

# **Cities and Economic Success: Some Lessons from the United States**

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## **Introduction**

A number of indicators suggest the U.S. economy has been performing reasonably well over the past several years. For example, unemployment has declined, GDP is up (though income growth at the high end continues to outpace growth of incomes of those of more modest means) , and productivity has grown apace. But there are some darker clouds on the horizon. On the other side of the ledger, many are concerned with potential fallout from a pop in the so-called housing bubble, rising foreclosures (especially in the subprime market), a low household savings rate, and a precarious government fiscal position. While many analyses focus at the national level, ultimately the health of the aggregate economy is determined by the health of its local components. Thus, this is a particularly fruitful time to consider the determinants of success (or lack thereof) in local economies – hereafter cities – and to consider especially what kinds of things national, state and local governments can do to facilitate broad and equitable economic development.

Deeply embedded in the U.S. system of governance is a partnership between state and local units of government. Heavy mutual reliance upon real estate, income, and sales taxes

requires a high level of commitment to communication and coordination between states and their partners in local government. At the most basic level, we are all members of a social partnership that aims to deliver, among other benefits, economic development. Economic development, broadly and appropriately construed, translates into improved standards of living and well-being for our citizens. Economic development also generates the resources -- fiscal and human -- that state and local governments need to do their job.

### **Recent Economic Performance in Perspective**

The U.S. population grew more or less steadily over the past four decades, from about 200 million in 1970 to about 300 million today or a growth rate of about one percent per year. These average growth rates mask significant differences among individual state and localities. Fast growing states like Arizona, Florida, and Nevada grew by 3-4 percent per year while New York and West Virginia's populations have barely changed. U.S. employment also grew more or less steadily over the past thirty years, from about 92 million to about 180 million jobs. Thus employment grew about twice as fast as population during this period, due to continued increases in female labor force participation, the growth of part time employment, and general demographic shifts including the move of the baby boom and the echo boom into the workforce. In 1970, income per capita was about \$15,000, (in today's dollars). Over the next thirty years, real per capita income grew at about 2.3 percent per annum to about \$35,000. Thus, incomes per capita more than doubled over the period.

Over the past several decades, real incomes were stagnant for U.S. households in the bottom of the income distribution, while the fastest household income growth was at the top of the distribution. Broadly speaking over the past three decades the gap between rich and poor has

been growing. However, this does not imply that growth and distribution are necessarily at odds. As we will see below, it turns out that metropolitan areas that grow fastest generally have the fastest growth in incomes at the bottom of the income distribution.

### **Why Do Regions Grow?**

Many of the findings regarding the reasons for economic growth and development are hardly surprising. For example, physical capital (machines, real estate, computers and so on) matters, although in the long run it is perhaps *human* capital that matters the most. Locational advantages, such as a clean environment and strong amenities, make a difference. Regions that have well functioning cities, and strong economic and transport links between cities and nearby rural areas tend to prosper. For example, my home state of Wisconsin is adversely affected by the fact that our largest city, Milwaukee, is smaller and less dynamic than nearby Chicago or even Minneapolis.

Nationwide, there are modest relationships between the structure of a region's economy and its growth patterns. The most careful studies show "high tech" regions grow only slightly faster on average than "low tech" regions. But that does not mean high tech development is not critical to regions that have a comparative advantage in such activities. Furthermore, many industries usually thought of as low tech and "Old Economy," like metal bashing or trucking, have been radically transformed by the application of technology. Certainly technology has been and will continue to be an important driver of development. But we should not turn our legitimate interest in technology into a fetish. We should recognize that many locations will need to focus on quite different comparative advantages, including relatively "low-tech" activities such as tourism.

The role of a region's culture is important, but it also is difficult to measure and analyze. Wisconsin benefits from a strong work ethic and high standards of public probity, the latter partly a consequence of our Progressive tradition. Some would argue, however, that we are less entrepreneurially minded than some other parts of the country.

### **Who Benefits From Economic Growth, and How?**

Despite the common perception that fast growth comes at the expense of a more equitable distribution of income, careful recent studies by the Upjohn Institute's Timothy Bartik, and by the University of Pennsylvania's Janice Madden, have demonstrated that metropolitan areas that grow faster also tend to see the best gains at the bottom of the income distribution. The best explanation for the positive long-run relationship between regional income growth and an improved distribution of income is the "hysteresis" model of labor markets. Put simply, hysteresis models are ones in which history matters: people aren't simply identical "labor units" entering and leaving the labor force. In rapidly growing areas, there is more opportunity for increased labor force participation by people who may not have been in the labor market before. Building up a work history and learning better work habits leads to faster growth, which increases the economic potential of low-income households, racial minorities and other disadvantaged groups even more than for citizens who enjoy greater economic advantage. Metropolitan growth is, therefore, generally progressive.

The progressive benefits of growth can be somewhat offset by increases in rents and house values. Growth in housing costs tends to benefit existing owners and increase the tax base, but such growth harms renters and newly forming young households, and may slow the growth of our labor force. Thus, on balance, increasing housing costs reduces the gains from growth.

