

# Economic development efforts in the Seventh District

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For the most part, individual states are limited in their ability to influence their economic prospects. National monetary and fiscal policies may offset state-level programs designed to stimulate employment growth. Shifting markets and foreign competition can also undercut state efforts to lean against the winds of change. But, while their impacts may be limited, economic development efforts in recent years have been a top priority for most states. The increased attention devoted to state economic development is primarily due to two factors. First, the back-to-back recessions in the early 1980s severely affected states dependent upon manufacturing, causing great concern among state officials. Second, the federal government has been gradually lessening its role in state development programs. Thus, states have had to fill in the gaps and find new sources of funds.

This study highlights the major features of the Seventh District states' economic development approaches but does not attempt to evaluate their impact. Such an assessment is not yet appropriate. First, none of the programs cited is more than five years old. Second, no common source exists from which to evaluate the extent to which program recommendations may have been adopted and if adopted what impact they have had. Also, few state-level studies have been done to provide the basis for such an analysis. Last, many of the recommendations made in development studies are vague and lack sufficient specificity upon which to conduct an evaluation.

## The programs

During the first half of the 1980s, all five Seventh District states published development programs and initiatives. For purposes of comparison, one study from each of the five District states has been identified as reflecting the approach adopted by the various states. These studies, listed below, have given rise to economic development efforts that tend to be long term in scope and customized to each

state's unique economic and demographic characteristics.

- Illinois: *Building Illinois: A Five Year Strategic Plan for the Development of the Illinois Economy (1985).*
- Indiana: *In Step With the Future... Indiana's Strategic Economic Development Plan (1984).*
- Iowa: *Rebuilding Iowa's Economy: A Comprehensive State Economic Development Plan (1985).*
- Michigan: *The Path to Prosperity (1984).*
- Wisconsin: *The Final Report of the Wisconsin Strategic Development Commission (1985).*

Numerous approaches have been adopted by the Seventh District states to help them better understand the performance of their economies and to develop programs in response to the problems they perceive. Some of the states (Illinois, for example) have relied on a more "traditional" state-sponsored approach to analysis, goal setting, and programs. Others (Wisconsin, for example) have adopted approaches that incorporate aspects of private sector strategic planning and have developed goals and programs that draw on both the public and private sectors.

While each state is different, the findings of the strategic and other economic development studies reviewed reveal that the more industrialized states (Illinois, Indiana, Michigan, and Wisconsin) of the Seventh District share similar economic structures and, thus, similar economic strengths and weaknesses. Consequently, strategies presented to address these problems have certain common characteristics. Though details vary across states, the economic development initiatives set forth revolve to a

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large extent around revitalizing the manufacturing sector, which has not only been the District's strongest economic sector historically, but also tends to produce goods that are high in value-added content.

### Individual state goals and targets

Michigan's strategic plan, *Path to Prosperity*, was designed to be a research-based, objective analysis of Michigan's economy which addresses the causes behind its decline. The study, conducted primarily by researchers at Michigan universities and businesses, recommended that policy makers orient their efforts towards resuscitating the state's historically strong industries—automobiles and auto parts. This approach differed from earlier studies that had called for Michigan to diversify its economy. To regain a competitive position, the report recommends that industries should employ the locally available pool of skilled labor and incorporate advanced technology into their manufacturing processes. Outside of the durable goods sector, *Path to Prosperity* calls on the state to promote its forest products and food processing industries, which were viewed as having growth potential. In the area of high technology, biotechnology was considered to have potential in relation to improving productivity in agriculture and forestry.

Drawing on individuals from both the public and private sector, the Wisconsin Strategic Development Commission (WSDC) devoted 18 months to developing a strategic plan for the state. Similar to *Path to Prosperity*, *The Final Report* of the WSDC determined that the state's economic future depends upon the strength of its manufacturing sector.

*The Final Report* recognized that further declines in existing industries were inevitable and that large amounts of scarce public and private resources should not be devoted to preventing the unpreventable. The study recognized that a state has only limited abilities to affect many areas. Thus, *The Final Report* recommended focusing policies and programs on the state's existing industries that are its basic strengths. The report found promise in emerging industries, small business, and entrepreneurship. In addition, the WSDC felt that the service sector would continue to expand. In the view of the WSDC, the service sector would account for an increasing share of

employment but would tend to generate lower income jobs and smaller value-added components than manufacturing.

Heavy specialization in agricultural and agriculture-related industries has made Iowa's economy vulnerable to swings in agricultural conditions. During the 1970s this specialization acted as a stimulus to Iowa's economy—adding jobs and income. However, during the 1980s, Iowa's agricultural specialization has become a detriment to growth.<sup>1</sup>

In response to the problems affecting the state, a study entitled *Rebuilding Iowa's Economy: A Comprehensive State Economic Development Plan* was prepared for the Iowa Legislature. The plan recognized that Iowa's economy would not miraculously rebound, given the domestic and worldwide agricultural outlook. The plan recommended two approaches to the problem: diversification of the state's economy and the organization of economic development activities on an in-state regional basis.

