Smart Economic Development for Minnesota

Getting It Right in Tough Times and Beyond

Matt Kane
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GROWTH & JUSTICE

Growth & Justice is a non-profit, non-partisan, public policy research organization and a leading progressive voice on state economic issues. Growth & Justice supports fair taxation and smart public sector investment — fiscally responsible and accountable investment that advances prosperity for all Minnesotans. A sustainable economy provides the foundation for a just society.

Executive Summary

In these tough times, the economy and jobs are top priorities. Minnesota's policymakers must act wisely now to assess short-term economic development options and guide the state toward opportunities for growth and expanded prosperity in the long term. This Growth & Justice report arms policymakers for those tasks, building upon evidence and economic development concepts.

Public sector economic development can be driven by a mix of high hopes, good intentions and influential special interests that sometimes cloud the appropriate government role in the economy and ignore the real drivers of regional economic growth. Policymakers aiming for a positive impact on the state's economy must understand the key principles and avoid the common pitfalls described in this report. And taxpayers, communities, policymakers and business interests should be clear about expected outcomes and who is accountable for achieving the results we want for Minnesota. This is always important but even more so when money is scarce and the stakes are high.

Here are the summary points from the full policy paper that follows:

Economic Development Priorities for the Downturn

With the recession, the economic development focus in Minnesota will shift in the short-term away from expansion to retention and survival. Useful approaches for the here-and-now include:

- ***Offer businesses advice and technical assistance.*** With the downturn, assistance will need to move well beyond marketing and planning help and address a broader range of immediate business concerns.
- ***Help laid-off workers.*** Some laid-off Minnesotans will need retraining. Others will benefit from job search assistance, particularly as the economy begins to recover.
- ***Encourage entrepreneurs.*** During this recession, state government should encourage and support entrepreneurs – including laid-off workers who start businesses – as they capitalize on economic change and emerging opportunities.
- ***Tap federal economic stimulus funding for the long-term benefit of the state.*** Minnesota should take full advantage of the federal dollars to counteract the downturn but also to make smart investments in infrastructure, workers and places that will pay off for years to come.

Smart Approaches to Long-term Economic Development for Minnesota

Beyond the recession, Minnesota should commit to the following approaches in order to spur economic development and growth. State government should:

- ***Invest in education and training to better the lives of Minnesotans and improve the skills and knowledge that they bring to their jobs.*** Public investment in education and training can result in broad benefits that will advance Minnesota's economy in the long run.
- ***Invest in public infrastructure that will yield high-return benefits for the cost.*** Done right, infrastructure investment can yield broad and lasting benefits for the region.
- ***Avoid or minimize company-specific tax breaks and public subsidies.*** Better to spend public dollars or cut taxes in ways that benefit broad sections of the economy than to offer narrow tax breaks for specific firms. To the extent that Minnesota offers subsidies and incentives, the state should use them sparingly and target them to aid distressed areas or low-income Minnesotans.
- ***Identify Minnesota's comparative advantages, critical region-wide industries and occupations, internal economic linkages, and emerging prospects for development and growth.*** State government should

further ramp up its use of objective economic analysis.

- ***Pursue economic development strategies that take aim at the drivers of economic growth.*** Smart approaches to economic development boost the productivity of key regional industries; improve the quality of life to keep and attract talent; encourage entrepreneurship; focus on industries and occupations that provide high-quality, good-paying jobs; and pay attention to industries and businesses whose sales bring new dollars into Minnesota, retain dollars within the state, or otherwise strengthen the state's internal economic connections.

- ***Avoid using tax dollars as financial capital for private ventures.*** Financial resources flow toward investment opportunities through the private sector, not through government.

- ***Secure a strong return on investment from any state economic development initiative, program or action – setting clear goals and demanding accountability for results.*** The measurement of impacts, while difficult, is important for accountability.

Four Tests to Help Ensure Real Economic Development Impacts

Real impacts from economic development efforts are more likely when policymakers carefully consider ways in which programs may fail to yield results at all. Four good tests are: 1) Will government action truly spur development and growth, or will the development and growth occur anyway, without government involvement? 2) Does the positive impact from economic development spending exceed the benefits that would have resulted from alternative uses for those funds? 3) Does the impact of government economic development activity sum to greater than zero for the state? 4) Do the overall benefits of the government economic development activity exceed its costs?

Guiding Economic Development Principles

The smart economic development approaches outlined above flow from the following guiding principles for government involvement in the state's economy.

- ***Market forces are the dominant drivers of the economy.*** Public policies influence economic development and growth, but they cannot supplant the private sector, nor should they try.

- ***Economic development should focus on factors internal to the workings of the state's economy and under the influence of the government.*** When it comes to economic development and growth, Minnesota's policymakers and state agency officials must understand what they can influence and how.

- ***Sensible economic development policy must build upon existing strengths.*** Policies and programs must take into account the comparative advantages that Minnesota and its sub-state regions have to offer.

- ***Economic development should yield real net impacts on growth in the long run or the potential for growth in the short term.*** Generally the preferred course of action is one that yields the greatest impact at the lowest cost.

- ***Economic development policies should generate broad benefits for people and businesses.*** Especially important are benefits that will continue to have a positive impact even if specific businesses downsize, close or move.