These increases in housing costs, however, are generally not sufficiently high to fully offset the gains from increases in income and declines in unemployment from employment growth. This is one reason it is important to put in place an appropriate regulatory environment for housing and real estate, that is, one that mitigates external costs of development (like congestion) without unduly increasing housing costs. Especially in cities like Boston, New York, San Francisco, and Portland; overly stringent real estate regulations have reduced the potential progressivity of local growth.

A number of recent studies show that net increases or decreases in employment mask even larger job "churning," the situation resulting from companies simultaneously firing and hiring employees. In a typical year in the United States, for every hundred manufacturing jobs, ten disappear (permanently or temporarily); and nine new ones are created. Employment growth is a combination of increasing our gross positive flows from employment openings and business expansions, while limiting gross declines from closings and contractions. In fact, about twice as much variation in employment net growth is explained by gross increases than is explained by gross declines. Declines do matter, of course, and the pain and cost of any plant closing is very real to those involved and not to be trivialized. But the data also show quite clearly that the "action" is in openings and expansions. One should be very aware of these facts when considering policies to address plant closings. While good arguments can be made for some advance notice of layoffs, and real issues arise related to the responsibilities of firms that have accepted large public subsidies, making plant closings or layoffs extremely difficult probably does nothing to retain plants in the long run, and can surely serve as a barrier to expanding and creating new openings.

Another growth-related question, which is often misunderstood, is the extent to which growth does or doesn't "pay." At first glance, a number of studies seem to imply that as employment and population grow, and new housing is added, the fiscal impacts on local governments may be negative. These studies often suggest that increases in local taxes collected will be exceeded by local expenditures on schools and other services. It is not clear, however, that these studies are correct, because they utilize incomplete accounting methods.

Broadly speaking, communities grow because population grows (from natural increase and migration) and because labor and capital productivity rises over time, and per capita incomes grow. Higher per capita incomes, in turn, increase the demand for better housing, improved infrastructure and other public services, and additional commercial real estate, among other things. Most "fiscal impact studies" done for local governments fail to capture these dynamics adequately, and thus are overly pessimistic about the cost-benefit of growth. It may well be, however, that in the short run, and for particular government entities, growth can be disadvantageous. But there is no evidence that in the long run city fiscal positions are harmed by growth. There is effectively zero correlation between population growth and city surpluses and deficits, taxes per capita, or municipal expenditures per capita.

Is local economic development a "zero-sum game?" Many economists believe that most local incentives for development simply subsidize location decisions that would be made even without a subsidy, or "at best" move jobs from one location to another. Some recent research suggests that, at least to a limited extent, this may be overstated. If we accept the hysteresis argument, and further posit that the locations that give the largest tax breaks may be those that have the worst economic conditions, it is then *possible* that economic development incentives will move production toward regions where there are greater external benefits. But possible

doesn't mean that it does, or that the effect is very strong. Our quantitative knowledge of the size of these effects is rudimentary at best. And at least with respect to some important subsidies, namely those from Tax Increment Financing (TIF) programs, it is usually the case that the richest localities provide the highest levels of TIF subsidy.<sup>1</sup>

Another important issue about who benefits from growth is the relative position of central cities and suburbs. Cities have been decentralizing for as long as they have existed. American cities have decentralized particularly quickly over the past century and a half, partly because of income growth and improvements in transportation and partly because of localized problems in central cities and localized benefits in some suburbs. Standard models used by urban economists highlight the fact that as citizens' incomes rise, they will tend to move out in search of larger houses on larger lots; and as transportation costs fall, commutes will cost less as one moves farther out. Thus, urban decentralization or "sprawl" is not a new phenomenon; it has been around as long as cities have been studied. However, this does not imply that suburban (or rural) areas are unaffected by the economic fortunes of central cities. In fact, a wealth of evidence suggests that the central cities and suburbs of most metropolitan areas rise and fall together, though growth rates of population, income, employment and the like are usually faster in the suburbs.

How does land use affect development? The United States, about 3.5 percent of land is urban (though despite its small area, the value of urban land is greater than the value of rural land). The amount of land in urban uses in most parts of the country has been growing more rapidly than the population. The majority of built-up urban land is used for housing, although roads and commercial uses are also significant.

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<sup>1</sup> Tax increment financing is a widespread method of subsidizing infrastructure and real estate development in the U.S. by dedicating some portion of post-project property tax revenues to subsidize the investment. See Malpezzi (2003) for details.

Developing cities, towns, villages and rural areas all require that sufficient real estate be developed (or redeveloped) in appropriate locations. Of course, real estate development can generate significant externalities (e.g., from additional traffic, storm water runoff, infrastructure requirements).

For all these reasons, real estate development is, and surely should be, a regulated activity. The key question, however, is how it should be regulated. We have already mentioned that overly stringent development regulations in some metropolitan areas adversely affect the affordability of housing. Still, in recent years concern has mounted in many quarters that development is insufficiently regulated, or at least poorly regulated. The current "Smart Growth" initiatives to control urban sprawl undertaken in many states are testimony to this concern. But the devil is in the details: what is smart, exactly? It will be important to ensure that, as "Smart Growth" programs are implemented in the years ahead, housing and real estate costs do not rise in excess of other benefits received from those regulations.

