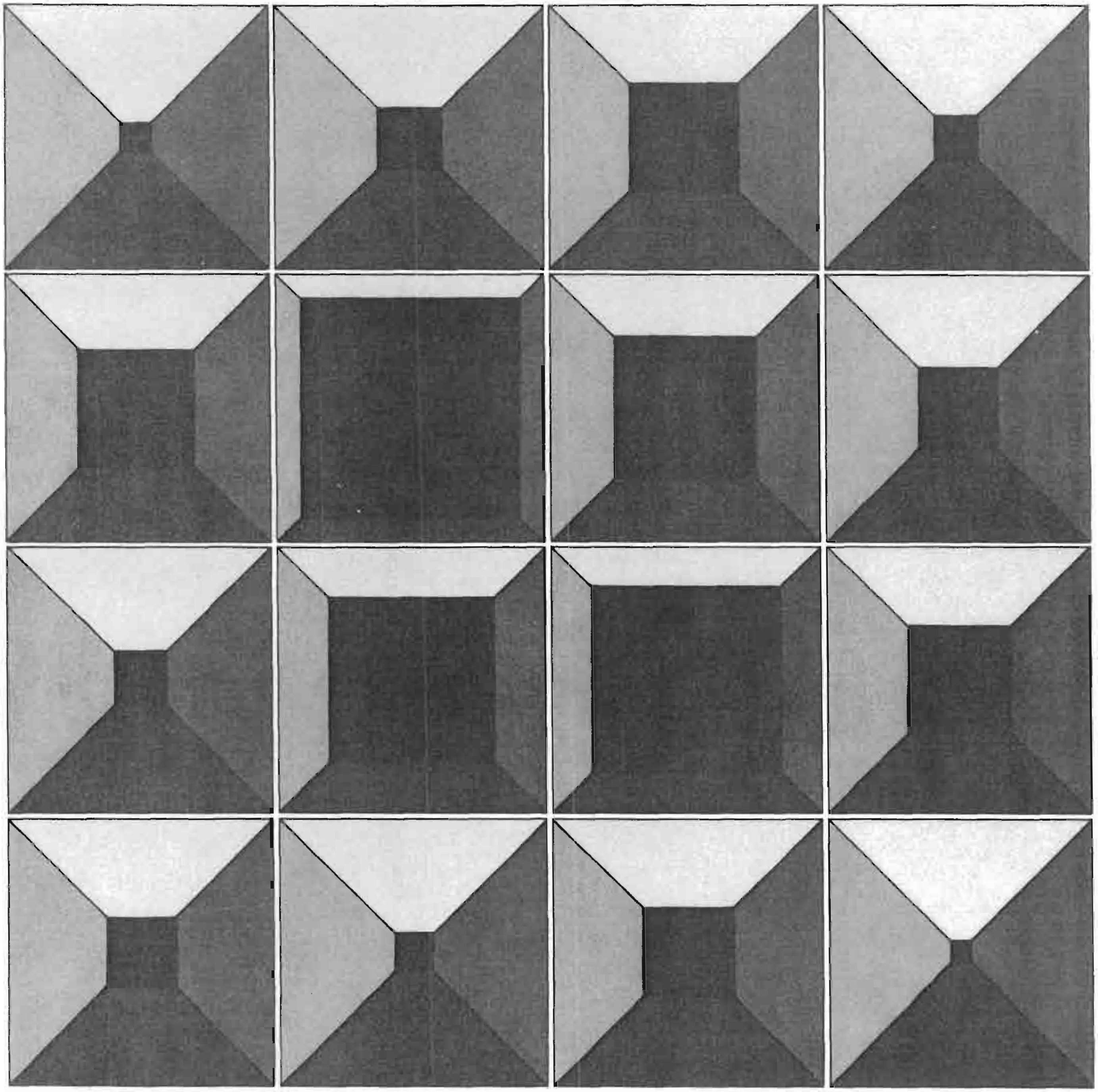
A CBO STUDY

The Federal Role in State Industrial Development Programs

July 1984

Congress of the United States
Congressional Budget Office



THE FEDERAL ROLE IN STATE INDUSTRIAL DEVELOPMENT PROGRAMS

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PREFACE

Much attention has been paid recently to the question of whether the federal government should adopt a policy of supporting industrial development. On the state level, governments already carry out extensive programs aimed at developing local industries. This study analyzes these state programs, their goals, the federal role in providing financing for them, and options for changing federal support. It was prepared at the request of the Subcommittee on Economic Stabilization of the House Committee on Banking, Finance, and Urban Affairs. In keeping with the mandate of the Congressional Budget Office (CBO) to provide objective analysis, the report makes no recommendations.

The report was written by Elliot Schwartz of CBO's Natural Resources and Commerce Division, with the assistance of Julia C. McKenzie, who researched, prepared, and drafted Chapter II. The paper was supervised by David L. Bodde and Everett M. Ehrlich. It benefited from many valuable comments on earlier drafts, particularly from Paul McCarthy, David Moore, Lawrence Forest, Richard Mudge, Mark Menchik, Howard Wachtel, Sally Ericsson, Edward Morrison, Michael Kieschnick, Pat Choate, and Pearl Richardson. The inventory of state programs included in this report would have been impossible without the cooperation of government officials in every state. Francis Pierce edited the manuscript and Kathryn Quattrone typed the numerous drafts and prepared it for publication.

Rudolph G. Penner
Director

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SUMMARY

Much has been said and written on whether the federal government should adopt a policy of assisting industrial development. While the debate continues at the federal level, state and local governments are providing significant support for businesses within their own jurisdictions. Much of this support is financed by the federal government. The support takes several forms. Federal grants to state and local governments for economic development and business promotion amounted to over $8.6 billion in 1983. Federal support for highways and mass transit, often a part of state industrial promotion programs, amounted to $12.8 billion. Beyond this, the states and localities have been able to issue tax-free industrial development bonds, which in 1983 represented a federal cost of $4 billion in taxes forgone.

Several questions arise from these state programs. One is the much-discussed issue of whether government efforts can be expected to improve on the performance of a market economy. Another is whether the state programs work to the national benefit or whether they only rearrange economic activity while adding little to the national economy. In view of these concerns, this study:

- Examines the goals and scope of existing state programs;
- Examines the federal role in these programs; and
- Analyzes options for changing the federal role.

CURRENT STATE ECONOMIC DEVELOPMENT PROGRAMS

Traditionally, state industrial support has been general in nature--centered on providing infrastructure and favorable tax treatment and on setting the rules of business behavior. Industrial revenue bonds and other tax-exempt debt issued through states and municipalities have gained popularity in all states as a means of financing business growth. Recently, however, states have introduced more specific economic development strategies. These are aimed directly at small business development, international business promotion, research and development activities, and labor adjustment and training services.

The Summary Table shows the relative amounts of business promotion assistance provided by the states and the federal government. Federal programs far exceed those of the states in dollar volume. Moreover, industrial revenue bonds, which comprise the bulk of financial resources allocated by state and local governments for business support, also represent commitments of federal dollars. Despite the disparity in size between state and federal programs, the states are increasing their presence--using both

SUMMARY TABLE. BUSINESS PROMOTION BY STATE AND FEDERAL GOVERNMENTS, FISCAL YEAR 1983 (In millions of dollars) a/

Type	State Programs	Federal Programs: Federal Administered	Federal Programs: State Administered
Direct Expenditures	280.0	18,260.2	8,604.0
Direct Loans	114.8	2,872.6	---
Loan Guarantees	23.2	12,095.9	---
Venture Capital Corporations	9.7	---	---
Industrial Revenue Bonds	22,800.0 b/	--	(4,025.0) c/

SOURCE: The Congressional Budget Office and the Office of Management and Budget.

a. Excluding promotions for Agriculture and Energy.

b. Total 1983 IRB issues, of which only a portion represent a subsidy to business through lower interest rates.

c. Federal revenue loss associated with cumulative state and local IRB issues.

their own and federal funds--and doing so in newer and more experimental ways:

- o Most of the business incentive programs recently initiated by the states are directed toward small business. State grants for small business programs amounted to $5.4 million in 1983. Other financial assistance to small businesses in 1983 included direct loans ($114.8 million), loan guarantees ($23.2 million), and equity assistance ($9.7 million). In addition, significant nonfinancial assistance, through regulatory reform, paperwork reduction, and targeted technical assistance, was provided to small business.

- o State governments have become especially active in promoting both international trade and foreign investment. In 1983, states spent an estimated $36 million on international business promotion, primarily through technical assistance and increasingly through export financing aid. Technical assistance includes state offices abroad, international trade shows, and other forms of information dissemination. Export financing, predominantly a federal activity, is currently available in eight states and under consideration in several more.

- o About 50 percent of all R&D nationwide is funded from federal sources. The states, however, are also beginning to finance some R&D projects aimed at business development. Much of this support is in the form of tax exemptions and support for public universities. In 1983, however, states also spent $67 million in direct R&D support.

- o The Job Training Partnership Act (JTPA) is now the primary vehicle for both federal and state support for job training and labor adjustment assistance. The JTPA is federally funded (with state matching requirements), but administered by state and local governments, with significant private-sector involvement. In addition to JTPA, 39 states currently run independent customized training programs to help businesses train workers for specific jobs. In 1983, over $121 million was spent by states on these programs.

ISSUES CONCERNING STATE DEVELOPMENT POLICIES

Many of the state programs are based on a considered belief that it is in the interest of the states to offer subsidies for business development. These subsidies can often be justified on strict economic grounds because

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they yield benefits to a state that exceed their costs. From a national point of view, however, this may not hold true if the state programs offset each other and serve mainly to move companies from one state to another rather than creating new growth. Some state policies, moreover, may conflict with national priorities.

When does a state development program merit federal support? A general analysis of the division of responsibility among governments suggests that federal support is most justified under the following conditions: when a program has spillovers or external effects that benefit other states; when federal support leads to greater efficiency through centralized coordination; and when the aim is to help disadvantaged groups or regions. State support of economic activity can be justified when the benefits and costs are primarily local in nature and when the administration of that support is most efficient on a decentralized basis.

Within this context, state programs offer the following advantages:

- Decentralized jurisdictions are better able to handle the diversity of tastes and situations that exists among states;
- Decentralized governments are more likely to experiment;
- State financing may supplement federal financing in some cases; and
- Greater proximity to local conditions means greater awareness of them, and hence better targeting of incentives.

State programs also have disadvantages:

- Locational incentives may only reduce economic efficiency by drawing firms away from technically efficient sites;
- Too many state programs show poor budgeting, particularly those that make heavy use of industrial revenue bonds and tax abatements;
- Where national purpose is paramount, control by the states may interfere with federal policies (such as treaty commitments);
- State programs can lead to administrative duplication among themselves and overuse of scarce management resources; and

- State programs can lead to expensive bidding wars to attract businesses.

On balance, the benefits of diversity and increased choice must be weighed against the costs associated with competitive and duplicative programs. Certain generalizations can be made. First, from a national perspective programs promoting productivity and economic growth should be preferred to those that are mainly designed to draw companies from other states. Some programs, such as R&D promotion, can help to create new economic activity.