- ***Any targeted economic development efforts should pay attention to the needs of lagging or distressed ar-***

eas and of populations at the lowest rungs of the economic ladder. In the long run, the benefits of growth will likely be greatest for low-income residents and for distressed places rather than growing ones.

- ***Regional economies benefit from the production of goods and services that depend upon capital-intensive processes and skilled workers, and ones that incorporate high levels of locally added value.*** These factors allow Minnesota's businesses to compete on innovation and quality, and earn strong profits from their goods and services.
- ***Economic development initiatives should emphasize environmental sustainability and protect water, air and natural resources.*** Given the magnitude of climate change and other environmental problems, Minnesota's economic development efforts should focus on prospects that will improve, not worsen, the outlook for the environment.

Reasons for State Economic Development Efforts

Minnesota's economic development and growth depend upon the independent actions of many players, the overwhelming majority of whom operate in the private sector. Yet government also plays a vital role as a strategic investor. Public sector involvement in economic development stems from legitimate concerns about positive and negative spillover effects, failures in the information marketplace, existing but underused public infrastructure and private resources, the social impacts of growth and development, and the political impacts of economic stagnation or decline.

What Drives Economic Growth

Commonly accepted ideas about what causes economic growth in a region provide an important framework for economic development policies, one that should shape strategies for government action. Key concepts about how regional economies develop and grow emphasize the importance of human capital, financial capital, productivity, specialization and trade, entrepreneurialism, industry clustering, the characteristics of place, the life-cycle stages of goods and service production, sales to customers located outside a region, and the internal economic linkages that increase the circulation of dollars throughout a local economy.

Growth & Justice Guidance Applied to Selected Strategies

This policy paper offers quick assessments of several economic development strategies using the approaches, principles and ideas outlined here. In summary, the following conclusions are drawn: Public sector investment in transportation, done well, is a smart economic development strategy. Minnesota's JOBZ enterprise zone program falls short of the mark. A new sports stadium for the Twin Cities does not meet the test for smart economic development. And state government should support technical advice and assistance for small manufacturers through manufacturing extension programs.

& Forging the Right Path for Smart Economic Development

The economy and jobs are top priorities for Minnesota as the sharp and prolonged economic downturn takes its toll. Since the recession began in 2008, industries have scaled back, workers are losing jobs and experts say recovery is not yet in clear sight. The State of Minnesota strives to encourage economic development and growth even in good times. In these tough times, state government must focus on sustaining businesses and jobs in the short term and then match its economic development efforts for the long-term with opportunities to spur real growth and expand prosperity.

The governor, state legislators, state agency officials and engaged citizens want to ensure that Minnesota's economic development efforts yield results for the state's residents and businesses. This Growth & Justice policy paper builds upon evidence and concepts to support Minnesota's policymakers as they assess economic development options and guide the state down the best policy pathway. The report highlights some pressing economic development challenges for the short-term, presents smart approaches and policy principles for the long term, explores why the public sector plays a role in economic development, and explains the potential drivers of regional economic growth.

Economic Development Priorities for the Downturn

With the current recession, the economic development focus in Minnesota for the most part will shift away from expansion to retention and survival. The question for state government in the here-and-now is how best to help businesses and workers adjust and weather the storm. Needless to say, Minnesota must continue its commitment to smart, long-term economic development approaches. But during the economic downturn, constructive economic development strategies include business assistance programs, help for workers who lose their jobs, encouragement for entrepreneurs, and good use of the federal stimulus funding. (Markusen, 2009.)

- ***Offer businesses advice and technical assistance.*** Small businesses in particular may welcome advice and assistance from experts during the recession, as their markets shrink and sales fall. For business assistance, the State of Minnesota fields several experts who aid firms in a few key industries, and the state helps fund a network of Small Business Development Centers that offer support, too. Several groups outside of government also offer assistance. The state should increase effective business assistance efforts. Advice and technical assistance will need to reach well beyond marketing and planning help and address business survival concerns for the economic downturn.
- ***Help laid-off workers.*** With the recession comes job loss and an opportunity to help laid-off workers. For economic development, Minnesota already places a strong emphasis on training and job search assistance through its Department of Employment and Economic Development. This recession, like those before it, will change the outlook for some industries and occupations. Consequently, some laid-off Minnesotans – but certainly not all – will need retraining for new work. Done well, training can improve workforce productivity and spur economic growth in the longer term. Job search assistance efforts, too, will help, particularly as the economy begins to recover and jobs open up.
- ***Encourage entrepreneurs.*** Economic recessions are periods of creative destruction, when the waning of some industries and businesses creates opportunities for new ones. As many talented but out-of-work Minnesotans look for new ways to earn their living, state government should ramp up initiatives that encourage and support entrepreneurs. Minnesota, like many Midwestern states, lags behind the nation in business start-ups, making the focus on entrepreneurship potentially worthwhile even aside from the current downturn.
- ***Tap federal economic stimulus funding for the long-term benefit of the state.*** The State of Minnesota should take full advantage of the federal economic stimulus package to counteract the current cyclical slump but also lay the base for future growth and prosperity. The American Recovery and Reinvestment Act, passed in February 2009 to boost the nation's sagging economy, includes funds for a range of federal programs that match with economic development concerns. The federal measure increases funding

for infrastructure, including highways, transit, high speed passenger rail, airports, drinking water and waste water systems, the electricity grid, and school building improvements. Dollars go to economic and community development initiatives, including Community Development Block Grants, neighborhood stabilization, home weatherization improvements and public housing upgrades. The stimulus package also provides additional funding for workforce training and dislocated worker programs. And it allows for new tax-exempt recovery zone bonds that state and local governments may employ for a variety of purposes, including infrastructure development, job training, economic development and education. While the federal funds need to be spent quickly to have the desired stimulative effect, they also offer Minnesota's government an opportunity to take fast action on smart investments in infrastructure, workers and places that will pay off for years to come.