### **Economic Development: What Works? What Doesn't?**

If one thing is critical to economic development today, it is the relationship between education and human capital formation. Many studies show strong private and social returns from education. Forty years ago, households headed by a college graduate had incomes that were about two-thirds greater than households headed by a high school dropout. Over the last forty years, the median incomes of dropout-headed households have fallen by a third, while the median incomes of households headed by someone with a college degree have increased by over one-third, so that now the typical household income "premium" for college over dropping out of high school is an astounding 250 percent.



But actually improving school performance is more difficult than agreeing on its importance. The link between school financing and performance is hard to find and is fragile; but this fragility should not be misinterpreted. Even those involved in the debate who find little empirical connection between resources and outcome, however, are careful to qualify the implications of the finding. Adequate finance is more a necessary than a sufficient condition for good school performance. Some schools use resources effectively, and get a positive return for dollars invested; other schools don't. Because of the latter, when all schools are lumped together, the aggregate data show little positive relationship between spending and performance. The key, then, is to pair increasing resources, where needed, with more effective use of resources. The problem is that it is not easy to design and implement policies to improve school effectiveness and performance.

A heated debate is under way regarding the possibility of improving schools via reliance on school choice and vouchers. A complete discussion of that issue is beyond the scope of this article, but details of any school choice program will surely matter. Among other program design features is the fundamental question of whether choice is extended only to schools within the public system or whether private schools are included as well. If private schools are included, what standards should these schools meet in order to be admissible? What role will charter schools play in such a choice system? Perhaps most fundamentally, how big and how portable will the vouchers be? If a student moves from one public school to another, how much of the first school's budget follows her or him? If private vouchers are contemplated, should they be marginal contributions or set at a level to pay full educational cost for even the poorest student? If vouchers are large, should they be needs-based?

Many of these issues are explored in recent studies, especially a recent study of Milwaukee's choice experiment (Witte, 2000). While the study found some positive effects of Milwaukee's parental choice program, particularly in parent satisfaction with the educational environment and discipline, it was harder to find any robust effects of the choice program on school performance. Part of the problem may involve the small sample sizes and the fact that the assignment of students to various samples is not random. Other research on school performance suggests that carefully measuring the value added by schools, and tying resources to such performance, may have greater scope for improving schools.

In today's economy, post-secondary education is another critical determinant of economic and social development.

The current system of financing many state universities is in flux. In many states both public contributions and tuition are held at relatively low levels, with an ever-increasing role played by outside research grants and private donations. Such a financing system has pros and cons, but one problem is that it will favor the institutions that attract the bulk of the research funds over institutions with primarily instructional missions. Even within research universities like the UW-Madison, such a system will tend to favor departments that inherently attract outside funding such as engineering, business, and hard sciences, at the expense of humanities and such vital basics as English and mathematics.

The typical state system subsidizes a modest number of primarily middle-class students at the expense of the general taxpayer. One broad approach worthy of more detailed consideration would be to increase tuition significantly, while offering more scholarships, based both on need and ability. Concomitant with its reduced role in funding universities, state governments should increase the administrative autonomy of the systems.

Appropriate provision of infrastructure is another key function of government with a high potential for return, albeit the word potential is important. In the U.S., much of the discussion among economists has been framed by the work of David Aschauer, whose work showed substantial correlations between past infrastructure investment and economic growth, both within the U.S. and across countries. Other research by Douglas Holtz-Eakins and others is skeptical of the size of the effect implied by Aschauer, and suggest that the “easy pickings” of large investment programs like the interstate highway programs are in the past; and that in the future selected new investment projects, carefully targeted, and more efficient maintenance and upkeep of existing infrastructure, will be relatively more important.

Many related debates are about exactly how this infrastructure should be provided. Deregulation of electric utilities, for example, is creating some controversies (although we have many lessons on how *not* to deregulate utilities from California). In terms of transport infrastructure, a debate rages on the relative virtues of roads versus rail, both inter- and intra-city. Airport siting, landing slots and fees, and the anti-trust implications of airline industry consolidation are also hot infrastructure issues that have important implications for economic development. Metropolitan areas that have greater airport capacity, relative to their population, grow faster than average. Another way governments try to encourage economic development is through the creation of infrastructure-rich industrial parks, high-tech incubators, and the like. Related activities include subsidized financing and other public policies meant to encourage high-tech spin-offs, or joint marketing an area and its products.

Another key lesson of economic development research is that general taxes matter, but one must examine the full tax-service package. Taxes should not be analyzed in isolation,

however. Given a choice, many of us would choose Wisconsin's high-tax-high-service package over, say, Louisiana's low-tax-low-service package. Many firms seem to do so.

Studies that examine economic growth as a function of taxes and other determinants, but that omit public service measures, tend to find weak relationships between taxes and growth. *Correctly specified* studies that control for public services provided as well as taxes find stronger relationships. A 1991 review by Timothy Bartik of a large number of studies determined that, if we control at least roughly for service provision, for every 10 percent decline in tax burden, measures of economic output (e.g., employment, investment or new firms) would increase by somewhere between 1 percent and 6 percent. These results tell us that firms and economic output respond to tax environments, although the size of the effect does seem to vary quite a bit from study to study. The differential effect of tax environments is somewhat blunted by the fact that state tax systems are growing more alike over time.

