an element of trust (Miller, 1993). Activities and exchange that require agents to rely on future performance of others can be accomplished with lower transaction cost in an environment of mutual trust. A lack of norms of trust and voluntary cooperation, on the other hand, drive up transaction costs and make exchange more costly (North, 1991). Cooperative norms also act as constraints on

narrow self-interest, leading individuals to contribute to the provision of public goods.

Several mechanisms link civic involvement and economic development. A combination of competition and cooperation is a critical component of economic growth. The work in new institutional economics (North, 1991; Miller, 1993) and common pool resources (Ostrom, 1991) point to the critical role of trust, cooperation, and credible commitment for the effective functioning of markets. Trust and civic norms may also effect economic development indirectly through their influences on government performance (Knack and Keefer, 1997). Civic involvements provide a check on rent seeking and the proliferation of socially inefficient public programs. Moreover, civic norms help voters overcome collective action problems in monitoring public officials.

The question of how societies and governments can enhance the stock of social capital to capture these economic benefits has gained much attention in recent years. Some scholars have linked human capital and social capital by arguing that civic education is critical to the development of norms of trust and cooperation (McGinn, 1996). Putnam (1993) linked social capital to participation in social organizations. By joining and participating in voluntary associations citizens build norms and habits of behavior which foster effective collective action. Norms developed in these settings contribute to the effective operations of public and private organizations.

Civic associations are seen to have beneficial effects for democracy and development because of their impact on the character of their members and their effects on the wider polity. They help create habits of cooperation and public-spiritedness. Associations reflect and contribute to effective social cooperation. They create knowledge, skills, attitudes, and behaviors that enhance self-governance. Moreover, associations are the source of patterns of behavior, and interconnections that foster effective governance. Putnam (1993) posits that civic community determine both civic involvement and economic development.

To date there has been little effort to test theories about the relationship between civic involvements, norms of trust and cooperation, and economic development. In an analysis of Italian

regions using data from the early 1900s to the 1980s Putnam (1993) indicated that civic involvement was a strong predictor economic development. Jennings and Haist (1998) provide a comparative study of civic community and economic development in the U.S. states. This analysis found no support for a positive relationship between organizational activity and development. More support for effects of social capital on economic growth come from a cross-country study of social capital and economic development by Steven Knack and Phillip Keefer (1997). Like Jennings and Haist, they found no positive relationship between organizational activity and economic performance. They then decomposed this relationship by directly measuring social capital based on survey information on trust, civic cooperation and confidence in government. This analysis confirmed a strong positive relationship between norms and trust and cooperation and economic growth. These results suggest that social capital does enhance economic development, but encouraging participation in voluntary associations is not an effective policy for building social capital. Knack and Keefer (1993) posit that group involvements may exacerbate polarization along social and income lines in a way that diminishes trust and cooperation. For this reason, they suggest that reducing income disparities may enhance social capital and enhance economic growth. Recent work at the local level has found that development programs that seek to reduce inequality are effective in improving community wide economic development (Tao and Feiock, 1999). One explanation for this relationship is that reducing income inequality has resulted in social capital gains that translate into enhanced growth.

I have demonstrated that incentive competition can enhance social welfare. Nevertheless, if market or government failures are present, positive sum outcomes may not result (Feiock, 1998b). The three approaches described here - institutional, human, and social capital development - present exciting and attractive alternatives to traditional incentive-based approaches to economic development. More systematic research is needed before these approaches can directly inform state and local development practices. In particular, in the case of social capital development it is unclear what types of government interventions can most effectively strengthen social capital. Nevertheless, these approaches promise to provide mechanisms for state and local governments to aggressively pursue development while retaining the benefits of these efforts internally. Moreover, the results

of development policy that seeks growth from institutional, human, and social capital investment will be positive sum rather than zero-sum.

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