Smart Approaches to Long-Term Economic Development for Minnesota

Beyond the recession, the State of Minnesota needs to take smart approaches to economic development as it looks to improve the long-term outlook. State and local economic development efforts work best when they fit the role for government action, and when they build upon regional potentials and strengths to increase economic growth and prosperity. The following approaches stand out as smart ones for Minnesota.

- ***Invest in education and training to better the lives of Minnesotans and improve the skills and knowledge that they bring to their jobs.*** To a great extent, governments exist to offer public goods and services that the private sector will not adequately provide because the benefits spill over broadly and cannot be fully captured by private sector sellers and buyers. Education is a classic public good because education's benefits flow not only to the student but also to the broader community, which gains from having an educated workforce and citizenry. Businesses benefit from high quality labor and improved productivity. However businesses will under-invest in education and training because they lose their return on investment if workers leave for new jobs. For these reasons, government action is called for. Public investment in education and training can result in broad benefits that will advance Minnesota's economy even if specific businesses downsize, close or move. This is true because well-educated and trained workers improve the productivity, vitality and growth potential of a regional economy. The Growth & Justice report on ***Smart Investments***SM ***in Minnesota's Students*** lays out principles for investing in education, including the pressing need to address disparities for students of color, and the need to get students ready for school, ready to learn and ready for life. (Growth & Justice, 2008.) (For more on workforce issues, see *Workforce First*, Growth & Justice, 2004.)
- ***Invest in public infrastructure that will yield high-return benefits for the cost.*** Infrastructure, too, is a public good that yields broad benefits for a region, its residents and its businesses. Minnesota's government has an important and positive role to play in economic development through its investment in and regulation of such infrastructure items as roads and transit, airports, water and waste systems, public safety, electricity generation and transmission, communications networks, and university-based research and development. As is the case with investment in education, infrastructure investment can yield benefits in the long term even if specific businesses relocate or close. However infrastructure investment must be grounded in a realistic assessment of benefits versus costs, of capacity versus anticipated demand, and of opportunities for development and growth. Public investment in traditional infrastructure alone will not turn around a declining regional economy. (Luger, 2002.)

Minnesota's Transportation Infrastructure

The quick assessment: Public sector investment in transportation, done well, is a smart economic development strategy and one that the State of Minnesota should emphasize, perhaps even more than it does now. Some positives for this approach include:

- Transportation investment stands out as an area that Minnesota's government clearly shapes and influences, and appropriately so because transportation, in general, is a public good that yields benefits not fully captured by buyers and sellers in the marketplace.
- Transportation improvements can yield broad benefits for Minnesota businesses by upgrading the movement of goods and people and in this way enhancing productivity.
- Transportation and land use patterns affect the quality of life, which increasingly influences the economic vitality of communities and regions.
- While careful considerations of return on investment must be weighed before the government invests in transportation improvements, research has found a positive relationship between infrastructure investment and regional business growth, although it's not certain if the investments drive the growth or the growth drives the investments.

- ***Avoid or minimize company-specific tax incentives and public subsidies.*** As a rule, it's better to spend public dollars or cut taxes in ways that benefit broad sections of the economy than to offer tax breaks for specific firms. Company-specific tax breaks and public subsidies can have some influence over business location decisions, particularly when it comes to different locations within the geographical region that a specific firm already finds attractive. But consequently the impact of company-specific tax incentives or subsidies largely shifts economic activity around within a region and does not add to it. What's more, tax breaks provided to one Minnesota company may be unfair to other Minnesota businesses that don't receive the same treatment. And the opportunity costs will be high – tax expenditures for incentives and subsidies shrink state funds that could have been used for other beneficial activities, such as infrastructure initiatives, education and business assistance. To the extent that tax incentives for economic development reduce funding for critical public infrastructure and services, they may even undermine long-term development and growth. (Lynch, 2004.) Beyond this, the high costs of tax incentives per job undermine their cost effectiveness. (Bartik, 1995.)

  However the State of Minnesota, like other state governments, does offer subsidies and tax incentives for economic development. When it does so, the state should use these tax breaks sparingly and target them to promote development and growth in distressed areas or to expand the economic opportunities for people with low incomes. Already the State of Minnesota strives to make tax incentives transparent, accountable, modest and strategic. Minnesota should put increased emphasis on agreements that reduce or recapture tax incentives and public subsidies if recipient businesses fail to meet the job or development targets that justified public sector involvement. (Weber, 2004.) And Minnesota should do a better job of fully disclosing the costs of lost revenues from business subsidies and incentives. (LeRoy, 2004.) In its annual *Tax Expenditure Budget*, the Minnesota Department of Revenue tallies overall program totals for the lost revenue from economic development tax incentives, but the state should group economic development tax breaks separately for easy comparison to economic development spending, perhaps laying out both in a unified development budget.