An obvious point stemming from these results is that an excellent economic strategy would be to lower taxes without cutting services -- if we could find a way to do that. Unfortunately, the experience of states that have adopted stringent tax limitations, like California and Massachusetts, tells us that in fact services do get cut substantially.

The way out of this dilemma is to increase the *productivity* of state and local governments. Determining exactly how to do this, of course, is not easy. Over the past several decades slow growth of government productivity has surely delayed growth in many other areas of the economy. But just as many private sector service industries have recently seen productivity grow because of increasingly effective use of information technology and improved business processes, similar benefits in state and local government productivity could occur if enough effort were devoted.

Another important lesson about local economic development relates to specific tax abatements for particular firms or plants. Today, nearly every state and the majority of municipalities provide at least some such incentives to some firms. We have already noted that the "traditional" view of economists, at least until a decade ago, was that firm-specific incentives usually ended up being given to firms that had already decided to move there for other reasons. Certainly firms that decide to pick a particular location based on transport, labor force, and other grounds have an incentive to claim to local officials that they are actively considering other locations in hopes of getting a tax break. Many studies in the seventies and early eighties seemed to confirm this. Some recent research suggests, however, that, on the margin, while not as central to the location issue as labor force, input, transportation, and other issues, taxes can matter.

Unfortunately, many of the studies to date have focused on simply whether a measurable effect can be found, rather than on the magnitude of the effect, or its relationship to any benefit to the citizens of a state or region. Not all who study this topic agree with the new findings that suggest tax breaks can have some effect; and no one has yet shown that the net benefits of such policies can be positive.

An important related issue is whether the best way to attract firms is to give tax cuts to specific firms rather than to try to improve the business tax climate generally. It is also important to keep sight of the fact that one firm's tax cut is someone else's tax increase. In the long run, this could lead to firms leaving the region or to a failure to attract firms that are small or unsophisticated in bargaining with local officials.

Recent studies of the effects of general state development spending are mixed, at best. Most studies find no significant or economically meaningful effect; those that do suffer from an absence of controls for other determinants of growth. The jury is still out on the effectiveness of

enterprise/empowerment zones, which are federally subsidized projects designed to increase economic development in distressed communities. Studies show that at best enterprise zones have demonstrated mixed results. The most recent and most carefully done studies show little result from enterprise zones as currently implemented.

Tax Increment Financing-TIFs-are now the rule rather than the exception in many communities. TIFs are enabled by the state and financed (implicitly) by local school districts and other units of government to encourage local development in “blighted” areas in need of economic improvement. In fact, many TIF supported projects are located in highly desirable places that would certainly be redeveloped and appreciate in value without TIF. The initial rationale, to encourage development of truly blighted locations, is hardly mentioned any longer. Despite their widespread use-perhaps because of it-it has been difficult to find any systematic positive net benefits of TIFs.

Many studies have been done of the economic benefit of "one-off projects" such as sports stadia and convention centers. The consensus of the careful studies is that such projects rarely have any significant development impact, despite pre-investment studies by project advocates that purport to show large economic development "multipliers." The main reasons such projects have little net impact is that the economic analysis often assumes that any employment associated with the project is net new employment (i.e., that all workers and other resources would be unemployed without the project), and that it is incorrectly assumed that there is no offsetting multiplier in the other direction because someone pays for the project, typically through increased taxes.

Another important development strategy is to pursue balanced land use and environmental policies. All economic activities pollute. The question is how much, how

pollution can be mitigated, and ultimately what tradeoffs communities are willing to accept. One of the defining characteristics of pollution and environmental problems is that almost all such problems are characterized by large “external costs.” If my car spews burning oil, for example, I may suffer somewhat, but others around me bear much of the cost. Because of this externality aspect, environmental regulation can be considered a core function of government.

A number of studies have looked at the effects environmental regulations have had on one aspect of economic development, namely firm location. These studies generally find that more stringent environmental regulations are associated with disincentives to firm location, but it appears that these effects are small. Furthermore, few studies have grappled with the effects that the environment itself has upon firm location; it is easy to imagine a positive relationship between environmental outcomes and regulation, although the nature of this relationship is not always straightforward.

A particularly important area for government intervention relates to transport. Many studies have been done regarding privatizing urban bus services and making toll roads. Transport economists tell us that in many cities congestion pricing is the best if not the only effective way to tackle congestion problems. In a congestion-pricing scenario, an automobile is charged for driving during hours of peak congestion. The proposed schemes will use purely electronic toll collections, *not* “Chicago-style” tollbooths. Debit systems can be designed to ensure privacy, and of course it is central that tolls be high during peak periods and zero (or very low) off-peak. This serves as an incentive for individuals to drive in off-peak hours or take advantage of carpooling and public transportation.

Economists have not made much headway in convincing the rest of U.S. society that congestion pricing is the best way forward in congested cities. In fact, around the world there

seems to be a bias away from pricing policies that could tackle congestion problems in a serious manner, and toward public investment in fixed rail transit, which is efficient only under very specific conditions (extremely high population density and a few fixed nodes of employment that would correspond to potential transit stops). In addition to congestion pricing, some increase in fuel taxes would address external costs of carbon emissions; perhaps most importantly, a more rational transportation policy would modify the way we tax trucks and other heavy vehicles.

