Twenty Years of State Economic Development Policy: North Carolina and the Nation

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Over the last twenty years, state funding, action, and capacity for economic development policy and practice have grown tremendously while federal involvement has waned. We enter the middle part of the last decade of the 20th century with unprecedented state involvement in funding for economic development policy and practice. At the same time, we face greater state vulnerability to changes in the global marketplace, to global shifts in capital and technology, to international trade agreements, and, consequently, to the declining ability of state policy makers to shape the direction of their economies. Fundamental shifts in the international and national structure of economic production are reshaping state economies, placing new demands on infrastructure, tax and regulatory systems, education and training systems, and research and development capacity in higher education. The rise of industrial competitors in developing countries and the rapid spread of technology are changing the structure of employment. They are pushing down some industry wages, reducing the rate of growth in blue collar jobs, and increasing the reliance on a bifurcated service sector of high wage and low wage jobs. State government will play a significant role in responding to the challenges that these changes create.

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Federal Disengagement

A little over twenty years ago, the Nixon Administration's "New Federalism" promised a new era of federal, state, and local cooperation. The federal government would give state and local governments greater flexibility in economic and community development policies and programs. Specific, rule driven, categorical programs would be combined into more flexible block grants to state and local governments. State and local governments, in turn, would assume greater responsibility for their own destinies. The Community Development Block Grant and the Comprehensive Employment Training Act promised federal funds without direct federal control.

A little over a decade later, much of the promised flexibility had not materialized or had been undone by creeping regulatory controls implemented in response to real or perceived inadequacies in state and local controls or due to disagreement with state and local priorities. In the 1980s, the Reagan Administration reintroduced New Federalism with renewed zeal for block grants, local flexibility in decision making, and the policy-making abilities and priorities of state government. This second round of block grants signaled a return of obeisance to the greater wisdom and knowledge of state and local officials. With greater freedom, however, came less funding. While budget reductions were never as deep or as widespread as initially proposed, the implicit understanding was that greater flexibility and control would be accompanied by declining federal funding.

In 1995, just over a decade later, state policy makers face another round of proposed block grants. Unlike prior programs, these block grants move far beyond the consolidation of categorical, discretionary programs into a combined block grant for states

to administer. Proposals governing welfare, food stamps, and Medicaid would turn over to states many of the "safety net" entitlement programs designed to catch those that fall through the cracks of the market economy. In addition, in discussions among interest groups, think tanks, and congressional staff, policy makers have pondered dismantling direct federal funding for economic development, rural development, and small businesses, and combining those funds into various block grants for states. As in the 1980s, the 1995 proposals would reduce or freeze program funds, with prospects at best for no real growth, and at worst for further reductions in real program funding. The twenty year trend, with some fits and starts, has included a polite but firm withdrawal of the federal government from policy making in community and economic development, a reduction in federal expenditures, and a "devolution" of greater flexibility and greater responsibility to state government.

While the block grant process has captured much of the press and public attention, a less marked but consistent retrenchment has taken place in other federal initiatives to stimulate state and local economic development. The Economic Development Administration, the Appalachian Regional Commission, the Title V Commissions, Urban Development Action Grants, and economic development funds within the Farmer's Home Administration have all been reduced or eliminated. There was a brief respite from this process in the early proposals of the Clinton Administration, which envisioned federal action to stimulate and invigorate the manufacturing economy, increase federal funding for research and development, and expand federal programs to increase financing for community and economic development. At the time this article was written, Congress appeared poised to dismantle the manufacturing and technology programs of the National Institute for Standards and Technologies and perhaps to eliminate the U.S. Department of Commerce. Following the flurry of federal action in the 1960s and early 1970s to provide both funding and policy direction for state and local economic development, the past two decades have seen a general federal withdrawal—a trend that seems likely to continue in the near future. What has been the state response to these changes?