Job Opportunity Building Zones (JOBZ)

The quick assessment: The state's JOBZ program, which offers state and local tax breaks to selected businesses that locate or expand in 10 designated zones throughout Greater Minnesota, falls short of the mark when assessed based on Growth & Justice approaches, principles and suggestions for smart economic development. Some of the reasons include:

- Instead of broadly improving the climate for all businesses in an area or even in a zone, JOBZ provides tax incentives for specific companies, some of which compete against other tax-paying Minnesota firms that don't qualify for the incentives.
- A large majority of JOBZ businesses acknowledge that they would have expanded in Greater Minnesota without the tax incentives, although most at lower levels, according to a 2008 legislative auditor's report.
- Although aimed at assisting distressed areas in Greater Minnesota, JOBZ follows the pattern for most enterprise zone programs in expanding well beyond distressed areas – JOBZ covers more than 1,000 subzones encompassing more than 300 cities and townships.

A 2008 legislative auditor's report criticized JOBZ but also noted that in some cases the program has helped attract businesses into Minnesota and in other cases has kept some business expansions within the state borders.

- ***Identify Minnesota's comparative advantages, critical region-wide industries and occupations, internal economic links, and emerging prospects for development and growth.*** The State of Minnesota should further ramp up its careful and objective economic analysis to ensure that development efforts match regional circumstances and strengths. Economic analysis helps guard against initiatives that have more to do with the latest economic development fads than with cost-effective opportunities to foster growth in Minnesota. Accurate economic analysis identifies regional specializations that build the economic base and drive growth through trade. Regional analysis helps Minnesota focus economic development resources on industries, occupations and approaches that hold the potential for growth.

- ***Pursue economic development strategies that take aim at the drivers of economic growth.*** On this score, smart approaches include economic development initiatives that:

  - *Boost the productivity of key regional industries.* The State of Minnesota can play a role through programs that provide business advice, technical assistance, information and training that helps businesses with production technologies, processes and approaches.

  - *Improve the quality of life in Minnesota's regions and its major metropolitan areas.* A high quality of life in an area keeps and attracts talent, including well-educated and skilled workers, entrepreneurs, and business leaders.

  - *Encourage entrepreneurship.* With Minnesota lagging behind the nation for business start-ups, the state should explore additional ways that government can encourage and support entrepreneurs.

  - *Focus Minnesota's economic development efforts on industries, occupations and businesses that provide high-quality, good-paying jobs.* To the extent that Minnesota uses its limited resources to foster economic development and growth in the long term, initiatives should take aim at industries and occupations with above-average pay scales and benefits.

  - *Pay attention to industries and businesses whose sales bring new dollars into Minnesota, retain dollars within the state, or otherwise strengthen the state's internal economic connections and keep dollars circulating in the state's economy.*

Technical Advice and Assistance for Small Manufacturers

Most state governments help fund a system of federally supported Manufacturing Extension Partnership centers. These centers offer production, workforce and business assistance to small manufacturers at reasonable prices. Enterprise Minnesota carries out this mission but receives no funding from Minnesota's state government. The quick assessment: State funding for manufacturing extension is likely a smart approach for reasons that include:

- Engineering, training and business advice from manufacturing extension centers aims to improve the productivity of businesses in the manufacturing sector and in this way ties to an important driver of economic growth.
- In terms of return on investment, several studies from U.S. Census Bureau economists show that productivity grew significantly faster among small manufacturers served by manufacturing extension clients than it did among comparable firms.
- Manufacturing extension assistance addresses a market failure by filling gaps in the technical information available to small firms – gaps that result in part from private sector consultants focusing their services on larger firms because it costs more to reach and serve smaller ones.
- Many of Minnesota's small manufacturers sell goods outside the state or supply other Minnesota firms that sell to customers beyond the state's border.

It's worth noting, however, that while manufacturing extension efforts target a subset of firms within the broad manufacturing sector, they do, in practice, provide assistance to individual firms, some of which compete for business against other Minnesota manufacturers.

- ***As a rule, avoid using tax dollars as financial capital for private ventures.*** For the most part, the State of Minnesota's best role when it comes to financial capital is that of providing information, reducing barriers to access, and fostering networks among lenders, investors, entrepreneurs and businesses. Overwhelmingly, financial resources flow toward investment opportunities through private markets, not through the government. Financial capital programs both funded and run by state or local governments often suffer from decision-making processes heavily influenced by political considerations. Such programs also tend to avoid risk, and that tendency then steers public sector lending and investment toward the very ventures most likely to find financing on their own through private sources. (Wirtz, 2001.) For these reasons, Minnesota's state government dollars should not be used for financial capital, including loans and venture capital. Better for the state to establish programs that encourage private capital sources and early-stage "angel" investors, perhaps through incentives. Such action can improve the financing prospects for types of businesses and groups of people generally overlooked by the private market. (Bartik, 1995.) State government incentives for the private capital market also may increase access to capital for individuals and businesses in need of very small amounts of financing and therefore not likely to be cost-effective customers for private investors or lenders under normal circumstances.