It turns out from engineering studies that road wear is roughly a cubic function of weight per axle. The practical implication is that autos have almost no impact on road wear; it's mostly from heavy trucks, and as they get heavier, our roads wear out *much* faster. Taxing trucks on a cubic function of weight per axle would not only generate the funds we need to maintain roads, but it would provide strong incentives to truck owners to choose "appropriate technology," i.e. to properly balance the benefits of larger trucks with their costs.

Such a major change could not and should not be made overnight. First of all, such significant changes in truck taxation (and, for that matter, aforementioned changes in fuel taxes) would have to be made in concert with other states. Secondly, current truckers have invested in trucks under one set of rules; a phase-in of improved (not necessarily higher, in the aggregate!) taxation would permit existing owners to amortize their prior investments.

Outside of a few of our largest cities, intracity rail has not returned much on investment, even when effects on congestion and the environment are properly included in the calculus. Experience in midsized cities like Dallas, Buffalo and Portland have demonstrated that light rail and commuter rail systems are generally ineffective transportation investments, because they are expensive, inflexible and soak up transit resources without attracting sufficient ridership.



Improving bus systems (and possibly some paratransit options), not rail, is the future of public transit.

Rail has and will continue to play an important role in the Nation's freight transportation system. What of inter-city passenger rail? Compared to many studies of intracity rail, fewer cost-benefit studies have been undertaken of intercity passenger rail. But the available data suggest that in the U.S. system, the only lines that may yield benefits in line with costs are in the Northeast Corridor. The financial performance of Amtrak, and even more instructively the dismal economics of more technically advanced systems in much denser France and Japan, makes it hard to imagine that the mooted Midwest high speed intercity rail network would be any more viable than today's Amtrak.

Governments not only tax and spend and invest in infrastructure; they also regulate. The panoply of regulations affecting business is so broad that some have championed "regulatory audits," studies of the broad range of regulations affecting business and economic development. Such studies lay out recommendations for regulatory reform in the areas of land use, regulation of professions and occupations, environmental regulations, regulation of rental housing, development and building codes, labor regulation, street vending, and parking.

Many "general" or "traditional" functions of government, not usually thought of as development policies per se, may have strong effects on economic development. For example, it's hard to attract footloose industries to locations that have high crime, or poor fire protection, or where trash collection is "hit or miss." Many authors and conventional wisdom suggest that economic development can be adversely affected by high crime rates, although strong relationships are surprisingly difficult to find in the empirical literature.

A range of strong views exist on how metropolitan governance affects or does not affect economic development and standards of living. On the one hand, much of the work of professional urban economists is informed by something called the Tiebout model, which posits a world of many competing small jurisdictions, each offering its own tax and service packages. In such a world, different households are assumed to have different tastes and needs for various tax and service packages and, at least in the long run, they will move to the jurisdiction that offers the most efficient choice. Among other pluses, the Tiebout model imbeds the notion of consumer sovereignty in public services; it gets around the problem of our inability to learn the true demand for public goods.

But the Tiebout model has its dark side. The model starts to collapse if there is to be any implicit or explicit redistribution of income by local governments. We often think of this redistribution in the classic form of cash payments (e.g., welfare), but many other kinds of government spending have redistributive effects, for example spending on education and infrastructure. It is not possible to tax, say, high-income single people to educate low-income children, according to the model. They will move to some jurisdiction with a lower tax and service package. Thus some analysts – more often political scientists than economists – suggest that metropolitan wide governance structures, or at least some metropolitan revenue sharing, could contribute. The experiences of Indianapolis and Minneapolis, who have implemented limited regimes of this nature, tell us there may be some scope for such initiatives, but also that they are not silver-bullet solutions to the fiscal problems of cities.

Recently, a number of economic development strategists have emphasized tying development policies to community development initiatives. These approaches are heavily influenced by the concept of social capital. The idea is that a phalanx of interrelated social

problems-poor schools, racial segregation, high crime, drugs, and the like-create a whole that is, unfortunately, worse than even the sum of its parts; and that these effects are compounded by their concentration in particular locations and neighborhoods.

Perhaps the most difficult issues related to the community development approach to economic development have to do with the fact that the definition of community development is somewhat fuzzy. Some authors focus on community development as the activities of nongovernmental community development corporations while others focus on government programs such as the Community Development Block Grant or Urban Development Action Grant programs. Several authors focus on housing activities because many Community Development Corporations (CDCs) that serve individuals and neighborhoods in economic distress happen to focus on housing. It's hard to disagree with the general notion that community matters. The question is what to do about it. This is made more difficult by the fact that despite the plethora of community development programs and activities by government and nongovernmental organizations including churches, and CDCs, virtually no rigorous social science research is available that tells us the costs and benefits of these activities.

## **Conclusion**

The best tax policy for development is obvious: lower taxes without reducing services. It helps the jurisdiction cutting taxes if nearby jurisdictions don't respond with their own cuts. Unfortunately, except for very marginal changes, it is often pretty difficult to keep service levels constant while cutting taxes. Nearby jurisdictions usually do respond, instituting their own cuts. Our best tax policy in such a world is to look constantly for improvements in public sector productivity that will help us reduce fiscal burdens while keeping service levels strong and to rethink exactly what mix of services the public sector should deliver.