State Engagement

In 1989, David Osborne released an influential book on state economic development policy, *Laboratories of Democracy*. Osborne argued that while federal involvement in state and local economic development had languished, states had become increasingly active and creative in designing public policy to stimulate economic activity. At the state level, new approaches to build a stronger economic base tended to reflect some common understanding or themes. Osborne argued that these state development policies focused on nine basic elements:

1. intellectual infrastructure,
2. a skilled and educated workforce,
3. quality of life,
4. the entrepreneurial climate,
5. adequate risk capital,
6. markets for new products,
7. industrial modernization,
8. an industrial culture of cooperation and flexibility, and
9. a social system that supports innovation and change.

In his book, Osborne profiles six states' policies and programs that address one or more of these elements. These innovations were actually relatively widespread in the nation and in the Southeast. In the 1980s, for example, North Carolina launched many of its initiatives to promote new technology development and commercialization, to increase cooperation between businesses and universities, to provide high risk capital for entrepreneurs, and to provide technical services and training for small businesses. Like most states, however, North Carolina did not abandon its traditional economic development policies that served it well throughout the 1960s and 1970s. The new initiatives were additions to the policy arsenal, which meant new money and increasing expenditures for economic development.

A common theme of policy initiatives launched in the 1970s is that they were new and experimental. Many of these efforts were centered in industrial states whose economic strength was threatened by the industrial recruitment policies of the Sunbelt states. However, for all the attention generated among policy makers, and for all the real energy and innovation these initiatives represented, they were quite modest in terms of funding and their relative portions of state expenditures on economic development. For example, the Ben Franklin Partnership of Pennsylvania, a model for connecting state government, business, and universities for technology transfer and commercialization, was launched with only a few hundred thousand dollars. By 1994, expenditures for the program had grown to about $20 million, while Pennsylvania's total expenditures on technology related economic development still totalled under $35 million. In North Carolina in 1994, direct state expenditures for technology transfer, commercialization, and industry modernization were estimated at $37 million—a significant but still small portion of the estimated total direct state expenditures of $150 million for economic development programs.[1] The new initiatives of the 1970s and 1980s were real, but in most states these expenditures were marginal compared to total spending on economic development.

Transitions in State Development Policy

Followers of state development policy at the Corporation for Enterprise Development characterized the transitions that took place in state development policy in the last two decades as the three waves of development policy.

Wave 1: Industrial Recruitment

The first wave comprised the industrial recruitment policies pioneered by the southern states. While popular wisdom has these recruitment/incentive programs beginning with Mississippi's "Balance Agriculture with Industry" economic development initiative of the 1930s, they actually date back to southern industrialization efforts of the 19th century. Legislative committee reports of the North Carolina General Assembly from the mid-1800s speak of the need to provide incentives for northern capital to invigorate the southern industrial economy until such time as the South has sufficient capital to invest in itself. A century later in the 1960s, industrial recruitment, combined with investments in transportation, infrastructure, and worker training, was a well established economic development policy in southern states. This first wave of development policy was certainly not limited to the southern states, but in the 1970s they were its primary beneficiaries.

Wave 2: The Individual Firm Approach

The second wave of state development policies was characterized by the initiation of the types of activities Osborne lauded in *Laboratories of Democracy*. Many of these were launched in the northeast and midwestern industrial belts to counter the successful industrial recruitment efforts of the Sunbelt states. Industrial revitalization and modernization policies were intended to introduce new technologies and production practices to make industrial plants more competitive. Technology commercialization and entrepreneurial policies were designed to create new firms or introduce new products in companies losing market share. The latter strategies gained nationwide attention in the 1980s, largely because of David Birch's analysis of sources of new jobs. Birch's widely reported findings argued that the principal sources of new job creation were small companies. Birch also argued that the differences in rates of growth of various states and localities were explained by the differential birth rates for small firms. Places that, for whatever reason, had higher than average growth in new enterprises also had higher levels of job growth. Although Birch's methodology was later criticized, his report had an immediate impact on state and local development policy. While few states had small business programs in 1980, by 1993 they were present in every state. By the late 1980s, most states had a combination of initiatives aimed at small businesses and entrepreneurship, technology commercialization, technology transfer, modernization, and financing. In 1980, North Carolina had only a modest program to assist small businesses located in the Department of Commerce, but by the 1990s the state had the following programs:

- the Small Business and Technology Development Center program, which housed small business services on the state's 16 university campuses;
- the Small Business Center program, which located center directors to coordinate small business courses and workshops in most of the state's 58 community college campuses;

- the Technology Development Authority, which provided capital to new ventures;
- the North Carolina Biotechnology Center, to stimulate start-up companies and commercialization of university research in biotechnologies;
- the Microenterprise Program, to provide loans and technical support to very small enterprises; and
- the North Carolina Enterprise Corporation, which used state investments and tax credits to develop venture capital for rapidly growing companies.

What is striking about the initiatives of the 1980s and early 1990s is their focus on intervention at the individual firm level. Throughout much of the 1960s and into the 1970s, most state economic development policy centered on investments in training and basic infrastructure. Development policies for constructing highways, financing water and sewer, creating technical and community colleges for worker training, and reducing taxation of manufacturing enterprises were all designed to improve the competitiveness of places through public investment or investment in education. In the era before block grants, major federal programs to improve the competitiveness of states and localities, such as the Economic Development Administration and the Appalachian Regional Commission, principally provided funds for public investment in infrastructure. By the 1980s this had changed and state policies that directed assistance to improving the competitiveness of individual enterprises were the rule.[2]

In part, the individual firm approach reflects the expansion of industrial recruitment activity as direct financial assistance and tax breaks to firms became more prevalent to attract new investment. To a large extent, however, this transition to intervention at the firm level was also fueled by the increasing emphasis on small business and the commercialization of new technologies. Traditional infrastructure policies were of little use to small companies. Traditional tax incentives also offered few benefits to small firms that had little investment in real property, limited inventory, and, particularly in early years of the company's life cycle, no tax liability because the company was not yet profitable. Financial assistance, technical and engineering assistance, and general business assistance delivered on the firm by firm basis were of greater value to these companies.

As experience with these types of programs grew, some of the more thoughtful policy makers identified several problems with state economic development policies that depended on the survival of individual companies. The first was scale. Given the large size of the small business sector and the limited number of companies any program could serve in a given year, policy makers questioned whether the impact on the economy justified the expenditure. In North Carolina, for example, there are 140,000 individual enterprises and thousands of births and deaths of companies annually. In contrast, a generous estimate of the outreach capacity of all of the state's technical assistance programs suggests the potential of contacting about 3,500 firms annually—and this assumes only a minimal level of assistance. Are programs that provide direct assistance to less than three percent of the companies in a state annually really effective in strengthening a state's economy?

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The above question raises the second shortcoming—the selection of firms to receive assistance. If only three percent of the state's firms receive assistance annually, how do you choose the most appropriate firms to maximize economic development impact? And among the thousands of firms that are born and die annually, how does a state program with limited capacity select the most likely candidates for financing and assistance? In fact, most state services tend to be provided on a "first come, first served" basis and little or no selection takes place. Alternatively, services are rationed through cumbersome application processes that only the most desperate of firms are willing to wade through. These firms may not be the most desirable in terms of economic impact.

A third concern that accompanied the individual firm strategy was raised by Birch in his discussion of "mice" versus "gazelles." Mice are the thousands of small companies that remain small, adding few if any new jobs over their life cycle; they begin with one or two employees and remain at that level. Only a small percentage of companies become gazelles and create the growth in investment, income, and employment that is typically the goal of state development policies. Should state policy for small business development be indiscriminate, or should it attempt to focus limited resources on the gazelles? If state policy attempts to discriminate, how do technical services and financing programs differentiate among the thousands of potential clients in order to identify the gazelles? And if state policy elects to discriminate in favor of high growth companies, will this require a higher level of more specialized technical assistance than generic small business assistance?