Second, while the desirability of targeting resources toward particular activities is open to question, states clearly have an advantage in doing so because of their greater knowledge of local conditions. They may also be able to serve small businesses at lower cost than the federal government. For these reasons the states may be able to supplement federal programs with smaller, but more precisely targeted, efforts.

OPTIONS FOR CHANGE

The Congress may wish to consider options that would modify the federal and/or state roles in business incentive programs. It can choose among four general strategies:

- Doing nothing to change present federal programs;

- Cutting federal programs that support state development efforts;

- Asserting greater control over federal funds used in state programs; and

- Turning back to the states federal programs and program funds that affect state development efforts.

Doing Nothing

In a choice among imperfect alternatives, the best course may be to leave the current system alone to seek its own equilibrium. Competition among the states for economic advantage may yield some benefits, while its costs may prevent it from being carried too far.

Cutting Federal Support

If state programs are viewed as inefficient from a national perspective, the Congress could reduce the subsidies they receive from industrial revenue bond issues. Legislation just enacted sets limits on the IRB issuances of each state of $150 per capita, or $200 million annually, whichever is larger.

An alternative not included in the new legislation (and, therefore, a longer-term option), might be to disallow tax-free treatment for IRBs. The Congress could even choose to give back to the states some portion of the revenues received from taxing interest on private-purpose investment bonds. This would make the programs subject to Congressional budgetary review.

Another alternative is to control or bound the performance of the IRB program. For example, the Congress could impose further restrictions on the types of activities qualifying for IRB support. Or the Congress could require greater state participation (perhaps through matching funds) in the issuance of IRBs, which would give states an incentive to be more selective in their use of subsidized funds.

Controlling Federal Support

The Congress may decide that state industrial support is desirable but that more controls are needed to increase the national benefits. One option is to give federal administrators more control over state programs to ensure that purely locational incentives are not followed.

Placing greater control in the hands of federal administrators would allow states to continue to fund development activities that are consistent with national goals. H.R. 4360, supported by the House Banking Committee, would authorize a national industrial development bank to invest in the stock of state public industrial development finance institutions. Federal directors on the boards of such state banks would, among other things, ensure that programs were not designed merely to attract businesses from other states. An argument against such federal oversight is that it might weaken the advantage that state programs have in diversity, independence, and willingness to experiment.

Devolving Federal Programs

State administration may be more effective than federal administration in certain programs, such as those supporting exports, some R&D activities, and small business development. States may be better able to target incentives to businesses that need them and to businesses that will make the best use of them.

One proposal under consideration in the Senate would establish a formula grant system of federal aid to state economic development agencies. Funds for this purpose could come from federal programs already allocated to small business, export promotion, and other business development purposes. This proposal suggests less federal control than the House Banking Committee proposal, and is consistent with the notion of encouraging state incentives and diversification of policy. A drawback, of course, would be the loss of federal oversight that such an approach would imply--with the result that interstate competition for industry might not only continue but be encouraged.

CONCLUSIONS

Recognizing that state industrial incentive programs already exist and that they have substantial federal support, the Congress is faced with two interrelated issues. Should it reduce federal support and leave the states free to pursue programs that may prove costly and ineffective? Or should it increase federal oversight at the expense of flexibility and diversity?

Ultimately, the Congress may want to address the more fundamental question of whether targeted business promotion programs can increase national income and raise living standards, as opposed to merely rearranging national output. The existence of 50 state industrial development programs, together with a number of uncoordinated federal programs, raises a broader issue of whether the national and state economies would be improved by rationalizing and coordinating these programs or by getting rid of most of them.

CHAPTER I. INTRODUCTION AND OVERVIEW

National attention has focused recently on federal support of industrial growth and whether there is a need for more extensive and explicit industrial development policies. 1/ Many states and localities are already pursuing strategies aimed at increasing industrial activity within their jurisdictions. Some of these state efforts are wholly independent of federal economic programs, but most are supported or encouraged by the federal government. The latter, as shown in Table 1, provides over $8.6 billion per year in direct support of state and local economic development and business promotion programs. Other federal expenditures that indirectly support those programs--largely through public works infrastructure, research support, and tax expenditures--are shown in Table 2.

The federal government also provides direct financial assistance to business independently of the state programs. In 1983, this was roughly double the federal expenditures channeled directly through state programs, as shown in Table 3. By contrast, state programs independent of the federal government paid for only small amounts of industrial support in 1983. 2/

These business assistance programs have raised questions as to the role of government intervention in the economy, especially when targeted on specific sectors or firms. Everyone agrees that the economic vitality of the states is tied to overall federal economic policies. Most also agree that appropriate monetary and fiscal policies, followed at the federal level, will generate more substantial job gains for the states than even the best state policies. Industrial policy supporters take the view that an increase in

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1. See, for example, Congressional Budget Office, The Industrial Policy Debate (December 1983) and Federal Support of U.S. Business (January 1984), for detailed analyses of these issues.

2. State business incentives can be categorized in a number of different ways. This paper primarily groups programs on the basis of intended policy effects (that is, small business promotion, labor training, etc.). The major alternative to this method of categorization is by policy tools (types of grants, loans, and interest subsidies), and these are also discussed. For a complete analysis of policy tools consult The Directory of Incentives for Business Investment and Development in the United States (The Urban Institute, 1983). These categories are summarized in Table A-1.

TABLE 1. FEDERAL GRANTS TO STATE AND LOCAL GOVERNMENTS FOR ECONOMIC DEVELOPMENT AND BUSINESS PROMOTION, FISCAL YEAR 1983 (In millions of dollars) a/

Agency and Program	Outlays
Department of Commerce	
Minority Business Development	2
Economic Development Assistance	248
Regional Development Programs	5
Regional Development Commission	3
Department of Transportation	
Research, Training, and Human Resources	15
Research and Special Programs	3
Department of Housing and Urban Development	
Community Development Grants	3,554
Urban Development Action Grants	451
Department of Labor	
JTPA State Grants	3,067
JTPA National Emphasis Program	98
Community Service Employment for Older Americans	51
Temporary Employment Assistance	45
Federal-State Employment Service	741
Other	
Small Business Administration	59
Appalachian Regional Development Programs	262
Total	8,604

SOURCE: Special Analysis H, Budget of the United States Government, Fiscal Year 1985.

a. Excluding Agriculture, Energy, and General Revenue Sharing.

TABLE 2. INDIRECT FEDERAL SUPPORT FOR STATE AND LOCAL PROGRAMS FOR ECONOMIC DEVELOPMENT AND BUSINESS PROMOTION, FISCAL YEAR 1983 (In millions of dollars)

	Amounts
Federal Payments to Public Universities for Research	2,800 a/
Department of Transportation, Highway and Mass Transit Funds, Airports	12,800
Environmental Protection Agency--Sewage Treatment Construction Grants	2,983
Direct Loan Disbursements to State and Local Governments	
Department of Transportation Federal Aid for Highways	27
New Guaranteed Loans to State and Local Governments	
Department of Housing and Urban Development Community Development Grants	117
Tax Expenditures Aiding State and Local Governments	
Small Issue Industrial Revenue Bonds (IRBs)	2,195
IRBs for Pollution Control and Sewage and Waste Disposal Facilities	1,345
IRBs for Airports, Docks, and Sports and Convention Facilities	485

SOURCE: Special Analysis H, Budget of the United States Government, Fiscal Year 1985.

a. Estimated by the Department of Commerce.

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TABLE 3. DIRECT BUSINESS PROMOTION BY STATE AND FEDERAL GOVERNMENTS, FISCAL YEAR 1983 (In millions of dollars) a/

Type	State Programs	Federal Programs: Federal Administered	Federal Programs: State Administered
Direct Expenditures	280.0	18,260.2	8,604.0
Major Expenditure Functions			
Small Business Assistance	5.4 b/	1,152.0	61.0
Training, Employment, and Other Labor Services	121.4	1,892.0	4,002.0
Research and Development	67.4	13,936.0 c/	18.0
International Trade Promotion	36.0	608.0	0.0
Direct Loans	114.8	2,872.6	0.0
Loan Guarantees	23.2	12,095.9	0.0
Venture Capital Corporations	9.7	---	---
Industrial Revenue Bonds	22,800.0 d/	---	(4,025.0) e/

SOURCES: The Congressional Budget Office and the Office of Management and Budget.

a. Excluding promotions for agriculture and energy.

b. Includes only grants, not state technical assistance to small businesses.

c. Civilian research and development.

d. Figure represents total 1983 IRB issues, only a portion of which subsidize business through lower interest rates.

e. Federal revenue loss associated with the cumulative stock of state and local IRB issues.

targeted intervention would be beneficial, provided that it was better coordinated and "rational." Supporters of a traditional free-market policy, on the other hand, argue that there should be less, not more, government intervention. They hold that conventional monetary and fiscal policies are sufficient for the purpose. 3/ This paper does not attempt to pass judgment on the central question of whether governments can outplan the marketplace. It starts from the recognition that governments do continually intervene in the marketplace. It deals with the more immediate and practical policy issue--the division of responsibility between state and federal industrial support programs. Accordingly, it analyzes three aspects of state development programs: their stated goals and objectives; the relative advantages of federal and state governments in meeting these objectives; and the performance of state programs in promoting national economic growth and other federal goals. 4/

UNDERSTANDING STATE INDUSTRIAL SUPPORT

Generally, the goals of state industrial incentive programs are similar to those of the federal government: to foster employment and income growth. Every state spends some resources on attracting and maintaining businesses within its boundaries. Because political jurisdictions vary so widely in endowments and preferences these expenditures have produced a tremendously diversified mix of public services, subsidies, and taxes. What are the benefits and costs of these state programs?

This study judges the effectiveness of state development programs by the criterion of their benefit to the nation as a whole, rather than solely to the political unit offering the incentives. States, to use the words of a recent Urban Institute study, are "rationally parochial"--it does not matter to them whether jobs are new to the national economy or simply realloca-

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3. For a detailed discussion of these topics, see Congressional Budget Office, The Industrial Policy Debate (December 1983).

4. The primary focus of the paper is on state business promotion programs. Programs specifically aimed at distressed communities or social groups (such as the targeted jobs tax credit and proposed enterprise zone legislation) are excluded. Local programs are treated as the discussion warrants. This does not imply that local programs or distressed community programs are unimportant. Indeed, local property tax abatements, zoning, licensing, and other activities may be of more significance to businesses than many direct state business programs.

tions from other states. 5/ Judged by their actions, states clearly believe that incentives to firms are necessary for attracting, maintaining, and stimulating local economic activity. Questions persist, however, regarding whether these incentives are needed to stimulate new economic activity or are defensive measures to ward off raiding by other jurisdictions. The effectiveness of these subsidies may be of secondary concern to state legislators and administrators who feel the need to do something for business development, if only for political visibility. The history of state and local government use of such incentives, particularly the mushrooming of industrial revenue bond financing, suggests a great deal of defensive activity. The competition among states for economic advantage has led to a rising minimum level of assistance to firms for expansion or new starts. States competing must ante up this minimum level, plus some premium to attract and maintain business enterprises. Although not all states will choose the same economic strategy or offer the same incentives, the competitive process will tend to push up subsidy costs for all states.