- ***Secure a strong return on investment from any state economic development initiative, program or action, setting clear goals and demanding accountability for results.*** When the State of Minnesota commits resources to economic development, the state should earn a positive return from that investment. For this reason, Minnesota's Department of Employment and Economic Development should increase its use of clear, consistent and transparent goals and objectives, and analyze all economic development proposals in terms of how well they meet the desired and measurable outcomes. (Luria and Dziczek, 2003.) The measurement of impacts is important for accountability and results. But measurement is difficult, too. Many of Minnesota's economic development and workforce initiatives strive for improvements over the long term, while comparisons of program benefits and costs often focus on results over a one- or two-year period. And goals may be in conflict. For example, job creation is often the focus, but economic development initiatives designed to improve productivity may result in fewer jobs, albeit better-paying ones. (For more on accountability, see *Governing with Accountability*, Growth & Justice, 2009.)

A New Sports Stadium

The quick assessment: A new sports stadium for the Twin Cities fails the test for smart economic development based on the Growth & Justice approaches, principles and suggestions outlined in this policy paper. Some of the reasons include:

- Public funding for a stadium provides a subsidy largely to one specific business and therefore does not contribute to improvements in the general business climate, nor does a stadium subsidy necessarily target help to distressed areas or people with low incomes.
- The potential benefits from a new stadium need to be measured against the potential returns from public investment in other, more promising areas, such as education, infrastructure and other economic development opportunities.
- Rather than pull new dollars into the state's economy, most of the increased spending on tickets for the new stadium will reduce entertainment spending on other events or activities, although it will likely increase the dollars flowing into the community where the stadium is located.
- In all likelihood, public investment in a sports stadium will not secure a strong return on investment because thorough research into the economic impacts of sports stadiums finds that stadiums as a rule have no significant impact on regional economic growth.

Four Tests to Ensure Real Impacts from Economic Development

Properly structured, economic development efforts by state and local governments can have a positive – albeit incremental – impact on growth. Real impacts may be hard to separate from the perception of impact. And while the perception of impact is often an adequate measure of success from a political standpoint, the economic framework demands more. For success, public sector economic development initiatives must pass the following four tests.

- ***Will government action truly spur development and growth, or will the development and growth occur anyway, without government involvement?*** Quite often in economic development, public dollars underwrite activity that would have taken place without any government subsidies or investments. Here there is no impact from the public sector activity at all, despite appearances to the contrary.

- ***Does the positive impact from economic development spending exceed the benefits that would have resulted from alternative uses for those funds?*** When state funds are spent on economic development – or when tax revenues are given up for economic development incentives – they cannot be used for other opportunities. Alternative uses include, by way of example, public investments in education, or private sector purchases that taxpayers might have made with the money they paid to fund economic development. These considerations are often referred to as opportunity costs.

- ***Does the impact of the government economic development activity sum to greater than zero for the state?*** The positive impact on one area may come at the expense of another, as in the case, for example, of a firm simply relocating its production facilities from one site to the next. Economic development efforts that encourage such relocation may only move economic activity and jobs around instead of creating real economic growth. What yields positive impacts for one community or one local economy, then, might have no positive impact on economic growth in a region or in the state as a whole.

- ***Do the overall benefits of the government economic development activity exceed its costs?*** Benefits must be weighed against the costs in order to assess whether or not economic development efforts yield true gains. Here, benefits refer not just to gains for governments from increased tax revenues but also to increased economic well-being of the region and its residents. Practically speaking, an accurate measure of costs and benefits is quite difficult to determine and easily manipulated for political purposes, which makes the measurement process a tricky one. And the time frame for measuring benefits needs to extend beyond the short-term – especially beyond the election cycle.

Guiding Economic Development Principles

The smart economic development approaches presented above flow from important, guiding principles for public sector involvement in Minnesota's economy. Minnesota must formulate and carry out its economic development efforts in ways that make sense for state government and that recognize the dynamics for economic growth. The following principles provide a useful framework for Minnesota's economic development policy.

- ***Market forces are the dominant drivers of the economy.*** Public policies influence economic development and growth, but they cannot supplant the private sector, nor should they try. For this obvious reason, Minnesota's economic development efforts must build upon history, current circumstances and realistic opportunities for growth in order to influence development. They should not attempt to create growth wholly through government investments and actions. (Hill, 2001.)

- ***Economic development should focus on factors internal to the workings of the state's economy and under the influence of the government.*** To a large extent, issues and elements beyond the control of Minnesota's government establish the circumstances for the state's economy at any point in time. The current recession is a clear example of this. Many crucial economic factors lie outside the realm of state and local governments, including national and international economic growth rates, capital flows, international trade arrangements, federal fiscal and monetary policies, currency markets, and technological changes. When it comes to economic development and growth, Minnesota's policymakers and state agency officials must understand what they can influence and how.

- ***Sensible economic development policy must build upon existing strengths.*** Policies and programs must take into account the comparative advantages that Minnesota and its sub-state regions have to offer and foster the opportunities for expansion and transformation presented by the state's resources and its existing economic strengths.

- ***Economic development efforts should yield real net impacts on growth in the long run or the potential for growth in the short term.*** From an efficiency standpoint, the preferred course of action is one that yields the greatest impact at the lowest cost. The true impacts of economic development are difficult to predict and measure, but the chance for impact improves when the state's policymakers are keenly aware of the ways in which programs may fail to yield results at all. (For more, see the section above on "Four Tests to Ensure Real Impacts.")