If we are to use localized tax incentives, we should limit their use to lagging regions. It makes little sense to subsidize thriving locations, as is often done. When using such incentives, think clearly about how to pay for them.

Infrastructure programs, going forward, need to show disciplined bases in cost-benefit analysis. Our current system of Congressional earmarks, which gave rise to (e.g.) hundreds of millions of dollars for a “bridge to nowhere,” needs change. Better incentives for appropriate maintenance of existing infrastructure will be critical going forward.

We must recognize that the most important economic development policies are rarely labeled as such. Of all the things governments do, improving the educational system, particularly primary and secondary schools as well as university, is very important. Well-functioning infrastructure systems are also critical. People-based human service programs, such as housing vouchers and TANF (Temporary Assistance for Needy Families, the successor to “welfare”) should be carefully examined through the economic development looking-glass as well as how well they meet their social goals.

While much remains to be learned, we do know a number of useful things about economic development. First of all, growth in employment is good: it increases incomes, particularly at the low end of the income distribution, and it lowers unemployment rates even in the long run after migration has had time to occur. Real estate prices tend to increase as economic development occurs. In the aggregate, however, this is not usually sufficient to outweigh the benefits of higher incomes. Some “new-wave” economic development policies involving location incentives might affect location decisions in some cases, but they are probably insufficiently effective to justify widespread use.

We know some things matter a lot (like education), and other things surprisingly little (like subsidies of sports teams and convention centers). Many studies of one kind of development activity or another suffer from focusing on either cost or benefit, but not both in tandem. For example, planners tend to focus on the benefits of land use regulation while economists (somewhat surprisingly!) focus mainly on the costs. In fact, we need more precise quantification, where possible, of the size of both the costs and the benefits. It's good to know that a particular activity increases economic activity (or decreases it), but the *magnitude* of the effect also matters, even though it is harder to know. We need more detailed research on the specific policies that governments have in their economic development arsenal. But we should be realistic about the limitations that are likely to always be part of our knowledge of such a complex phenomenon.

## Sample Policy Options for Economic Development

### Education

- Increase the accountability of schools by measuring performance.
- Base state aids to local schools on the difference between demonstrable needs and what the local tax base can reasonably provide.
- Continue to strengthen and improve the performance of technical and continuing education systems.
- Substantially increase scholastic aid by need and by ability to counter our reduced general state support for universities.

### Infrastructure

- Base infrastructure investments on cost and benefit analyses.
- Monitor changes in electricity pricing and availability and carefully incorporate lessons learned from other states in our own energy deregulation efforts.
- Consider expanding airports rather than undertaking passenger rail projects.

### Service Delivery and Improved Productivity

- Cut taxes where possible, while preserving the high standards of service delivery that citizens and firms rightfully expect.
- Use new technology such as e-government where appropriate.
- Institute performance contracting and consolidate job functions to increase governmental productivity on the state level.
- Create fiscal incentives to encourage rationalization of local service delivery.

### Regulation

- Develop accountability and performance measurement for regulation based on cost-benefit principles.
- Use regular audits to analyze government's role in regulating business.

### Land Use

- Balance land usage through a combination of regulation and accommodation.
- Set impact fees to recover the marginal costs of development, rather than "what the traffic will bear."

### Infrastructure

- Base infrastructure investments on solid, project specific cost benefit analysis, rather than broad appeals to infrastructure as an asset class.
- Change the politics of "earmarks."
- Reform and strengthen incentives for maintenance and upkeep of existing infrastructure.

### Public Projects

- Take a realistic view of economic advantages and disadvantages of public projects like sports stadia and convention centers.

- If a project is to be justified on non-economic grounds, do not introduce specious economic arguments that confuse the decision.

#### Industries and Locations

- Tailor economic development activities to local conditions while understanding that the localities are economically interconnected.
- Identify ways to retain university graduates in the state, as well as make the state more attractive to graduates from other states.

#### Place-based Development Subsidies

- Concentrate taxpayers' dollars for subsidies to the areas of greatest need.
- Place stronger limits on Tax Incremental Financing.
- Study the extent to which TIF funds are actually used in blighted areas and distressed communities.

#### Business Culture

- Focus our locality's public image on advantages related to quality of life, the economic base, and quality public services.
- Highlight our natural amenities
- Celebrate and encourage entrepreneurial talent. Strive for excellence rather than what's "good enough."

#### Economic Research and Evaluation

- Integrate program evaluation as a process of continuous improvement.
- Consider upgrading research on local economic development.