Despite the large number of incentives offered to businesses by the states, there is little evidence that these programs do much to determine where firms will locate. Nor do they appear to have a significant effect on investment and job creation. The earliest studies of the relationship between business incentives and firm location concentrated on relative tax burdens among the states. 6/ Interstate tax differentials, like other forms of business assistance, have a financial impact on the firm's bottom line. These studies concluded that tax effects were not a significant factor in business location. Even though tax incentives did provide some subsidy, the actual costs of taxes were so small relative to other business costs that the effects could not be of major importance. In some (marginal) instances, however, the tax subsidy was found to play a determining role, since other factors balanced each other. This was most likely to be within a metropolitan area (where property taxes were a chief concern), or when a suitable site location straddled a state border. This suggests that intrastate

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5. Larry C. Ledebur and David W. Rasmussen, State Development Incentives (The Urban Institute, May 1983).

6. See, for example, John F. Due, "Studies of State-Local Tax Influences on Location of Industry," National Tax Journal (June 1961). Many of these points were reiterated in more recent work done by Michael Kieschnick. See for example, Taxes and Growth: Business Incentives and Economic Development (Council of State Planning Agencies, 1981).

relocation may be more malleable to special incentives than interstate. 7/ Even here, however, the number of such cases was quite small. Some studies gave added weight to tax incentives as an indicator of general business climate, which did influence a small portion of all business location decisions.

In 1969, Stober and Falk used a theoretical model to show how state and local subsidies could affect a firm's investment decision and locational choice. 8/ Their work suggested that financial inducements could be a strong factor altering locational advantages, even overcoming some labor cost differentials, particularly for capital-intensive firms that do not employ large quantities of labor in the first place. Their work, however, was largely theoretical and did not offer any empirical evidence. Moreover, they did not address the question of whether such inducements would be cost-effective from the issuing states' perspective.

Most current work, building on location theory, argues that firms' location decisions are dominated by fundamental long-run economic factors: the proximity to and size of markets; the availability and costs of labor, materials, energy, and land; and other economies of location (including agglomeration and transportation economies). 9/ Because these factors tend to outweigh any subsidy that affects only a relatively small portion of total costs, such subsidies will usually influence just a very few firms. The

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7. Intrastate competition for business location among localities is likely to be as fierce if not stronger than interstate competition. Such intrastate competition is, however, beyond the scope of this paper.

8. William J. Stober and Laurence H. Falk, "The Effect of Financial Inducements on the Location of Firms," The Southern Economic Journal (July 1969).

9. See, for example, Bennett Harrison and Sandra Kanter, "The Political Economy of States' Job Creation Business Incentives," Journal of the American Institute of Planners (October 1978); and James V. Jordan, Peter A. Sassone, and Ralph A. Walkling, "A New Test of State Industrial Development Policy," paper presented at the Southern Regional Service Association Meetings, Knoxville, Tennessee (1982).

percentage of new jobs created by firms moving across state borders has been estimated to be less than 1 percent of all job creation. 10/

The Issues of Federalism

For some purposes it is useful to think of states as sovereign entities that interact with each other much as independent nations do in international trade. The states measure their economic success by the standards of job creation and rising personal income, just as nations do. They seek to enhance their economic base by instituting various promotional programs, such as promoting exports, providing subsidies to local firms, and sponsoring job training.

But the states are obviously not independent nations. Unless state development programs serve to increase productivity and improve adjustment to market forces, they would, from a national perspective, only cancel each other out by competing, through subsidies, for the location of a fixed amount of economic activity. To the extent that the states only offset each other's policies, no net national benefit results from the vast number of development incentives offered by the states. National economic goals are more likely to be served if programs either create new economic activity or enhance the efficiency of market performance.

With the exception of aid to distressed regions, the location of economic activity is not a matter of explicit national policy. Absent government intervention, firms are assumed to locate in the most economic-

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10. The Advisory Commission on Intergovernmental Relations (ACIR) estimated that between 1969 and 1976 only 554 major manufacturing establishments (that is, those having 20 or more employees) changed locations from one state to another. This was 0.4 percent of all such manufacturing firms. See ACIR, Regional Growth: Interstate Tax Competition (March 1981), pp. 6-7. An MIT-Harvard Joint Center for Urban Studies report showed similar results for the 1970-1972 period. It estimated that only about 0.3 percent of the jobs added to the economy and about 0.2 percent of jobs lost were in branch plants that made interstate moves. In no state was the share of net job change attributable to "moving" plants ever greater than 0.5 percent. Peter Allaman and David Birch, Components of Employment Change for Metropolitan and Rural Areas in the U.S. by Industry Group: 1970-1972, as cited in Bennett Harrison and Sandra Kanter, "The Political Economy of States' Job-Creation Business Incentives," Journal of the American Institute of Planners (October 1978).

ally advantageous sites, based on natural geographic and market conditions. From a federal perspective, business should not need governmental inducements to locate in the most efficient places. To the states, however, it can be vitally important for both fiscal and employment reasons whether a firm locates within one jurisdiction or another, and firms may care a great deal about the level and types of government services available where they locate. State and local governments also may care a great deal about what firms locate within their jurisdictions. Firms differ in their use of government services and their contribution to the local economy and society.

Federal, state, and local governments all share in the goal of assisting business development and job growth. Whether one agrees or disagrees with these goals, the interactive effects of government programs imply that some delineation of responsibility among governments is necessary. Conceptually, the Constitution reserves to the states all governmental powers not specifically delegated to the federal government. Federal government powers include the regulation of interstate and foreign commerce, the coinage of money, and the conduct of international affairs. These powers are based on: the inseparability of actions that cross state boundaries; economies of scale in both program administration and access to resources; the need for setting rules and standards; and the (occasional) need to assign jurisdictional responsibility to an impartial authority not directly involved in local affairs.

State and local responsibilities are based on the fact that many differences exist among the regions and localities with regard to economic conditions, climate, geography, and even political and cultural preferences. State governments are closer and more responsive to the unique circumstances of their populations and locations. States have traditionally played the predominant role in such areas as education, roads and mass transit, and regulation of local commerce. Recently, as a result of Administration proposals, much attention has been directed at sorting out federal and state responsibilities. 11/ Issues raised by this debate remain unresolved.

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11. See, for example, Congressional Budget Office, The Federal Government in a Federal System: Current Intergovernmental Programs and Options for Change (1983) and Claude E. Barfield, Rethinking Federalism: Block Grants and Federal, State, and Local Responsibilities (American Enterprise Institute, 1981).

PLAN OF THE STUDY

Chapter II provides an in-depth look at current state economic development strategies. It discusses their goals and the policies adopted to achieve them. It also examines federal efforts that relate to these state goals, and the interaction between federal programs and those of the states.

Chapter III examines the pros and cons of state incentive programs, particularly with regard to their contribution to national economic policy. In Chapter IV alternative options for restructuring state and federal roles in this area are explored and analyzed.

CHAPTER II. CURRENT STATE ECONOMIC DEVELOPMENT PROGRAMS

The purpose of this chapter is to discuss the objectives of state business development programs and catalogue the programs used by the states to meet them. It also examines the size and structure of state outlays. 1/ Following are the objectives most commonly pursued:

- o Creating an attractive climate for all businesses;
- o Assisting small and new businesses;
- o Promoting international business;
- o Supporting research and development activities; and
- o Expediting economic adjustment through worker training, employment, and other labor services.

Traditionally, the states' role in business development has centered on providing infrastructure and establishing legal, political, and fiscal conditions to create a favorable "business climate." This was based on the idea that if a business was able to choose between an area with a favorable tax structure, readily available Industrial Revenue Bonds (IRBs), and adequate public physical capital such as good roads, and an area without these characteristics, it would decide to locate or remain in the former. Increasingly, however, it has become evident that these factors are marginal to a firm's location decision, which is more heavily influenced by specific market conditions, the availability of labor and materials, and other factors. Further, because all states now make use of IRBs, much of their incentive effect has been offset. In response, some states have begun to change their

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1. Quantifying expenditures made by the states in these areas has proved to be very difficult for several reasons: a lack of central reporting; differences in programs that render classification imprecise; and differences in data collection methods and fiscal years. Data for similar programs have been added together wherever possible. For simplicity, state expenditures are treated as if they were all made within the same time period, usually fiscal years running from July to June.

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economic development strategies, experimenting more and targeting them upon specific types of activity.

New emphases in the current programs include those of facilitating small business and "high technology" development. Many states believe these warrant government attention because the private capital market has not been favorable to them, and also because of competition from other states. These "new" state development strategies, however, represent an emerging trend rather than a predominant characteristic. The traditional infrastructure and tax incentive programs still absorb most of the resources devoted to business assistance. The state programs, moreover, are predominantly financed by industrial revenue bonds (IRBs), which generally do not permit their benefits to be restricted to particular kinds of business.

It is unlikely that states will voluntarily decrease their reliance on IRBs. Even though widespread use means that IRBs no longer offer a competitive advantage in attracting industry, to abandon them would clearly put a state at a disadvantage. As noted in Chapter I, the use of IRBs has become a prerequisite to offering other forms of assistance.

BUSINESS CLIMATE AND INFRASTRUCTURE

Taken broadly, the notion of business climate includes not only state assistance to business and the kinds of state regulations governing business, but also the qualitative factors that make one location more desirable than others, including access to recreation and cultural activities. In this section, however, the discussion of business climate is limited to tax incentives, industrial revenue bonds, and infrastructure improvements. Important but less tangible government services such as police and fire protection are not discussed, nor are educational systems, right-to-work laws, unemployment insurance, workers compensation, consumer protection laws, and other state regulations affecting business.

Tax Incentives

Tax incentives for businesses are special provisions offered to reduce tax liabilities for firms that engage in certain activities. These incentives are often referred to as "tax expenditures," since revenue forgone is equivalent to a budgetary outlay. Every state government uses its tax system in this way to promote or discourage certain types of business behavior. Interstate competition has led to a large number of these incentive programs, including property tax concessions, investment tax credits, and sales tax exemptions. The mix of incentives offered varies considerably among the states, perhaps reflecting differences in natural endowments and social preferences. 2/ It is impossible to estimate the aggregate revenues that states forgo through their use of tax breaks, but the costs must be very large.

Industrial Revenue Bonds

While 31 states offer tax incentives, all states offer industrial revenue bond financing. Industrial revenue bonds (IRBs) are tax-exempt bonds that state and local governments may issue to provide financing for private firms. In general, the only backing for the bonds is the credit of the borrowing firm. Since interest income from the bonds is exempt from federal taxation, they enable private businesses to borrow at below-market rates--the cost of the subsidy being borne largely by the federal government. 3/ Like tax incentives, the use of IRBs has grown substantially. Total IRB issues are estimated to have risen from $5.7 billion in 1975 to $22.8 billion in 1983, with $28.4 billion projected for 1985 (see Table 4). The Treasury Department estimates the revenue loss to the federal government in 1983 at $4 billion, for cumulative IRB issuances.