- ***Economic development policies should generate broad benefits for people and businesses, especially benefits that will continue to have a positive impact even if specific businesses downsize, close or move.*** The desire for efficiency from public sector economic development efforts must be balanced with the desire for an equitable distribution of the benefits. The residents and businesses that pay for Minnesota's economic development programs through their taxes should benefit from their investments. They are more likely to do so when economic development efforts secure broad and long-standing benefits then if the positive impacts are narrowly focused and fleeting.

- ***Any targeted economic development efforts should pay attention to the needs of lagging or distressed areas and of populations at the lowest rungs of the economic ladder.*** In the long run, the benefits of growth will likely be greatest for the unemployed and underemployed and for distressed places rather than growing ones. The short-term employment prospects for low-skilled and low-wage workers will affect their work experience, job skills, occupational standing and earnings potential in the long run. (Bartik, 1991.) When it comes to place, Minnesota may benefit from measures taken to spur growth in stagnant or declining locations where the public and private sectors have already invested in infrastructure, instead of locations where new infrastructure investment is required. The marginal cost of growth to Minnesota's governments will be lower in areas where existing infrastructure is underutilized. From the standpoint of fiscal impacts on government, economic development initiatives may have negative impacts if job creation and business growth occurs in areas that require major government investments in new roads, schools and other public infrastructure. (Bartik, 1995.)

- ***Regional economies benefit from the production of goods and services that depend upon capital-intensive processes and skilled workers, and ones that incorporate high levels of locally added value.*** (Hill, 2001.) These factors allow Minnesota's businesses to compete on innovation and quality and earn strong profits from their goods and services. State economic development efforts should recognize the importance of firms and industries that take this high road and offer good quality jobs.

- ***Economic development initiatives should emphasize environmental sustainability and protect water, air and natural resources.*** Climate-changing air pollution and threats to water quality stand out as critical environmental challenges for Minnesota, the nation and the world. Given the magnitude of these problems and others, Minnesota's economic development efforts should focus on growth prospects that will improve, not worsen, the outlook for the environment. With green as the guidepost, the state should assess the growth potential for Minnesota of renewable energy producers and their suppliers, work with businesses to improve energy efficiency, and help industries cut costs through waste reduction.

Why Government Plays a Role in Economic Development

Minnesota's economic development and growth rely upon the independent actions of many players, the overwhelming majority of whom operate in the private sector. The regional economy is shaped by the decisions of consumers, workers, corporate officials, business owners, entrepreneurs, investors, loan officers and students, all of whom make choices and take actions that affect economic outcomes.

Yet government also plays a vital role in the regional economy. Clearly public sector decisions and activity significantly influence the economic environment of a region when it comes to education, infrastructure investment and upkeep, taxes and regulations, zoning and land use, and the provision of public services. Governments also take economic development actions to assist industries and workers. There are solid reasons for public sector involvement in economic development, including legitimate concerns about positive and negative spillovers, failures in the information marketplace, existing but underused public infrastructure and private resources, the social impacts of growth and development, and the political impacts of economic stagnation or decline.

- ***Spillovers.*** When acting in their own self interest, buyers and sellers fail to take into account the spillover effects of their actions in cases where those actions result in larger costs or benefits for a community or region. Consequently the market will produce too much when buyers and sellers overlook negative spillovers, such as pollution, and too little when they overlook positive spillovers, such as the overall gains from public education. Negative spillovers justify some government interventions, such as pollution regulation. In the case of positive spillovers, they create a market for public goods and services, including education and training, transportation infrastructure, water and waste systems, police and fire services, and the like. For each of these examples of positive spillovers, private sector market signals would miss the broader, community-wide benefits if buy-and-sell decisions were left solely to the private sector.
- ***Information market failures.*** Free market theory assumes that buyers and sellers have perfect information about all elements of production, employment and consumption decisions. The reality often falls short of the ideal. Adequate information may be lacking in the case of investors searching for opportunity, businesses looking for production locations, entrepreneurs needing start-up capital or business know-how, firms lagging behind on production processes, and workers hoping to hone their skills and knowledge for emerging occupations and industries. The regional economy will benefit to the extent that the public sector can improve the flow of information in the regional economy in a cost-effective manner.
- ***Existing but underused capacity.*** Economic growth depends upon how a region puts its productive capacity to work. If public infrastructure or private resources are left idle, a community misses out on the economic potential of those existing investments. Better, also, to have new growth occur at locations in a region where businesses can take advantage of existing but underused roads, utility systems and other infrastructure elements than to have the growth occur where it will require significant expenditures for new infrastructure. (Bartik, 1995.) And the regional economy can benefit from government efforts to deploy overlooked resources for productive use, as is the case when development occurs in distressed urban areas or at abandoned industrial or commercial sites.
- ***Social impacts.*** Growth can have long-term positive impacts on the economic well-being of people and places. Job experience improves the ongoing employment prospects and job opportunities of less-educated, low-skilled residents over time and in this way has long-term effects on rates of unemployment and poverty in a region. (Bartik, 2003.) Development may also prevent or short-circuit physical and economic deterioration in a community, neighborhood or other small geographic area. In these cases, successful public sector economic development activity will improve the well-being of people and places. Such gains may be particularly important to low-income, low-skilled residents who are less likely to move from declining areas to growing ones. (Hoover and Giarratani, 1984.)