Wave 3. Beyond the Individual Firm Approach?

There have been a number of attempts by state policy makers and other designers of development policy to devise solutions to concerns raised by the individual firm approach. The Corporation for Enterprise Development dubbed these efforts the "third wave" of state development policy. This wave, however, never fully formed. A number of programs have adopted design principles to address problems of scale and focus, as well as related issues such as leverage, decentralization, inter-firm cooperation, and program accountability. As a result, these principles are more likely to be considered in policy development. Still, the process appears more incremental than transformational.

The Current Environment and Policy Challenges

The mid-1990s finds conflicting influences at work on state economic development policy. States find themselves with greater responsibility, fewer dollars, and more susceptibility to economic forces outside their borders. Despite evidence of an economy with low inflation and stable, if subdued, growth, people remain anxious about their economic futures—and with some reason. Real reason for concern comes from stagnant real incomes; corporations' continued adapting to competition by reducing labor costs; employment instability from downsizing, mergers, and restructuring; and a high percentage of new job creation in lower wage sectors of the economy. The national and state economies are continuing a process of restructuring. While the long-term prognosis may be positive, in the short-term structural changes produce both winners and losers. A significant challenge for state economic policy over the next decade is to maximize the winners and minimize the losers, while ameliorating the negative consequences for people and communities that suffer from this structural change.

Over the last two decades, net manufacturing employment in North Carolina increased by about 107,000. During that same period the labor force grew by ten times that amount, about 1.3 million workers. Most of the balance was absorbed by growth in the trade and service sectors, which, like manufacturing in an earlier period, grew principally through additions to the work force rather than increases in capital investment and productivity.[3] In at least some sectors, however, non-manufacturing technology is producing the same types of structural change and productivity improvements that occurred in manufacturing. If the technological revolution produces the same types of employment effects in service and related industries as occurred in manufacturing, similar turmoil will be felt in that segment of the economy.

Innovations in information and communication technologies are making possible new alliances that will dramatically alter some industries. Bank mergers, alliances between financial institutions and financial software companies, and the advent of on-line banking services will produce new products, alter the nature of customer interactions with banks, and rearrange the location and employment patterns of financial institutions. Growth in financial services, especially banking, made strong contributions to the growth in North Carolina's gross state product. The application of information and communications technologies will restructure markets, products, customer relationships, job classifications, and investment and employment patterns in the financial services industry—with likely positive, but for now unpredictable, effects on economic activity within the state. Similar effects are probable in other non-manufacturing sectors.

These structural forces will particularly challenge the State's abilities to solve conflicts in place-based policies and to deal with the thorny issue of rural development. As noted earlier, "rural" is something of a misnomer and is not a very useful term for understanding the problems of economies struggling to make the rapid transition from agriculture to manu-

facturing to information and service-based economies. In the short term, the state will face extremely difficult policy choices. Investment in research and development, higher education, urban infrastructure, and higher level training programs will likely pay the greatest dividends in gross state product. These investments will do little, however, for less developed local and regional economies where the technology infrastructure, workforce, business services, and education and training opportunities are better suited for agriculture or lower technology manufacturing. As more companies require access to the amenities generally available only within a reasonable proximity to metropolitan areas, competitive forces will place greater pressure on these communities. States will, of course, create policies to serve both urban and rural areas. The challenge will be balancing resources to promote opportunities for less developed places while continuing to make the level and kind of investments needed to keep the overall state economy competitive.[4]