IRBs account for an overwhelming portion of all state resource commitments to industrial development, excluding infrastructure. For the most part, this financing is not targeted according to any strategic plan. While some states limit the kinds of investments qualifying for IRB financing, most seek only "targets of opportunity" in providing support through IRBs. The fact that the states have not been constrained in their use of this federal subsidy means that they have had no incentive to target or otherwise economize on its use.

The Deficit Reduction Act of 1984 sets limits on the provision of IRBs by state and local governments. It limits the amount of IRBs that can be issued within a state to the greater of $150 per capita or $200 million. Unless the states elect otherwise, 50 percent of this amount is allocated to local jurisdictions on the basis of population. Numerous transitional and

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2. See Table A-2, which shows ten categories of business incentives offered on a state-by-state basis.

3. For a detailed dicussion of industrial revenue bonds see Congressional Budget Office, Small Issue Industrial Revenue Bonds (September 1981).

TABLE 4. INDUSTRIAL REVENUE BOND FINANCING, BY TYPE, CALENDAR YEARS 1975-1985 (In billions of dollars)

Year	Pollution Control	Small Issue	Other a/	Total
1975	2.1	1.3	2.3	5.7
1976	2.1	1.5	2.5	6.1
1977	3.0	2.4	3.2	8.6
1978	2.8	3.6	3.2	9.6
1979	2.5	7.1	2.2	11.8
1980	2.5	9.2	2.5	14.2
1981	4.3	12.6	2.7	19.6
1982	5.9	12.7	4.1	22.7
1983	4.5	13.7	4.6	22.8
1984 Estimate	5.0	14.4	5.1	24.5
1985 Estimate	5.5	17.3	5.6	28.4

SOURCES: Department of the Treasury and Congressional Budget Office.

a. Includes activities such as sewage disposal, airports, and docks.

special provisions mean that the limits will probably have little immediate impact other than to obligate states to monitor more closely the volume of IRBs issued. In 1986 the tax exemption for small issues, except those used to finance manufacturing facilities, is to end. At that time the $150 per capita ceiling will be reduced to $100.

Infrastructure

Federal, state, and local governments have traditionally participated in providing infrastructure for two purposes: to achieve an efficient use of resources and to assure an equitable distribution of services. 4/ Infrastructure is defined here to include highways, public transit, wastewater treatment, water resource works (ports, canals, dams, etc.), airports, and municipal water supplies. In making infrastructure investments, each level of government has played its own role. State and local governments have financed projects with benefits that are primarily local in nature while the federal government has pursued national goals, although it also has involved itself in fundamentally local projects.

In addition to the objectives of achieving an efficient use of resources and ensuring an equitable distribution of services, states and localities also finance infrastructure to meet general and specific needs of business in their jurisdictions. As a rule, businesses require access to the same sorts of structures and services as the general population. A firm obviously would not choose to locate or remain in an area that lacked basic transportation or municipal water supply and sewer facilities. To this extent the provision of infrastructure is a prerequisite to any sort of economic development; a particular state or locality does not necessarily create an advantage for itself by providing it but would clearly be at a disadvantage without it.

It is not uncommon, however, for a state or locality to offer infrastructure specifically to attract or retain firms. In the early 1970s, for example, the state of New York financed several unprofitable branch railroad lines to induce a group of firms to locate near them. Such provisions obviously benefit the firms more than the general public.

States and localities also go to great lengths to promote the more outstanding features of their infrastructure. For instance, proximity to a large airport or a good deepwater harbor will be used as a major drawing card by a state or locality, although aggregate data on these sorts of incentives are not available.

The Federal-State Responsibility. States and localities, of course, finance significant portions of the nation's infrastructure--more than two-thirds of all highway investment, for example. Many projects are also financed through user fees paid by private firms and individuals: airports, for example, issued more than a billion dollars a year in municipal bonds between 1978 and 1982--almost all backed by future airport fees.

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4. For a detailed discussion of public support of infrastructure, see Congressional Budget Office, Public Works Infrastructure: Policy Considerations for the 1980s (April 1983).

Federal involvement in the financing of state and local infrastructure generally comes about after the initial stages of planning have been completed. The process consists of three stages: project nomination, appraisal, and finance. The financial terms provided by the federal government may exert considerable influence in determining which projects are nominated and analyzed. Nevertheless, nominations are primarily based on the perceptions of state and local officials as to the needs of their communities and their resources to meet these needs.

Table 5 shows federal and state or local capital outlays for selected infrastructure programs in 1983. Federal outlays amounted to an estimated $18.4 billion while the state or local outlays were just under $16 billion.

TABLE 5. ESTIMATED CAPITAL OUTLAYS FOR SELECTED INFRASTRUCTURE PROGRAMS, FISCAL YEAR 1983 (In billions of dollars)

	Federal	State
Highways	8.8	11.0 a/
Mass Transit	2.7	0.7
Airports	0.5	1.6
Water Resources	2.5	1.2
Wastewater Treatment	3.9	1.1
Total	18.4	15.6

SOURCE: Congressional Budget Office.

a. Includes local outlays.

SMALL BUSINESS ASSISTANCE

Most of the business incentives introduced by states within the last several years are aimed, in some way, at assisting small businesses. Awareness of the problems facing small businesses has increased dramatically in recent years as evidenced by a wave of state-sponsored small business conferences that were inspired by the White House Conference on Small Business held in 1980. By October 1983, 30 states had held small business conferences and seven more had proposed having one. The most pressing concern arising from these conferences was a lack of access to capital at rates manageable by small firms. Another problem frequently cited was that small businesses have difficulty in shouldering the burden of government paperwork and regulation. In a similar vein, managers of small businesses argue that high costs prohibit them from fully utilizing the judicial system to their benefit. State and federal governments have begun to address these concerns through financial assistance and other business aid.

Benefits and Liabilities of Small Business Assistance

Proponents of government assistance to small business argue the importance of small business to the U.S. economy. Recent studies indicate that small firms have accounted for a substantial proportion of the new jobs created in recent years. 5/ They also employ about one-third of the nation's workforce and have approximately 40 percent of the total assets and net worth of all non-farm, non-financial business. 6/ State development officials have begun to view the promotion of small business as essential to the success of their economic development plans. 7/

The key economic question, however, is whether the market difficulties of small-sized businesses are correctable by government action. One source of difficulty may lie in the supply of capital. Proponents of assistance to small businesses claim that private capital markets do not operate efficiently because: capital markets have oligopolistic or monopolistic elements that cause them to discriminate against small firms; investors may not have adequate information on small firms, leading them

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5. See, for example, David L. Birch, The Job Generation Process (Cambridge, Massachusetts: MIT Program on Neighborhood and Regional Change, 1979), or Catherine Armington and Marjorie Odle, "Small Business--How Many Jobs?," The Brookings Review (Winter 1982).

6. The State of Small Business: A Report of the President (March 1983).

7. The definition of "small business" varies among states. Some states use federal definitions. Others more flexibly define "small business" by limiting their assistance to levels that would only be attractive to relatively smaller firms.

to consider such firms riskier than they are; transaction costs may be too high for small firms, so that only their most profitable projects are fundable; and capital suppliers may be prejudiced for racial, political, sexual, or locational reasons against some firms, denying them funding for non-economic reasons.

A common complaint of small-business managers has been that capital is in shorter supply and more costly to them than to larger businesses. If this merely reflects the greater risk associated with investing in less-established firms, then government action is not appropriate. On the other hand, if these conditions exist because of market imperfections, some sort of market-correcting government intervention may be warranted.

Not all market imperfections are necessarily best corrected through capital subsidies. If the market imperfection arises from lack of information about markets and potential borrowers, for instance, it would seem preferable for the government to supply the missing information; both federal and state governments provide this type of "technical" assistance. The government may also assist small business through legislation to reduce the burden of regulations and paperwork, and to ensure equal access to the courts. Loosening up regulations that restrict pension funds to low-risk, long-term investments may be another measure, short of government subsidization, that would help to free up the capital market.

Advocates of capital subsidies to small and emerging businesses argue that these businesses lack access to venture capital. Against this one can point to a dramatic increase recently in the availability of private venture capital for new and emerging industries. On the other hand, there is some evidence of regional imperfections in capital markets. A review of 20 recently formed venture pools in 1980 revealed that the pools were more likely to invest in their own locale, where potential clients and contacts were available, even though none of the groups surveyed intentionally restricted themselves to a specific site. 8/ This suggests that in states where few private venture organizations exist, venture funds may be less available than they would be in a perfectly functioning market.

State Financial Assistance to Small Business

States try to fill perceived capital gaps for small business in a variety of ways, including:

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8. Venture Capital Journal (July 1980), pp. 9-11.

- Direct loan programs;
- Loan guarantee programs;
- Grant programs;
- State-chartered/funded venture capital corporations;
- Privately sponsored development credit corporations.

Most types of state assistance are available only if a firm has been unsuccessful at obtaining funds from private sources, but this is often quite easy to demonstrate.

Most states explicitly target their financial assistance to small business. Moreover, even in states that do not, the primary recipients are overwhelmingly small businesses.

Direct Loan Programs. In 1983, 21 states operated direct loan programs (see Table A-3). States obligated nearly $114.8 million to businesses through direct loans, about two-thirds of which was provided by one state--Pennsylvania. 9/ Fourteen of the 21 programs were explicitly targeted for small business, although in the other seven states small businesses were the primary recipients. The loan programs are generally administered by a state government agency, usually a state economic development authority or a department of commerce.

Loan Guarantee Programs. States guarantee loans to reduce lenders' risk, and to encourage them to extend credit to firms that would not qualify without the guarantee. In 1983, 11 states offered loan guarantees (see Table A-4). The total number of loans guaranteed was 126, amounting to about $23 million. Six states' programs were specifically targeted at small businesses, while the others primarily assisted small businesses.

Grant Programs. Four states (Alabama, Connecticut, Indiana, and Ohio) offer direct grants to small businesses, with Indiana granting the most (see Table A-5). In 1983, 42 grants for a total of about $5.4 million were awarded in these states. Because grants are not directly or immediately

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9. Several states offer direct loans to individuals or firms that are trying to bring a product or process to market. These loan programs are included in the discussion of applied research and development later in this chapter. See also Table A-10.

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repaid, states generally avoid making them. Ohio, however, has attached a royalty requirement to one class of its grants.

State-Chartered/Funded Venture Capital Corporations. The idea of creating public venture-capital corporations has received a great deal of attention by state legislatures (see Table A-6). Six states have actually instituted them--Alaska, Indiana, Maine, Massachusetts, Michigan, and Wisconsin--although Michigan's was never successfully implemented and Wisconsin's is not yet making investments. 10/ In fiscal year 1983-1984, the other four states authorized 46 investments for a total volume of $9.7 million. Alaska's corporation will begin phasing out in fiscal year 1984, and Indiana's, although initially capitalized by a state appropriation, is now a private, for-profit operation. Only Massachusetts's Technology Development Corporation and Community Development Finance Corporation are entirely public venture capital corporations--that is, operated as agencies of the state government with state funds.