- ***Political pressure.*** Economic stagnation or decline prompts demands from voters for economic development action. This is certainly true now, during the economic downturn. Serious concerns about the state of a region's economy will lead to government economic development efforts, good or bad. Even in prosperous times and in regions with healthy economies, opinion leaders and engaged citizens may press elected officials for action if they perceive the performance of their economy as lagging behind that of other regions or if the trend line for growth has slowed. And governments might pursue economic development initiatives – wise or not – because of political pressure and heavy lobbying by specific businesses or others who stand to gain from government action.

What Drives Economic Growth

In order to affect the economy, Minnesota's economic development efforts must take aim at the drivers of regional economic growth. Ideas and theories about growth provide an important framework for economic development policies, one that should shape strategies for government action. Minnesota's policymakers and economic development officials can use ideas about what creates growth as a reality check to assess the potential for specific economic development initiatives. The following list summarizes notable concepts regarding how regional economies develop and grow.

Human capital. The workforce is a vital element of any economic development equation but one too often underemphasized. The human capital that people bring to the workplace – skills, knowledge and ideas – can drive innovation, productivity improvements and economic growth. An increased emphasis on brain over brawn among businesses makes human capital critical, particularly as costs have fallen for other production factors, such as communications and transportation. (Fairbanks, 2004.) People apply knowledge and create innovation in ways that foster development and spur growth in the regional economy. And the benefits of workforce skills and knowledge will have positive spillover effects on a broad range of businesses and the regional economy as a whole. (Lucas as discussed in Clement, 2004.) The vitality of a region may depend, at least in part, on clusters of highly skilled, educated and creative workers. (Florida, 2002.) Because workers can move from place to place, regions need to improve their livability, or quality of life, as a way to keep the talent they have and draw in new talent, also. (Markusen, 2000.) As the mix of skills and occupations becomes increasingly important to the economic well-being of regions, quality of life factors increasingly influence economic development.

Financial capital. Investment drives growth. Increased private investment – made in response to existing markets or emerging opportunities – creates new jobs, which increase local income, which leads to greater local demand for goods and services, which in turn leads to more private sector investment and continues the cycle of growth. (Eisinger, 1988.) The flow of financial capital within or to a region depends primarily upon the rate of return that investors can expect, but it also may be influenced by the knowledge of investment opportunities, the familiarity that investors have with a place and its people, or the experience they have had before in the region. (Hoover and Giarratani, 1984.) The free flow of financial capital may fall short of the ideal if markets fail because of imperfect information about funding sources for businesses or opportunities for investors, or because groups of people or types of businesses face institutional barriers that hinder their access to capital.

Productivity. Increased productivity means fewer resources – labor, material and equipment – are used to produce the same or more output. The unused resources are freed up for other productive purposes, and this drives economic growth. Productivity improvements can yield higher wages, profits and levels of capital investment. Productivity increases may stem from technological innovations, education and training for workers, improved business processes, investment in plants and equipment, new sources of production inputs, and trade. (Kedrova, 2004.) The built environment, including public infrastructure, also affects productivity. With advances in productivity, trade within the regional economy can be a powerful source of growth. (Markusen, 2000.) Increases in productivity also may lead to production advantages that attract buyers from outside the area for sellers inside the regional economy.

Specialization and trade. Businesses in a region can capitalize on efficiencies and productivity advantages to specialize in goods and services for sale to buyers in their own geographic area and for trade with other regions. Regions benefit from trade to the extent that they are able to focus on the types of production best suited to local inputs, including knowledge, skill, technology, natural resources and the base of strong businesses and supplier firms. A region concentrates on its most efficient economic activities, earns income from those activities, and then uses that income to import goods and services that are the specialties of other regions. Demanding local customers may spur production efficiencies and quality breakthroughs among local businesses and in this way set the stage for specialization and export sales. (Fairbanks, 2004.) As concepts, specialization and trade highlight the importance of imports as well as exports to regional growth and development. Trade among regions can drive continued increases in productivity and well-being.

Entrepreneurialism. When it comes to economic growth from new businesses, labor, capital and good ideas alone aren't adequate. Risk-taking entrepreneurs are needed to take turn opportunities into businesses – some with the potential to dramatically grow in size and scope over time. Research shows that high levels of entrepreneurship contribute to economic growth and job creation. (Verheul, et. al, 2001.) Entrepreneurs contribute to the capacity and dynamism of a regional economy. Regions can capitalize on new business development if the economic, cultural and regulatory environments are favorable for entrepreneurialism. (U.S. Economic Development Administration, 2001.)

Place and space. Geography affects how economic activity spreads across places, as businesses balance their need for access to labor, materials and consumer markets against the costs for land and transportation. The catalyst and outlook for economic development in an area, then, is often tied to the characteristics of place and space. For example, the need for cost-effective transportation explains why many major cities sprang up alongside rivers and sea ports, and it explains as well as why many towns are located along once-critical rail lines. Access to and use of natural resources – including timber, iron and oil – spur economic activity and regional development.