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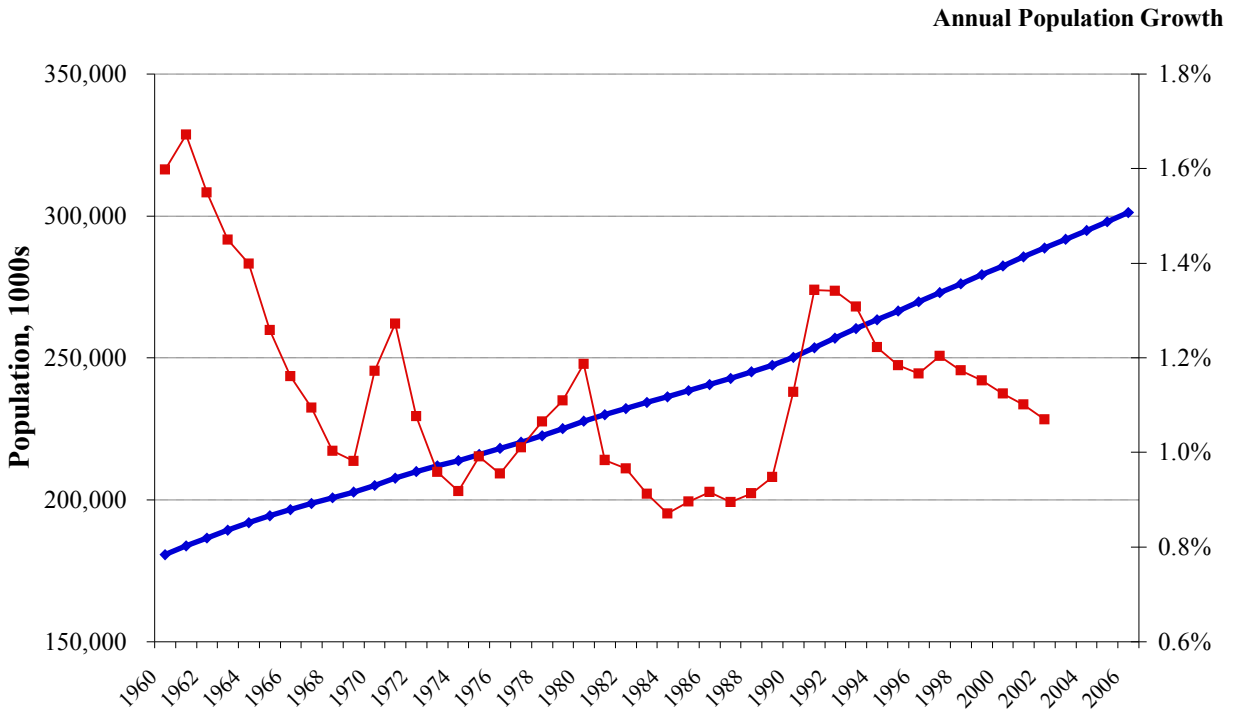
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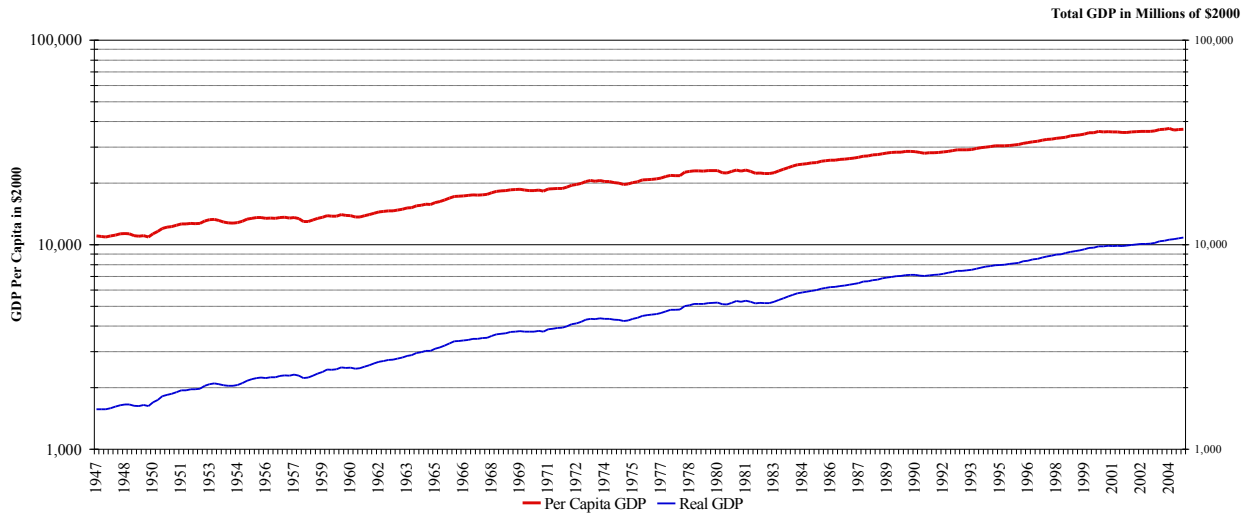
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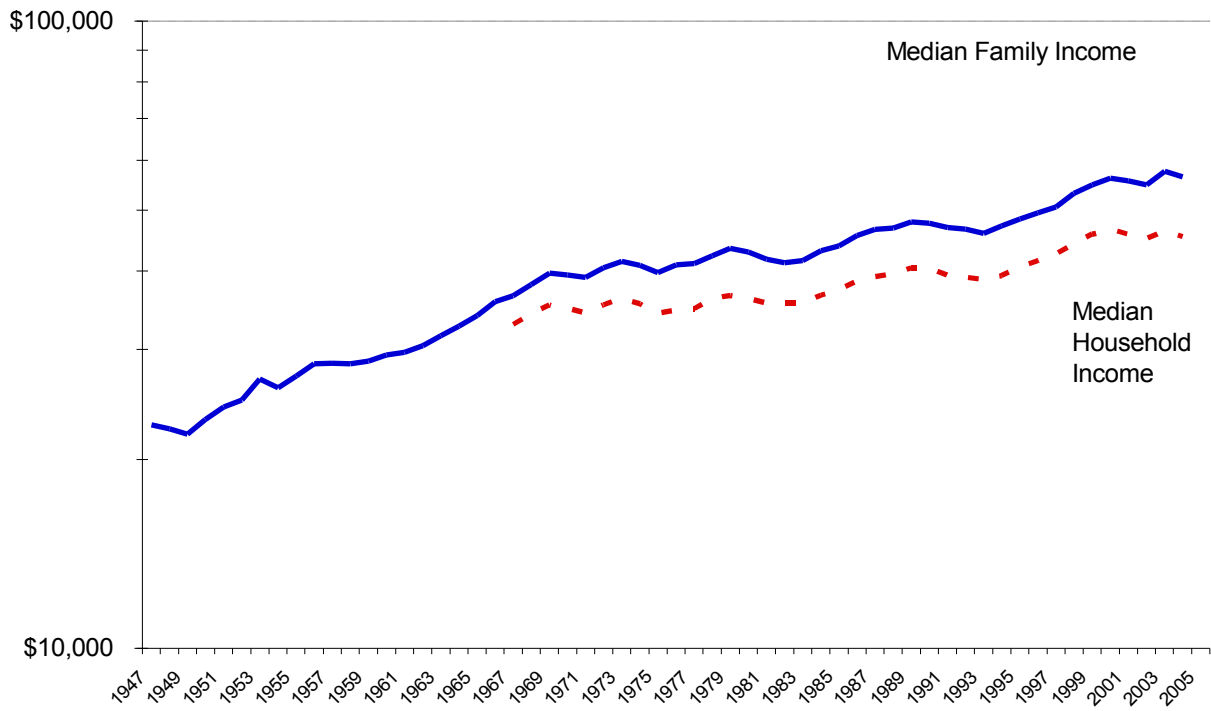
# U.S. Resident Population