Privately Sponsored Development Credit Corporations (DCCs). States also encourage loans through privately sponsored development credit corporations. DCCs are not state funded or state-run; they generate most of their capital from private sources. They are, however, chartered and regulated by the states in which they operate, and are sometimes known as Business Development Corporations.

Funds provided by DCCs are an important source of capital for small businesses, although DCCs do not limit their funds to small firms exclusively. The attraction of DCC loans is that the interest rates, although they are above prime, are lower than those that would be available to the borrowing firms from conventional lending sources.

Nonfinancial Assistance to Small Business

Regulatory Flexibility and Paperwork Reduction Legislation. Several recent studies have shown that smaller businesses bear a disproportionate

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10. The Connecticut Product Development Corporation (CPDC) might also be considered part of this group, although the CPDC's own view is that it is more of a research and development organization than a venture capital institution. The CPDC is discussed in the R&D section of this chapter.

burden in complying with federal and state regulations. 11/ To lessen this burden, 21 states have passed regulatory flexibility acts and six others have legislation pending (see Table A-7). 12/ Under these acts, state agencies are given the authority to analyze the impact on small business of proposed legislation and to adjust compliance and reporting requirements, standards, penalties, and schedules according to business size.

Closely related to regulatory burden is the problem of managing paperwork. Twelve states have passed paperwork reduction legislation, and three more have such legislation pending (see Table A-7). Several of these states have set up one-stop centers whose services range from specifying which forms need to be completed to providing a single system for obtaining the complete array of licenses and permits.

Equal-Access-to-Justice Legislation. Small businesses are often forestalled from taking legitimate legal action against a regulatory agency because of the large costs involved. Equal-access-to-justice legislation usually requires a government agency to reimburse a small business for court costs and attorney's fees when the business prevails against the agency. Fifteen states now have such legislation; five states have legislation pending; and in nine states it has been proposed and defeated (see Table A-7).

Minority and Women-Owned Business (MWOB) Assistance. In 1983, 31 states offered assistance to minority and women-owned businesses (see Table A-7). Most of this aid has been in the form of technical rather than financial assistance, including services such as identifying and registering MWOBs capable of contracting with the state, helping to develop financial management capacity, and linking MWOBs with potential sources of capital. Twenty-three states offer only technical assistance while ten others have MWOB set-aside requirements. In addition, four states--Louisiana, Maryland, Pennsylvania, and Texas--offer loan programs specifically for MWOBs.

State Procurement Legislation. By 1983, 12 states had legislated that a certain percentage of their agencies' purchases be with small businesses, (see Table A-8). The set-asides range between 5 and 25 percent. 13/

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11. See, for example, Roland J. Cole and Philip D. Teplen, Government Requirements of Small Business (Lexington Books, 1980); Roland J. Cole and Paul Sommers, "Costs of Compliance in Small and Larger Businesses" (U.S. Small Business Administration, January 1980).

12. U.S. Small Business Administration.

13. U.S. Small Business Administration.

The Federal-State Relationship

State activities to assist small business parallel federal efforts in many ways. At the federal level small business concerns are addressed primarily by the Small Business Administration (SBA), although several other federal agencies such as the Department of Housing and Urban Development and the Department of Commerce also sponsor some assistance programs. SBA makes direct loans and guarantees loans by banks and other institutions; licenses and regulates small business investment companies; guarantees payments of small business for required pollution control facilities; guarantees surety bonds for small contractors; and provides management and technical assistance to firms receiving SBA financial assistance and to small concerns buying from and selling to the federal government. Table 6 indicates the activity levels of the SBA from 1979 to 1983. It shows that SBA activity has largely reflected that of the economy, falling off with the recession in 1981 and picking up with the recovery in 1983.

Over the last two years, SBA has significantly increased the degree of its activity with state and local government economic development agencies and officials. In 1979, SBA started to hold small business conferences for state officials to provide a forum in which they could voice and address their concerns. Reports from five conferences show that the level of interest and involvement on the part of state officials has risen dramatically, and that the relationship between federal and state governmental officials has become increasingly cooperative and productive. 14/

The official involvement of the SBA with the states exists on a programmatic basis rather than as a general policy mandate. The program in which this involvement is greatest is SBA's Section 503 Certified Development Company (CDC) program, enacted in 1980 as an amendment to the Small Business Investment Act of 1950. Since then, 471 CDCs have been established.

A CDC may be organized as a private non-profit corporation or as a for-profit stock corporation. It may operate on a local, regional, or statewide basis. Of the 471 CDCs, 294 are local, 150 are countywide, and 27 are statewide. A CDC must include representation from all of the following groups: government at the appropriate level, a private lending institution, a community organization, and a business organization. Every

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14. The Administration has proposed a decrease in federal appropriations to the SBA in 1985. Proposed program cuts include the elimination of most direct loans and a reduction in loan guarantee levels from $3.3 billion in 1985 to $0.9 billion in 1989.

TABLE 6. SMALL BUSINESS ADMINISTRATION (SBA) ACTIVITY LEVELS, FISCAL YEARS 1979-1983 (In millions of dollars)

	1979 Actual	1980 Actual	1981 Actual	1982 Actual	1983 Program
Regular Business Loans					
Direct and immediate participation	218	219	205	115	85
Guaranteed	2,573	2,961	2,805	1,517	2,510
Total	2,791	3,180	3,010	1,631 a/	2,595
Handicapped Assistance Loans					
Direct and immediate participation	21	20	25	13	15
Guaranteed	1	--- b/	2	1	5
Total	22	20	27	14	20
Economic Opportunity Loans					
Direct and immediate participation	62	63	49	22	45
Guaranteed	34	25	20	13	60
Total	96	88	69	35	105
Solar and Energy Conservation Loans					
Direct and immediate participation	11	14	7	1	5
Guaranteed	2	11	7	1	15
Total	13	26 a/	14	3 a/	20
Vietnam and Disabled Veterans Loans					
Direct	--	--	--	--	25
Guaranteed	--	--	--	--	--
Total	--	--	--	--	25

(Continued)

TABLE 6. (Continued)

	1979 Actual	1980 Actual	1981 Actual	1982 Actual	1983 Program
Development Company Loans					
Direct and immediate participation	42	45	6	--	--
Guaranteed	31	30	67	100	250
Total	73	75	73	100	250
Small Business Investment Companies					
Direct and immediate participation	22	32	41	26	35
Guaranteed	87	149	160	134	160
Total	109	181	201	160	195
Business Loan and Investment Fund					
Direct and immediate participation	376	393	333	177	210
Guaranteed	2,728	3,176	3,061	1,766	3,000
Total	3,104	3,569	3,394	1,942 a/	3,210
Disaster Loans					
Physical	1,375	1,118	1,473	237	c/
Nonphysical	34	119	49	--	--
Total	1,409	1,237	1,522	237	c/
Pollution Bond Guarantees	40	99	100	51	250
Surety Bond Guarantees	1,391	1,534	1,382	764	1,200

SOURCE: U.S. House of Representatives, Committee on Small Business, Summary of SBA Programs (February 1983).

a. Discrepancy from rounding.

b. $300,000.

c. Open-ended subject to availability of funding.

CDC's incorporation papers state that its primary purpose is to assist business, especially small business, and that profits or other benefits are incidental to the CDC and its shareholders. In general, the state or local government representatives on CDCs are heavily involved with the administration and allocation of funds.

INTERNATIONAL BUSINESS PROMOTION

Concern over the U.S. trade deficit--about $65 billion in 1983--and the international competitiveness of particular U.S. industries has led to a search for ways to deal with these problems. Since 1970, state governments have become increasingly active in international business promotion--both of trade and foreign investment.

Initially, the states were reluctant to become involved in the international marketplace and did not until encouraged by the federal government. Soon they began to expand the scope and variety of their efforts until by 1980 the total of all annual state budget expenditures for international business promotion almost equalled that of the U.S. Department of Commerce. In 1983, state expenditures were approximately $36 million. 15/ Whereas during the 1970s most state involvement was concentrated on attracting foreign investment, over two-thirds of these expenditures are now on export promotion.

Individually, states believe they have a great deal to gain from successful trade development programs. Along with increased employment, tax revenues, and income, states having a strong presence in international markets are often buffered from domestic economic downturns--although at the expense of not reaping the full benefit of upturns. 16/ This is because of the countercyclical benefits of foreign trade that come about when recessions do not occur simultaneously around the world. Such benefits may be more highly valued during downturns in the U.S. economy than the losses from missed opportunities during expansion.

Benefits and Liabilities of Export Promotion

The effect of government export subsidies is ambiguous. Theoretically, in a world with flexible exchange rates, export subsidies are self-

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15. Estimated by the Congressional Budget Office.

16. John M. Kline, State Government Influence in U.S. International Economic Policy, (Lexington Books, 1983), p. 54.

defeating for the economy as a whole. While they may increase sales of the subsidized products, the increased demand for dollars in foreign exchange markets to pay for those purchases will cause the value of the dollar to rise. This in turn will dampen demand for all other exports and increase the demand for imports, leaving the overall trade balance unchanged. The net effect is a change in the composition of trade favoring subsidized products. Nevertheless, individual states may see it as within their interests to support in-state industries, if they can be fairly certain that out-of-state industries will bear the burden of compositional changes in the traded sector.

State Programs

Many state officials believe that there is a significant potential for encouraging additional U.S. exports, particularly in their jurisdictions. They feel that many small-to-medium-sized businesses do not export primarily because they lack the technical and managerial expertise necessary to trade internationally. State governments, because of their proximity to their constituents and their relatively more flexible and less complex bureaucracies, believe they are in a good position to respond quickly and appropriately to the needs of the small- and medium-sized firms within their boundaries.

States pursue three fundamental strategies in trade development. These are: to assist in the start-up of new firms that will export (assuming these firms will hire in-state employees); to encourage foreign firms to locate in the state; and to help existing in-state firms increase their sales abroad (assuming that this will not cause a decrease in sales of other in-state firms). Within these three strategies, states offer two general types of direct assistance to potential trade participants--technical assistance and export financing.

Technical Assistance. By far the greatest amount of resources devoted to international business promotion by states go for technical (non-financial) assistance--approximately $30 million in 1983. Many states maintain foreign offices that provide market knowledge, presence, and government contacts, enabling firms to establish foreign sales, distribution, and service networks. States with offices abroad increased from 19 in 1976 to 33 in 1980. These ranged from a single contract consultant to three of four fully staffed offices for a total of 66 overseas offices. The offices began as an effort to attract foreign investment but are now predominantly engaged in the promotion of state exports.

At home, states provide firms with market diagnostic services, information on trade opportunities, marketing assistance, help in organizing trade missions and trade shows, export seminars, foreign buyer programs, promotion of tourism, and guidance to federal resources. On average, each state offers about seven of these programs or activities (see Table A-9). Nevada's International Trade Focus program, for example, is a computer-based program designed to provide cross-references on products, manufacturers, and markets for foreign buyers attending major trade shows in Las Vegas. The information contained in the computer enables officials to match visiting firms with local ones. The service, for which no fee is charged, was developed under the terms of a U.S. Department of Commerce, Economic Development Administration (EDA) grant.