Clusters or agglomeration. Economic geographers have long noted the tendency of dominant firms in an industry to develop or locate relatively close to each other. This pattern of clustering, or agglomeration, is no surprise: Businesses cluster to take advantage of access to buyers or to production inputs. Clusters also may develop around cost savings from economies of scale, when, for example, a location offers a large pool of workers with the necessary occupational skills for an industry, or a location contains a large number of qualified supplier firms competing for business. (Hoover and Giarratani, 1984.) What's more, the existence of a successful firm can lead to the spin-off of new firms in that same industry, thus fostering agglomeration. Knowledge clusters of people with the right education, skills, ideas and experience may propel a business sector forward and foster its growth in a given region. (Lucas as discussed in Clement, 2004.) While a force in regional economics, however, clusters are counterbalanced by the tendency of production to spread out over time as an industry matures and moves through its product life cycle.

Product life cycles. Regional growth may be affected by the "life cycle" of a product as it moves from the start-up phase to standardized, or mass, production. The initial production of new products and services is likely to happen in locations where the innovation occurred and the entrepreneur first set up shop. However production will spread out to other locations as the industry matures and the production process becomes routine. For routine production, businesses may base location decisions on such factors as access to markets, transportation and communication costs, and costs for labor and materials. (Economic Development Administration, 2001.) Often process changes take place that lead to different elements of the production occurring in different locations instead of one facility or area.

Economic base and linkages. For the economic base theory, the basic sector consists of businesses that sell goods or services to buyers from elsewhere. Sales outside of a region bring new dollars in and can spur economic growth. In keeping with the dynamics of regional economies, the greater the level of these "export" sales, the greater the volume of dollars flowing into the region. Once they flow in, those outside dollars multiply as they roll around the regional economy as income that local owners and workers spend at businesses in the area, or as revenues that businesses in the region spend to purchase supplies and services from other local businesses. The strength of this multiplier effect for a regional economy depends upon the economic linkages among businesses and people in a region. As a flip side to exports, import substitution aims to reduce the share of dollars leaking out of the regional economy by encouraging local businesses to meet a greater share of the local demand that otherwise would be met by businesses located outside the region. Many state economic development efforts emphasize economic base and linkages, including those that focus on manufacturing firms and on tourism sales to visitors from elsewhere. But this simplistic economic base concept is incomplete and inadequate. Export sales and import substitution contribute to the regional economy, particularly in the case of smaller, more isolated areas. But export sales and import substitution are not the only – or even the main – sources of growth. If they were, the world economy would not grow without export sales to other planets. (Tiebout, 1956.) An overemphasis on exports and import substitution can crowd out internal development and short-circuit important trade-driven economic gains.

Conclusion

The State of Minnesota has both a strong interest and legitimate role to play in economic development efforts aimed at increasing the economy's capacity to create wealth for Minnesota's citizens. State and local governments help spur development and growth through investments in education, investments in public infrastructure and services, and assistance to industries, businesses and workers. State economic development efforts work best when initiatives build upon Minnesota's potential and strengths to improve the long-run outlook for growth. And government action must be aimed at issues and factors over which governments and their private sector partners have control or influence.

Unfortunately, state economic development efforts often fail to yield true, positive impacts. In order to avoid wasteful initiatives, Minnesota's policymakers must pursue economic development with an understanding for both the appropriate government role in the economy and the drivers of regional economic growth. And they need to put forth policies and programs that avoid common pitfalls, such as economic development initiatives that simply move economic activity from one location to another within the state or that take aim at economic activity that would have occurred even without public sector involvement.

The best government economic development approaches will flow from careful and realistic analysis of Minnesota's economy and its potential going forward. To spur growth, state government should support quality education and skills training, make cost-effective infrastructure investments, and improve the quality of life in the region. With support from state elected officials, Minnesota's state agencies and their public and private sector partners should pursue strategies that boost the productivity of key Minnesota industries. They should look for ways to aid industries and types of businesses that sell their goods and services outside the Minnesota region, compete for in-state sales that would otherwise go to businesses located elsewhere, or in other ways strengthen economic connections and keep dollars circulating in the state's economy. They should encourage the development and growth of industries and occupations that offer high-wage, high-quality jobs. The State of Minnesota should avoid or minimize its use of firm-specific tax breaks and public subsidies, and also avoid the direct funding and operation of business financing programs. And the state should secure a strong return to the broader community from its economic development efforts.

Minnesota's economic development policy must recognize the obvious – that private, market forces drive the regional economy. The State of Minnesota should pursue economic development policies that yield broad benefits for residents and businesses in the region, especially benefits that will continue to have a positive impact even if specific businesses downsize, close or move. Economic development initiatives should pay attention to the needs of distressed areas and low-income groups. And economic development policies also should acknowledge the importance of businesses and industries that depend upon capital-intensive processes, use skilled workers and incorporate high levels of locally added value.

Public sector economic development can be driven by a mix of high hopes, good intentions and influential special interests that sometimes cloud the appropriate government role in the economy and ignore the real drivers of regional economic growth. Policymakers aiming for a positive impact on the state's economy must understand the key principles and avoid the common pitfalls described in this report. And taxpayers, communities, policymakers and business interests should be clear about expected outcomes and who is accountable for achieving the results we want for Minnesota. This is always important but even more so when money is scarce and the stakes are high.

Acknowledgements and Selected Sources

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GROWTH & JUSTICE

2324 University Ave. W., Suite 120A
Saint Paul, MN 55114
Phone: 651-917-6037
info@growthandjustice.org
www.growthandjustice.org