The plan recommended diversification in both the agricultural and nonagricultural sectors. While the study recognized that farmers were not likely to move away from the state's two traditional crops—corn and soybeans—it noted that there might be entrepreneurial gaps that could broaden the agricultural base.

For the nonagricultural sector, among other things, the plan called for a program of import substitution, in which in-state products would be substituted for out-of-state products purchased by Iowa businesses. Strengths were identified in the fields of technology-oriented agronomy, laser applications, biotechnology, and "tech-based industries" (those using technologically advanced equipment).

Indiana's strategic economic development plan, *In Step with the Future*, identified five industries—primary metals, fabricated metals, electrical machinery, nonelectrical machinery, and transportation equipment—as dominating the state's economy. While benefiting from their central location, the state's dominant industries have been affected by increasing competition and structural change. The report identified the greatest opportunities in expansion of existing firms and the integration of advanced technology into the production process. Such transfers of technology might be facilitated by the establishment of technology transfer centers and closer cooperation between universities and industry.

Illinois' approach to economic development is a broad-based expenditure program. Entitled *Build Illinois*, the program allocates public monies for infrastructure improvements, large-business attraction efforts, and small business loans. This program reflects a more traditional approach to state economic development efforts.

### **Common themes**

Contained within these five studies are three basic themes: recruit new firms, maintain existing firms, and create new businesses and enterprises. These are clearly not mutually exclusive activities. Different mixes of these activities produce different policies and sometimes internal inconsistencies.

The policies suggested in the five studies reflect a movement away from limited industrial recruitment programs ("smokestack chasing") toward a wider selection of programs designed to deal with particular circumstances. Increasingly, more emphasis is now placed on encouraging existing in-state businesses. This should be welcomed by the state's business community which frequently argues that industrial recruitment financed by subsidies and tax exemptions is being conducted at its expense with little or no evidence of net benefits to the state.

Another reason for the decreased emphasis on industrial recruitment is that studies on firm location decision-making have cast doubts on the long-run effectiveness of state efforts to attract businesses by offering them tax and financing incentives. First, it has been found that during a year only a small percentage of all businesses (and even a smaller percentage of the jobs) relocate.<sup>2</sup> Second, the decision by General Motors, for example, to locate its Saturn plant in Tennessee suggests that incentives may not be necessary if the state can provide an attractive business climate overall.

Despite the potential pitfalls, industrial recruitment is still undertaken by states in the Seventh District. For example, while Illinois has stated that "job retention is more important than attracting out-of-state firms," the state has vigorously pursued auto plants and has allocated several millions to business attraction efforts under its Build Illinois Large Business Development program. Michigan similarly promised subsidies to Mazda in the

form of lower taxes, worker training, and infrastructure investments in an effort to convince the company to locate its automobile assembly plant in Flat Rock, Michigan.

The 1980s have seen the emergence of both technology recruitment and technology application as development policies. Technology recruitment is a form of industrial recruitment applied to "high tech" industries, which have been sought for their reputed high growth, high wage, and nonpolluting characteristics. Based on the apparent successes in California, Massachusetts, and North Carolina, states sought to attract high-tech firms as a new base for their economy. However, such opportunities are limited, and thus the states have become intensely competitive whenever large projects arise. For example, both Michigan and Illinois are currently striving to attract the multibillion dollar Superconducting Super Collider particle research facility to their states.

Initial optimism has been tempered by the realization that the "high tech" sector will account for only a small percentage of future jobs. In *The Final Report*, high-tech employment was forecast to account for only about 6.5 to 6.8 percent of Wisconsin's total employment by 1995.

While high-tech industries have a role to play in future economic growth and job creation, the key point stressed in the studies is the application of technological advancements to traditional industries in order to advance production processes and product innovation. The implementation of robotics, automated processes, and computer-aided design and manufacturing (CAD/CAM) offers industries a means to decrease unit labor costs, increase their productivity, and thus boost sagging competitiveness.

With "smokestack and high tech chasing" reduced in priority, District state economic development policy-makers have turned more of their attention to supporting indigenous companies and fostering the growth of entrepreneurs and small business-creation strategies. All five states in the Seventh District have some type of small business development focus within their economic development programs. This emphasis on firm creation is attributable to several factors. First, small business has come to be viewed as a major job generator. This view is most frequently associated with research undertaken by David Birch

of the Massachusetts Institute of Technology. Birch found that small businesses (firms with less than 100 employees) were the source of 82 percent of all the jobs created between 1969 and 1977. While these findings have been challenged by later studies, the consensus remains that small businesses account for over half of all new jobs created.<sup>3</sup> Second, small businesses are considered a source of entrepreneurial talent and innovation that can stimulate the implementation and dissemination of technology.