Multistate trade promotion efforts, which originated in the EDA Title V regional commissions but were eliminated with them in 1980, are attracting renewed interest, this time from the states themselves. Multistate efforts offer obvious advantages to their participants in shared costs, larger trade missions and catalogue shows, increased information dissemination, and rotating responsibility. Thus, the Mid-South Trade Council, formed by the export offices of state development agencies in Alabama, Arkansas, Mississippi, and Tennessee, and the International Trade Mart in New Orleans, is a loose-knit council that shares trade leads and sponsors joint catalogue shows and trade missions. State officials have convened to discuss or participate in joint trade initiatives in the Upper Great Lakes region (Illinois, Indiana, Michigan, Minnesota, Ohio, and Wisconsin), the Northeast (Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, and Vermont), and the West (Arizona, Utah, New Mexico, and Nevada).

Export Financing. Approximately 95 percent of total U.S. exports are financed by commercial banks and exporters. 17/ Public financing of non-agricultural exports traditionally has been limited to the Export-Import Bank (Eximbank). Most of Eximbank's clients are larger firms; only 3 percent of the dollar volume of export business assisted by Eximbank in 1982 directly involved small businesses. 18/ One reason for this is the greater administrative costs of servicing small loans. Eximbank has done little to sell its services to small business or to promote exports needing only small-sized financing packages. Several provisions of the Eximbank Reauthorization Bill of 1983 are intended to alter this situation. One

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17. Study of State Export Financing Needs: Report on Phase I (First Washington Associates, 1983), p. 42.

18. Testimony of William H. Draper, III, President and Chairman of the Export-Import Bank of the United States, before the Committee on Small Business, United States Senate, April 7, 1983, p. 12.

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requires that Eximbank set aside 6 percent of its total expenditures in 1984 for small business assistance, increasing to 10 percent in 1986. The bank is also directed to use (an unspecified) part of the small business set-aside to provide lines of credit or guarantees to state export finance agencies, smaller banks, export trading companies, export financing cooperatives, small business investment corporations, or other financing institutions that serve small business.

State government officials are showing great interest in developing their own financial mechanisms to support exporters. Such financing is currently available in eight states, although only three programs--Indiana, Minnesota, and Ohio--were operational at the end of 1983 and none had yet closed a financing agreement. Many state economic development agencies, however, are beginning to consider making export financing a major component of their economic development programs (see Table 7).

States have found it difficult, however, to pass and implement export finance legislation. When they have done so, the capitalization of funds has been arranged so as to minimize the costs and risks to state budgets. Of the eight states that have passed legislation, only two have capitalized their funds with state appropriations (Minnesota has appropriated $2 million and Indiana, $4 million). Five others have authorized bond issues for a specified amount. The remaining state, Ohio, has authorized up to $100 million of the state's normal cash deposits in state depositories to be used for loans at lower-than-market rates for small business exporters. The depositories are responsible for lending and collecting on loans made for this purpose.

Although specific state programs vary, their aims are similar in that they are directed at the small and medium-sized firms that lack the reputation and/or resources to secure financial support from commercial banks or federal sources. Five basic types of options have been implemented or are under serious consideration by the states for export financing: exporter finance counseling, exporter guarantees, medium-term funding, export credit insurance, and Eximbank delivery programs. A recent study has estimated that of these five, medium-term fixed-rate funding offers the highest leverage factor to states (i.e., exports generated relative to net costs) although it is the only option of the five that requires a substantial amount of state money. 19/

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19. For details see Study of State Export Financing Needs (First Washington Associates).

TABLE 7. STATE ACTIVITIES IN EXPORT FINANCING, JULY 1983

Export Financing Available	Legislation Pending	No Legislation but Seriously Considering	State Constitutional Prohibition	No Current Activity
Illinois	New Jersey	Arkansas	Alabama	Alaska
Indiana	New York	California	North Carolina	Arizona
Louisiana	Utah	Connecticut	Virginia	Colorado
Minnesota	Washington	Georgia		Delaware
Ohio		Iowa		Florida
South Carolina		Maryland		Hawaii
Tennessee		Massachusetts		Idaho
Wisconsin		Michigan		Kansas
		Mississippi		Kentucky
		Missouri		Maine
		Oklahoma		Montana
		Oregon		Nebraska
		Pennsylvania		Nevada
				New Hampshire
				New Mexico
				North Dakota
				Rhode Island
				South Dakota
				Texas
				Vermont
				West Virginia
				Wyoming

SOURCE: National Association of State Development Agencies, Trade Monitor (July 1983), pp. 2-5.

The Federal-State Relationship

The federal government's influence over international trade manifests itself largely through its macroeconomic policies, its treaties, and through the institutions it has set up to respond to the needs of domestic and foreign traders--namely the U.S. Departments of Commerce, State, Treasury, and Agriculture, the U.S. Trade Representative, the Export-Import Bank, and the International Trade Commission.

In macroeconomic policy, the combination of large government budget deficits and anti-inflationary monetary policies is having a major impact on U.S. trade performance. High interest rates have drawn significant amounts of foreign capital into the United States. This has proved to be a mixed benefit. Without the capital inflows, the crowding out of interest-sensitive expenditures would likely be more severe. On the other hand, the capital inflows have pushed up the dollar exchange rate and thus weakened U.S. ability to compete internationally, putting heavy pressure on U.S. export and import-competing industries. 20/

The states have also begun to play a role in international trade, by developing formal and informal overseas relationships. These networks have been fairly successful in promoting individual states' exports; the states are rapidly expanding their foreign relationships, instigating some debate over the proper role of states in facilitating trade. 21/ Much of the controversy has focused on the question of whether state activities encroach upon the treaties and the treaty-making powers of the national government.

An historical survey has shown that in general the conflict of state policies with international treaties has not been a problem, as the national government has successfully defended its supremacy in direct legal challenges by the states over national treaty powers. 22/ Nevertheless, new state export finance proposals may conflict with national treaty obligations such as the General Agreement on Tariffs and Trade (GATT) and the OECD Arrangement on Export Credits. At present, only one type of state export

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20. For details see Congressional Budget Office, The Economic Outlook (1984).

21. The U.S. Constitution, Article I, Section 10, forbids states to "enter into any Treaty, Alliance, or Confederation" with a foreign power without Congressional approval.

22. Kline, State Government Influence, p. 17.

financing proposal, medium-term fixed-rate funding, is potentially troublesome since terms for such financing are subject to GATT rules. [23]

As states increase their international business involvement, the chances of their activity conflicting with that of the federal government may increase as well. The current controversy surrounding the issue of state unitary taxation is a notable case in point. [24] Twelve states currently use the unitary tax method for computing corporate income taxes. In June 1983, the Supreme Court upheld California's right to tax multinational corporations, with operations in California, on a unitary basis. Since then, foreign-based corporations have complained that the unitary tax violates international tax treaties because it results in double taxation of earnings made outside the United States. A Treasury Department panel consisting of state governors, corporate executives, and other officials has been unable to resolve the issue, and in a recent report declared that federal legislation would not be sought to resolve the problem. Instead, Treasury officials suggested that states agree to limit their taxing powers to a firm's domestic operations.

In general, the relationship between state officials and their federal counterparts is productive and amicable. Jurisdictional disputes cause some friction, although not to the extent they did six or seven years ago. Recent efforts by the U.S. Department of Commerce may further ameliorate relations. In July 1983, Commerce initiated annual planning with state development agencies to coordinate activities in export promotion. The planning is of two types: "cooperative" and "integrated."

Cooperative planning is conducted primarily to coordinate activities in order to prevent duplication and overlap. Decisions are also made to cosponsor events such as trade shows. Integrated planning is conducted to organize events in which federal and local trade officials participate together, such as joint trade missions abroad. Most of the effort is expected to be concentrated in cooperative planning.

Another effort to coordinate federal and state trade promotion activities was initiated in 1981 by the U.S. Department of Commerce, the

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23. Study of State Export Financing Needs: Report on Phase VI, p. 5.

24. State unitary taxation requires that corporations be taxed on a prorata share of total earnings, including profits in other states and countries. This is desirable for the states because it inhibits underreporting of income by corporations and limits their ability to switch profits among subsidiaries to avoid state taxes.

National Association of State Development Agencies (NASDA), and the International Trade Committee of the National Governors' Association. Specifically, Commerce allocated funds to support NASDA assistance to states in building stronger export programs with the stipulation that they maximize coordination with federal government efforts. With the same intention, the Congress, in its 1983 Eximbank reauthorization legislation, has required that Eximbank promote small business exports and its small business export financing programs in cooperation with state agencies, the U.S. Department of Commerce, SBA, and the private sector. Eximbank also plans to increase interaction with state officials by providing them with training and other forms of assistance in utilizing their resources.

RESEARCH AND DEVELOPMENT

Public support for research and development (R&D), which accounts for about 50 percent of the total carried out in the United States, comes predominantly from federal sources. Total federal spending for R&D equalled $38.9 billion in fiscal year 1983. Ten agencies [25] provide over 97 percent of all federal R&D funding, with the Department of Defense accounting for nearly two-thirds of the total. [26] Increasingly states are beginning to view R&D as a mechanism to enhance their own economic development; state-originated funding for R&D is becoming an important component of state development strategies.

Benefits and Liabilities of R&D Support

The term research and development encompasses a number of activities. Research is classified, generally, as either basic or applied, according to the objectives. "Basic research" is conducted without specific applications in mind, while "applied research" seeks to determine the means by which a recognized market need may be met. "Development" refers essentially to the systematic use of research findings for the design and production of prototypes and processes. These three activities are generally

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25. Department of Defense, National Aeronautics and Space Administration, Department of Transportation, Department of Energy, Department of Commerce, Department of the Interior, Department of Agriculture, National Science Foundation, Department of Health and Human Services, and the Environmental Protection Agency.

26. For a detailed discussion of federal support for R&D see Congressional Budget Office, Federal Support for R&D and Innovation (March 1984) and Research and Development Funding in the Proposed Fiscal Year 1985 Budget (March 1984).

seen as part of a continuum extending between the two extremes of pure science and commercialization, without any clear demarcation.

Government support for R&D is often justified on the grounds that some socially desirable projects are unlikely to be funded by private firms. Because basic research is far removed from commercial use, it is least likely to be funded privately. Accordingly, a government role in supporting basic research has long been recognized.

Development (except in national defense) is thought to be the role of private firms, since products and processes at this stage of innovation are nearest commercialization. There is considerably less agreement, however, on the question of who should support applied research.

Those who advocate government support of applied research argue that basic research of itself offers few economic benefits, even in the long term. Also, since scientific advances are rarely restrained by national boundaries, their economic effects could not be expected to enhance the competitiveness of American industry.

Opponents argue that firms will bring projects through the applied research and development stages on their own when there are sufficient market incentives to do so. This reasoning is grounded in the notion that the market will perform as it should and that governments cannot improve on it in selecting viable products and processes. Opponents to increasing direct governmental support also frequently argue that the government would do better simply to enhance the environment in which innovation occurs. This could be achieved by: providing R&D tax credits, removing regulatory barriers to private joint R&D activities, and/or acting as a broker between private industry and universities.