A second major theme that will shape state economic development policy is the movement to rethink the scope and reach of public policy in general. Recent state and national elections have elevated this issue in the popular arena, but even prior to 1994, narrowing the scope of government (if not the size) had proponents in both conservative and liberal policy discussions. In the economic policy arena, this was usually accompanied by increased respect for the operations of private markets and growing skepticism about government intervention in those markets. The array of small business services and financing programs that proliferated in the 1980s, for example, attracted greater scrutiny in the 1990s. Ron Ferguson and Dewitt John argued that the first responsibility of state development policy was to focus on the fundamentals: tax policy, regulatory policy, education, and infrastructure.[5] The "innovative" programs that attracted so much attention were, in their view, unlikely to compensate for inadequate infrastructure, poor education systems, or tax and regulatory policies that created high costs or inefficient business environments. Challenged both by progressive policy thinkers and conservative proponents of reducing governmental expenditures, state development policies that embraced firm by firm intervention will be reassessed in the next decade.

The policy issue of incentives to attract new investment or encourage expansions of existing plants also promises to be more visible and contentious. State and federal incentives to stimulate private investment or influence the behavior of individual firms have a long history. Over the last few years, however, the use of financial incentives, whether by direct payments or tax credits and concessions, has spread throughout the South as well as the country. Initially limited to "trophy" firms that were nationally or internationally known and that committed large investments, incentive programs were extended by statute to any firm that met qualifying criteria. Competition among states for economic investment is keen, and enterprises show growing interest in any action that will lower costs. These forces provide a "push" that threatens to escalate into incentive wars. It is a war most states prefer not to fight, but they are leery of unilateral disarmament. A counter force comes from both conservative and liberal critics who view extreme forms of such incentive-driven policies as market distorting, as corporate welfare, or as eroding tax bases that would generate revenues to invest in the fundamentals. Add to this the recent decision by a North Carolina court that incentive payments violate the constitutional requirement that all government expenditures have a clear public purpose, and the resolution of this issue becomes tricky.[6] States must serve new investment if they are to meet economic development goals. Thoughtful policy makers will struggle to balance reasonable competitive responses against the more extreme policies of some states.

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Conclusion

A state policy maker who slept through the last two decades and awakened in the 1990s would find a landscape that is quite familiar in some respects, but quite different in others. States continue to devise strategies to attract new investment, but they also devote significant resources to small business development and improving the competitiveness of exist-

ing industry. The impact of technology on manufacturing, an issue on the horizon twenty years ago, has become a fundamental force in economic restructuring. The rapid growth of the microprocessor, as well as communications and information technologies in non-manufacturing sectors, will further alter the competitiveness of industries, people, and places. Federal dollars for economic development have declined, international investment and international competition have increased, and firms driven to lower costs are more sensitive to state and local taxes and regulations. State policy makers are asked to shoulder greater responsibility amidst a heightened awareness of the limited tools the public sector can bring to bear on a global market economy and a growing skepticism of government's ability to achieve outcomes that improve the quality of people's lives. It is a time when state governments cannot afford to squander scarce dollars, energies, or public confidence. The demand for critical policy analysis and policy development has grown and will continue to grow. CP

Endnotes

[1] From resource audits and surveys by the North Carolina Alliance for Competitive Technologies. Information on initial funding for Ben Franklin Partnerships from interview with Walt Plosila, Executive Director of NC ACTs and former Deputy Secretary of the Pennsylvania Department of Commerce.

[2] This discussion is drawn from a presentation by the author, published in Cooperation and Competitiveness, Proceedings of the International Conference in Lisbon, October 1993.

[3] Information from the United States Bureau of Economic Analysis.

[4] This discussion was presented at greater length in Rethinking Rural Development, Corporation for Enterprise Development, 1993.

[5] From a presentation by Ferguson and John at a state policy forum sponsored by the Aspen Institute's State Policy Program.

[6] Using a 1968 NC Supreme Court decision as legal precedent, a Forsythe County Superior Court found that use of public subsidies to directly benefit a private company were unconstitutional, in violation of the provision in the North Carolina Constitution that all public funds be applied to a public purpose. A later opinion in a different county ruled that incentives are constitutional if they promote broader economic development goals. Both decisions have been appealed.