### **The changing role of state government**

The tools available to state government to pursue the economic development objectives cited above can be divided into two categories. The first is composed of the traditional instruments such as: taxes, fiscal incentives, regulations, education, and job training. In addition to these traditional approaches to stimulating the economy, some innovative programs have been developed such as strategic funds and business incubators. It is through these novel approaches that the state's role in economic growth has changed dramatically.

Among the traditional tools, the items scrutinized the most are state taxes (personal, property, and business). Even though tax reform, incentives, and abatements are often used as a state government tool to promote economic development their effectiveness has been widely challenged.<sup>4</sup> Michigan's *Path to Prosperity* points out that there was little evidence that state tax and other financial incentives were a powerful or cost-effective tool for reversing Michigan's decline and expanding its economic base. *The Final Report* of the WSDC cites the results of a tax study, conducted by the Wisconsin Department of Revenue, which shows no strong relationship between state and local taxes and economic growth. Another conclusion shared by these two studies was that tax abatements (e.g. property tax relief) are ineffective and negatively affect businesses not receiving such subsidies.

While these findings suggest that tax policies play only a limited role in business attraction, tax levels and changes do send signals about the attitudes of the state governments toward business. The study by the Wisconsin Department of Revenue revealed that all five of the District States had introduced legislation

to decrease the tax burden on industry. Taxes being eliminated in some states include sales and use taxes on industrial equipment, machinery, and computer equipment; taxes on inventory; and unitary taxation on multinational corporations.

Another way to reduce business costs and to expand employment is through the creation of enterprise zones. Illinois, Indiana, and Iowa have enacted legislation for the establishment of such zones. The primary purpose of the enterprise zones is to foster economic development in depressed, particularly urban, areas by offering incentives to industries that locate there. The incentives offered may include investment tax credits, job creation grants, income tax credits to encourage job creation, and sales tax exemptions.

Worker's compensation (WC) and unemployment insurance (UI) have also been targets of state development efforts. Since WC and UI costs are comparatively high in four of the Seventh District States (the exception is Indiana), state governments have taken steps toward reform. Michigan's Task Force for a Long-Term Economic Strategy highlighted Michigan's WC costs as above average. In response, the state government has worked, since 1982, to reduce total WC costs and opened up the insurance system to competition.

State-controlled business costs have not been the only focus of recent state economic development efforts. State-provided services have also been evaluated, services such as education, which had previously not been integrated into development initiatives. Job training and retraining programs are now viewed as part of the states' overall economic development strategies—not just an educational issue. Seventh District states have actively established programs to expand or up-grade work skills in reaction to the growing number of dislocated workers caused by the shrinking of the manufacturing base. Programs introduced include: customized training to match the needs of a specific company and start-up programs which satisfy short-term labor needs.

The innovative state development programs share similar goals with the traditional programs such as lessening external business costs but have applied novel instruments to achieve them. In addition, they have focused on particular segments of the economy such as

entrepreneurs and start-up companies rather than all sectors.

To assist entrepreneurs, some of the programs offer technical assistance such as Indiana's Institute for New Business Ventures and Illinois' Technology Commercialization Centers. State governments have also become active in providing business counseling through small business development centers (SBDCs). Counseling programs are an attempt to combat failure due to lack of expertise. Studies of small business failures have shown that the majority of failures are caused by mismanagement. In some instances states also provide specialized services catering to entrepreneurs. Wisconsin has been active in creating programs that fill technical needs. Its SBDC program has become a multi-faceted program providing technical assistance that meets the needs of the entrepreneur and innovator.

While the entrepreneur's technical needs are the target of many state programs, the financial needs of the entrepreneur remain a critical factor. Entrepreneurs often face capital constraints because of the lack of access to national sources of equity and debt financing. They thus have difficulty in commercializing their ideas. As state governments have become aware of the special needs of the entrepreneur, they have introduced programs to improve the innovator's access to financing.

Until recently, state government assistance for project funding was limited to more traditional means, such as industrial revenue bond financing. Financial assistance has been expanded to include the increased availability of pre-venture capital and venture capital financing for small start-up companies. For example, in 1985 Michigan established The Michigan Strategic Fund (MSF). The MSF was designed to use small amounts of public resources to generate large amounts of private lending to Michigan's small and medium-size companies.