State Programs

Until very recently, state R&D funding was primarily provided indirectly, in the form of exemptions from sales and property taxes on resources employed in R&D endeavors and through support of state universities. Fourteen states continue to provide these and similar sorts of tax incentives. [27] In 13 states, industrial revenue bonds can be used to finance research facilities. [28]

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27. Urban Institute, Directory of Incentives for Business Investment and Development in the United States (1983), p. 652.

28. Larry C. Ledebur and David W. Rassmusen, State Development Incentives (Urban Institute, 1983), pp. 3-12.

Increasingly, states are beginning to change the ways in which they support R&D. Specifically, they are increasing their direct support for applied research and development, becoming more involved both financially and administratively. This shift in emphasis is not surprising since applied research and development, by their nature, pay off sooner than basic research and thus offer more benefits in the short and medium term.

Direct state funding for applied research and development in fiscal year 1983-1984 existed in 17 states.[29] Total expenditures amounted to over $67 million (see Table A-10), with more than half concentrated in three states--Massachusetts, Pennsylvania, and New York. Most of these states are promoting university-industry research partnerships for R&D. These are being initiated with two general intentions: to allow industry to tap university resources (e.g., people, ideas, products, processes) and to provide universities with industrial input that may be conducive to the formation of theories that could eventually feed back to industry and apply to technological problems. Pennsylvania's Ben Franklin Partnership is a notable example. The Partnership, founded by the state in 1982, is a consortium of universities, companies, industry associations, labor groups, and, increasingly, venture capital organizations that conduct joint research projects, educational projects (e.g., filling federal job training gaps), and "entrepreneurial systems" to create marketable products, processes, and jobs. The projects are funded jointly by the state and private sources, the latter being required to provide 60 percent of the total. Total obligations (not just state funds) for all projects funded in 1983-1984 amounted to $38 million.

The Connecticut Product Development Corporation (CPDC), established in 1975, is unique among state R&D promoting agencies. Many, in fact, would consider it more of a venture capital institution than an R&D promoting agency, although the CPDC prefers to think of itself as the latter. The CPDC provides firms with capital for new product development, in exchange for royalty payments based on sales of the product. Typically, the CPDC provides 60 percent of development or acquisition costs of the new product. In return the firm agrees to pay CPDC a 5 percent royalty until five times the original CPDC investment has been repaid. In 1983, CPDC funded five projects at a cost of approximately $1.9 million.

Also gaining popularity are state-sponsored, university-run research parks, created to encourage actively the development of commercially useful products and processes. Illinois, for example, has established a biomedical research park in Chicago and is developing a $5.3 million

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29. A number of other states have proposals that are awaiting executive or legislative approval.

microelectronics center at the University of Illinois. Also, several states are taking a less involved approach by providing grants and/or loans for research that can be shown to be of potential commercial value. Iowa has recently appropriated $2 million for research grants to be used at in-state universities, with priority given to research projects that are most likely to produce marketable products and create jobs.

The Federal-State Relationship

The increased emphasis of the states on support for applied research and development has been more than offset by a decrease in federal civilian expenditures, which fell from $12.6 billion in fiscal year 1981 to $9.5 billion in fiscal year 1982. It has been argued that because successful innovation occurs on a continuum, all three stages of the process must be supported in order for any of it to contribute to economic growth. 30/ The present Administration believes that the private sector is best suited to support applied research and development activities, with the incentive of potential economic benefits. Non-defense basic research, in contrast, is receiving real increases in federal support. 31/

State and local government agencies also perform R&D, using federal dollars. 32/ Table 8 compares federal funding of state and local governments for the three stages of research. It shows that total obligations for applied research over fiscal years 1982-1984 are roughly four times the support afforded basic research, and two times that directed to development efforts.

The amounts in Table 8 represent a very small proportion of all federally funded R&D. In 1983, state and local government agencies (excluding universities and colleges) directly performed or administered: 0.6 percent of basic research, 1.4 percent of applied research, and about 0.3 percent of development (see Tables A-11, A-12, and A-13). Of this, the Department of Health and Human Services (primarily through its National

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30. For a detailed analysis of federal spending on R&D, see Congressional Budget Office, Federal Support for R&D and Innovation (March 1984).

31. Ibid.

32. Research and development activities by state and local governments include those performed either by state or local agencies themselves or by other organizations under grants or contracts from these agencies.

TABLE 8. TOTAL FEDERAL OBLIGATIONS TO STATE AND LOCAL GOVERNMENTS FOR BASIC AND APPLIED RESEARCH AND DEVELOPMENT, FISCAL YEARS 1982-1984 (In millions of dollars)

	1982	1983 a/	1984 a/
Basic	24.5	35.0	27.5
Applied	101.4	109.6	112.2
Development	58.4	65.5	49.4
Total	184.3	210.1	189.1

SOURCE: National Science Foundation, Federal Funds for Research and Development, Fiscal Years 1982-84, vol. 32, pp. 52-103 (September 1983).

a. Estimated.

Institutes of Health) provides most of the funding to state and local governments for basic research, while the Department of the Interior provides the most for applied research, and the Department of Transportation the most for development.

EMPLOYMENT TRAINING AND OTHER LABOR SERVICES

Federal and state governments have created various job training programs as one way of reducing unemployment. The most recent federal job training programs were established under the Job Training Partnership Act (JTPA) of 1982, replacing those mandated by the Comprehensive Employment and Training Act (CETA).

The primary philosophy underlying JTPA is that job training programs and other employment services are best administered by state and local governments, with heavy private-sector involvement. Many states, in addition to administering the federally funded JTPA training programs--39 in fiscal year 1983-1984--also fund training programs of their own. But while JTPA programs function primarily to assist the unemployed, state programs by and large are developed to serve as an incentive to businesses that are looking to locate or expand. This may be seen from the fact that only six of the 39 state programs are intended primarily to assist workers. States make funds available and train workers for specific eligible firms that need them, thus effectively lowering the cost to the firms of doing business in those states. Moreover, some states, such as Oklahoma and South Carolina, link their entire vocational and technical education systems to their economic development programs to ensure that local businesses will have trained workers. In as much as states count on the incentive effects of their training programs, it is obvious that they also fully realize and expect the concurrent benefits of having trained and employed workers for jobs for which they would otherwise not be qualified.

Benefits and Costs of Labor Training

Governmental support for labor training and other employment services has long been justified as a way of increasing job opportunities. Recently, it has been seen as a way of easing the problems created for workers and firms by economic transition. The belief is that when technological change outruns the capacity of the labor force to adjust to it, economic growth may be hindered and some workers may be unemployed for long periods of time.

If training and other services offer social and economic benefits that are national in scope, federal support may be appropriate. But it can be argued that sufficient economic incentives exist both for workers to train themselves and for firms to train workers. The former view assumes that the government can improve on labor market signals by subsidizing training and adjustment. The latter assumes that all individuals have equal opportunities to educate themselves and that all firms are equally able to provide training for workers.

Job Training

State Programs. In fiscal year 1983-1984, states spent approximately $122 million to train over 200,000 workers (see Table A-14). This represents a doubling since 1981, in both expenditures and number of workers trained. Thirty-nine states fund customized training programs. Thirty-one of these programs are targeted at attracting new and expanding firms. In general, states agree to train workers for particular firms that request assistance. In 29 of the 39 programs, the training is paid for entirely by the state. When some contribution is required from the firm, it is usually only special equipment necessary for the training courses.

In 16 of the 39 programs, firms are required to make a commitment to hire program trainees. States often require that a certain number of jobs be created by the participating firm both as a quid-pro-quo stipulation and to ensure that their programs are cost-effective.

State training programs primarily emphasize pre-employment and on-the-job training. Thirty-one states offer both types in their programs, five others offer pre-employment training only, and three offer on-the-job training only.

When states use their own revenues to finance training services, they can exercise greater discretion as to the firms they want to assist. For example, 16 of the 39 state programs target (though not necessarily limit) their eligibility to manufacturing firms. Most states (33 of the 39) stipulate that only new or expanding firms are eligible. Only eight states target a particular type of worker for assistance. Three programs target less-advantaged workers and five target dislocated workers.

Federal Programs. The federal government supports job training with four types of programs operated under the authority of JTPA: block grants to states, assistance to dislocated workers, the Job Corps, and other federally administered training programs. Of the four programs, as shown in Table 9, most federal funding is allocated through the block grants to states ($2.3 billion in 1983). Outlays for assistance to dislocated workers (of which training is only one of the allowable activities) amounted to $26 million in 1983; Job Corps outlays totaled $563 million.

The block grants to states (a consolidation of CETA categorical grants) are designed to involve the private sector integrally in the organization and distribution of training services. The intent is to make the allocation of training services more appropriate to the needs of workers and firms in particular communities than it was under CETA. It is estimated that over 1 million people will be trained under JTPA guidelines in both program years 1984 and 1985.

Federal/State Relationship. In job training, the relationship between the federal and state governments is very clearly defined. The JTPA mandates a "partnership" between the federal and state governments; their respective responsibilities are explicitly described in the law. In three of the four JTPA training programs, the state governments have primary responsibility for administering the funds.

Only a few restrictions are placed on block grants to the states and their service delivery areas: 90 percent of the participants must be

TABLE 9. FEDERAL TRAINING, EMPLOYMENT, AND LABOR SERVICES, FISCAL YEAR 1983 (In millions of dollars) a/

Federal	Outlays
Training and Employment	
Block grants to states	2,291
Summer youth employment	
Existing law	750
Proposed legislation	---
Assistance to dislocated workers	26
Job Corps	563
Older Americans employment	274
Work incentive program	289
Other training programs	294
Federal-state employment services	763
Expired programs	44
Subtotal	5,295
Other Labor Services	599
Total	5,894

SOURCE: Budget of the United States Government, Fiscal Year 1985.

a. Federal fiscal year.

economically disadvantaged, at least 40 percent of the resources must be spent for youth, and welfare recipients must be served on an equitable basis.

Of the funds for grants appropriated under Title III of JTPA to assist dislocated workers, 75 percent are distributed to states by formula and the remainder are granted to states at the discretion of the Secretary of Labor based on applications describing special needs. States that wish to receive federal funds for dislocated workers are required to match, dollar for dollar, their federal allocation. States whose unemployment rates are higher than the national average, however, get a reduction from their required match according to the number of percentage points their rates are above the average. Table 10 shows the distribution of federal allotments to states in 1983 for dislocated worker assistance, and the state matching requirements.