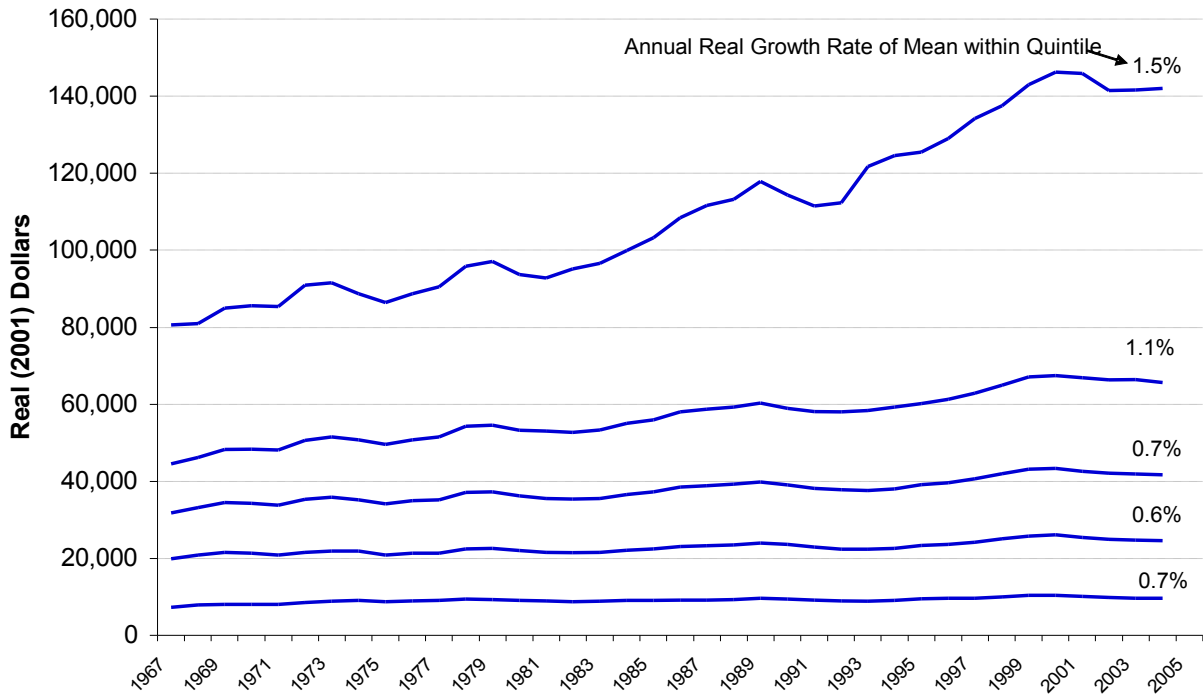
## Real GDP, and GDP Per Capita Logarithmic Scales



# Median Income in \$2005



## Mean Income within Income Quintiles



## Growth in MSAR Real Income Per Capita, and Employment, 1994