States have also examined their public pension funds as a potential source of long-term debt and equity financing. Michigan has taken legislative action to free up public pension funds for investment in small innovative businesses. The legislation, enacted in 1982, allows up to five percent of the assets of public pension funds to be invested in small, qualified businesses or venture capital firms. Illinois passed a finance bill in 1983 allowing monies to be

borrowed from the Public Pension Fund, as a guarantee on business loans made by private lenders.

The establishment of business incubators is another attempt to ease capital constraints and to facilitate business development. The objective of such programs is not direct financing but rather an attempt to decrease small business start-up and overhead costs. Business incubators are facilities where the tenants pay below-market rents, share central services (e.g., secretarial and financial consulting) and in several cases have access to seed capital. By lowering overhead costs and facilitating the development of management skills, incubators attempt to help their tenants through the crucial start-up period. The average lease periods (about 18 months) are sufficient to allow most small businesses to establish themselves and their clientele. A secondary benefit arising from incubators is the potential for maximization of entrepreneurial creativity through the interaction between the incubator's diverse tenants.

### **The wave of cooperative efforts**

A major trend is noted toward the formation of coalitions between the state government, universities, labor, and businesses. Most frequently the public sector has been responsible for bringing these groups together. For example, Illinois Inc. brings together the state government, private businesses, and organized labor in order to pool their resources and promote Illinois through advertisements in national publications.

In recent years, more public/private efforts have been initiated by the private sector. Utility companies, for example, have become major players in development efforts. These companies have a vested interest in their state's economy, since the growth of the utility is linked to the growth or decline of its client base.

In addition to public-private coalitions, business-university cooperative efforts have grown significantly. The primary motive behind these efforts is to accelerate the transfer of technology from the lab to the marketplace, and increase research and development efforts. Most of these programs offer technical assistance through technology service centers (e.g., Indiana) or innovation centers (e.g., Iowa).

These centers couple the scientific and technical expertise of university faculty with the needs of the business community. Some of the programs provide financial incentives as well—contingent upon the project being a joint effort between a business and an institute of higher education (e.g., Illinois Business Innovation Fund and Wisconsin's Technology Development Fund).

### **International trade—export promotion and reverse investment**

International trade is being incorporated into many state economic development plans. Initially the focus was on export promotion, with the state playing a role similar to that of an export trading company. Recently, however, programs have been added to deal with reverse investment. Trade promotion and development offices in the District have become increasingly active in this area. State legislatures have formed committees to deal with foreign trade issues and have become more generous with appropriations to the state trade departments.

Three examples of innovative programs illustrate the growing importance of foreign trade. In Indiana, a Japanese Language Program sponsored by Indiana University and Purdue University has been introduced. This program provides children of Japanese nationals working in central Indiana with classes taught in Japanese that prepare them for their return to the Japanese school system. In Iowa, the Foreign Student Contact Program arranges meetings between businesses and foreign students attending Iowa colleges and universities. The students are able to provide information on subjects ranging from their country's culture to business ethics. Finally, Wisconsin has developed a program under which foreign student graduates from its universities can act as "honorary commercial attachés" in their native country to help find markets for Wisconsin products.

### **Conclusion**

State-level economic development efforts have proliferated in the District during the

1980s. These efforts have evolved from merely responding to changing economic circumstances to taking an active role in determining the course of the local economy. The resulting strategies and programs reflect the underlying uniqueness of the five states' economies. Reviewing studies from each of the District states reveals development themes relating to recruitment, retention, and creation of new businesses.

There is no reason to conclude that the role of the states in economic development will be less in the future. In fact, there is every reason to think the opposite. States should develop a larger role as they expand their development role beyond traditional recruitment activities.

The programs that evolve will be based on longer term strategies and a better understanding of the state economies. As such, more emphasis will have to be placed on the costs and benefits of programs' priorities among competing programs, and coordination of programs and institutions to achieve the desired result.

Lastly, programs and institutions must be flexible, and responsive to change. Those that have outlived their useful lives must be replaced by newer, more flexible, and responsive entities. These changes must anticipate and not merely respond to changes in the underlying private sector.

The states cannot alter the forces that affect their economies. They can, however, take advantage of opportunities that arise.

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<sup>1</sup> See *The Iowa Economy: Dimensions of Change*, Federal Reserve Bank of Chicago, January 1987.

<sup>2</sup> See: "State-Local Fiscal Incentives and Economic Development," G. Cornig, W. Testa, F. Stocker. Urban and Regional Development Series No. 4, Academy for Contemporary Problems, Columbus, OH, 1978.

<sup>3</sup> For a discussion of the role of small business in the Seventh District, see: E. Erdevig, "Small Business, Big Job Growth." *Economic Perspectives*, November/December 1986.

<sup>4</sup> See, for example, John Rees, "Government Policy and Industrial Location in the United States," U.S. Congress, Joint Economic Committee Special Study on Economic Change, December, 1980.