TABLE 10. JOB TRAINING PARTNERSHIP ACT, DISLOCATED WORKER AND STATE MATCHING REQUIREMENTS, FISCAL YEAR 1983 (In thousands of dollars)

States	Federal Allotment to States	State Matching Requirements	Total Program
Alabama	460.8	0.0	460.8
Alaska	34.0	27.2	61.1
Arizona	179.7	179.7	359.4
Arkansas	168.8	135.1	304.0
California	1,937.8	1,550.3	3,488.1
Colorado	148.3	148.3	296.5
Connecticut	169.4	169.4	338.8
Delaware	47.4	47.4	94.9
Florida	569.0	569.0	1,138.0
Georgia	303.4	303.4	606.9
Hawaii	42.1	42.1	84.1
Idaho	67.8	54.2	122.0
Illinois	1,204.2	722.5	1,926.7
Indiana	646.7	258.7	905.3
Iowa	215.5	215.5	430.9
Kansas	93.2	93.2	186.4
Kentucky	307.3	245.8	553.1
Louisiana	333.0	266.4	599.4
Maine	68.6	68.6	137.3
Maryland	342.3	342.3	684.6
Massachusetts	361.8	361.8	723.6
Michigan	4,446.2	0.0	1,446.2
Minnesota	231.3	231.3	462.7
Mississippi	200.1	120.1	320.2
Missouri	376.9	376.9	753.9
Montana	57.1	57.1	114.3
Nebraska	52.0	52.0	104.0
Nevada	70.9	70.9	141.9

(Continued)

TABLE 10. (Continued)

States	Federal Allotment to States	State Matching Requirements	Total Program
New Hampshire	48.0	48.0	96.0
New Jersey	560.5	560.5	1,121.0
New Mexico	83.8	83.8	167.7
New York	1,261.1	1,261.1	2,522.2
North Carolina	406.8	406.8	813.6
North Dakota	25.8	25.8	51.6
Ohio	1,288.5	515.4	1,803.8
Oklahoma	80.9	80.9	161.7
Oregon	279.2	167.5	446.7
Pennsylvania	1,118.3	894.7	2,013.0
Rhode Island	73.8	73.8	147.6
South Carolina	284.1	170.4	454.5
South Dakota	20.1	20.1	40.3
Tennesse	434.8	260.9	695.7
Texas	605.9	605.9	1,211.7
Utah	79.5	79.5	158.9
Vermont	27.0	27.0	54.0
Virginia	282.8	282.8	565.6
Washington	431.4	172.5	603.9
West Virginia	210.1	84.1	294.2
Wisconsin	460.6	368.5	829.1
Wyoming	13.1	13.1	26.3
National Total	18,750.0	12,952.9	31,702.9

SOURCE: U.S. Department of Labor.

NOTE: Totals may not add because of rounding.

States have the responsibility for developing and administering their dislocated worker programs, which may include: making workers aware of new occupations that require their skills; training workers in new skills; job search assistance; and relocation assistance.

The Job Corps, although a national program, operates on a local level through Job Corps centers administered by state and local government agencies. The Job Corps centers are required to be designed and operated so as to provide enrollees with education, vocational training, work experience, counseling, and other services appropriate to their needs. A Job Corps center may not be established within a state if the governor of that state disapproves it, lending states an additional degree of participation with the federal government with regard to training services.

Employment Services

Like training programs, the state employment services are funded by the federal government but administered by the states. Total federal outlays for the employment services in 1983 amounted to $763 million (see Table 9). The U.S. Employment Service is a nationwide no-fee system serving persons who are seeking employment and employers who are seeking workers. Services include job search and placement, recruitment for employers, and the gathering and dissemination of information on the labor market. Under the Wagner-Peyser Act, as amended by the JTPA, grants for the Employment Service are made to states under a formula based on each state's share of the civilian labor force and of unemployed individuals. These grants support 100 percent of the cost of job search and placement services to job seekers, and recruitment and special technical services for employers.

Employment Service activities that serve national needs, including interstate job listings, labor certification of aliens, and the Targeted Jobs Tax Credit programs, are conducted through specific reimbursable agreements between the states and the federal governments. (At present, states do not appear to be funding employment services of their own in addition to those offered by the federal government.)

CHAPTER III. ISSUES IN STATE DEVELOPMENT POLICY

The previous chapter has described the ways in which the states are actively pursuing business development. Because these programs are so new and their impact on business decision making so difficult to measure, it is impossible to estimate their effects. Instead, this chapter discusses the issues they raise: the division of responsibility between federal and state governments (federalism) and the advantages and disadvantages of state support for business.

PRINCIPLES OF FEDERALISM

Many of the activities described in Chapter II are undertaken jointly by the federal government and state governments, or separately but in parallel fashion. For example, both the federal government and some state governments operate separate, but parallel, export financing programs. Even where state and federal goals are the same, however, there has not been a great deal of coordination among programs. Moreover, no federal agency tracks the resources invested by states and localities in industrial promotion. This lack of accounting and coordination makes policies less effective and leads to duplication of effort on the one hand and conflicts of policy on the other. An example of the latter is the controversy over unitary taxation by the states, discussed in Chapter II.

These problems are exacerbated by disagreement over which level of government should provide particular services, and how they should be provided. A recent CBO study addressed these questions in the process of examining federal grant programs. 1/ The analysis provided by that study creates a useful theoretical framework for analyzing the specific advantages and disadvantages of state programs.

Characterizing Federalism

Three questions arise in evaluating the federal and state division of public policy responsibilities. First, is any government intervention called

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1. See Congressional Budget Office, The Federal Government in a Federal System: Current Intergovernmental Programs and Options for Change (August 1983).

for? Second, should it be the concern of federal or of state governments? Third, what form should federal or state involvement take?

This paper is primarily concerned with the second question--whether the federal or state governments should provide business incentives--and partially concerned with the third question--what form federal involvement should take--although the latter question is not taken up until Chapter IV. The question of whether any government support for business development should be provided is, of course, important. Since this support already exists, however, the study accepts that governments, both state and federal, have found ample justification for it. As noted in Chapter II, however, the justification is often contested.

Once a need for some governmental role has been established, the justification for federal involvement depends on the extent to which the problem is non-local in nature. Conversely, the justification for state and local involvement depends on the importance of local conditions and local impacts. In this context, states are often presumed to be more responsive to local conditions and the wishes of local voters than is the federal government.

Even if federal involvement is necessary, the form it takes will depend to some extent on the reason for intervention. In some cases the federal government will define its role as a source of funds and want the states to administer programs. In other cases the federal government will want to provide directly certain goods or services, bypassing state participation. These concerns will be elaborated more fully in Chapter IV.

Analyzing Federalism

Any assessment of intergovernmental relations benefits from having a set of standards to guide discussion. However, there are no universally agreed-upon standards for evaluating the relative merits of federal and state support of business. One of the most ambitious attempts to develop such criteria was undertaken by the Advisory Commission on Intergovernmental Relations (ACIR). 2/ The ACIR suggested five criteria--national purpose, economic efficiency, fiscal equity, political accountability, and administrative effectiveness. Although not exhaustive, they establish some of the principles needed to evaluate the relative strengths and weaknesses of state and federal programs.

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2. See ACIR, The Federal Role in the Federal System: The Dynamics of Growth (June 1981).

National Purpose. The traditional federalist position is that the federal government ought to exercise restraint in helping to solve problems hitherto viewed as the responsibility of the states. This position generally opposes attempts by the federal government to help state or local officials pursue local policy objectives. It would apply a strict test of national purpose to justify federal actions.

From this viewpoint, a strong federal role is most frequently justified by three major concerns:

- Spillovers or external effects--that is, costs or benefits from activities that cross jurisdictional borders;

- The efficiency advantages of centralized coordination; and

- Poor distribution of resources, especially for certain disadvantaged groups or regions.

The relative importance of these concerns varies among programs. Spillovers and administrative efficiency are significant considerations underlying federal support for environmental and infrastructure programs, while public assistance and regional development programs are motivated by concern over resource distribution. 3/

Economic Efficiency and Administrative Effectiveness. Economic efficiency would dictate that governmental functions should be assigned to those jurisdictions that are best able to perform them at a reasonable cost and level of effectiveness, based on economies of scale and on appropriate pricing policies. Administrative effectiveness has to do with questions such as legal authority, geographical jurisdiction, and management capability.

Fiscal Equity. This criterion emphasizes the "fairness" of assigning governmental functions on the basis of ability to encompass costs and benefits, capacity to tax, and ability to absorb financial risks.

In general, jurisdictions should be large enough to encompass the costs and benefits of a function they perform, and should be able to absorb any financial risk involved. For example, some trade experts doubt that state fiscal capacities are sufficient to bear the costs of export promotion. States have, however, shown an ability to exercise significant control over the scope of their fiscal and risk-bearing capacity. An examination of

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3. See Congressional Budget Office, The Federal Government in a Federal System (1983), p. 5.

recent state export financing legislation, for example, reveals a variety of financial mechanisms that states have developed to limit actual budget outlays and reduce the risks to local taxpayers. These strategies include issuing bonds for initial capitalization of exporting funds, using earnings from state investment portfolios, charging participants service fees, allowing principal and interest on bonds to be insured, charging rental fees on state property used by participants in conjunction with exporting, and acquiring loans, grants, and gifts from private and other public (e.g., federal) institutions.

Political Accountability. This criterion emphasizes: control, access by the public and accountability to it, and the maximizing of political participation by citizens. Although there is no reason to assume that state or local governments are more democratic or responsive than the federal government, they are presumably more directly representative of smaller populations than is the federal government. Local political interests may, because they represent more limited concerns, conflict with broader national interests. Federal programs are more frequently justified on administrative efficiency and equity grounds than on that of political accountability, although the need to harmonize conflicting local interests is obviously one of the strong points for federal action.

ADVANTAGES AND DISADVANTAGES OF STATE PROGRAMS

On the basis of the foregoing criteria, this section looks at the advantages and disadvantages of state support for economic development policies. It assumes, without prejudice, that existing state or federal programs are warranted. For example, the federal government provides, through a variety of channels, subsidies to encourage business investment, and this section accepts them as desirable. The question of how that support should be provided--whether through tax credits, grants, or loan guarantees--is left aside for the moment. The sole concern in this section is the advantages and disadvantages states might have in providing for the particular types of business support catalogued in Chapter II.

Major Advantages

States offer several advantages, primarily associated with decentralization, in providing economic assistance to business:

- Decentralized jurisdictions are better situated than the federal government to respond to the diversity in preferences, activities, and natural endowments that exists among the states;

- Decentralized governments are more likely to experiment and introduce new programs than is the federal government;

- To the extent that states supplement federal financing, more resources can be targeted at national economic problems; and

- Being closer to and more knowledgeable of local conditions, decentralized jurisdictions can better target incentives and fill in gaps left by broad federal policies.

Advantages in Responding to Diversity. Among the merits of decentralization is that it permits a closer connection between the government services offered and local preferences. This is particularly relevant when governments are forced by circumstances to balance their desires for economic development with the attendant effects, such as pollution, land-use charges, and population inflow. Local government units can adjust the levels of services and taxes to meet social preferences, and conversely people and businesses can locate where local governments provide the mixture of services and taxes they prefer. 4/ That is, governments compete like goods in the marketplace, and both enterprises and individuals can vote with their feet for governments they prefer. For example, New Hampshire and Massachusetts are geographically close states with widely different business development strategies, New Hampshire offers low taxes, low public services, and a low-wage labor force. Massachusetts, on the other hand, is one of the most aggressive states in offering a large number of business incentive programs. Wages, taxes, and public services are all higher in Massachusetts than in neighboring New Hampshire.

Greater Experimentation. Decentralized governments are often thought to allow greater democracy and popular control over decision making, based on local circumstances. Historically there has been more experimentation and quicker introduction of new ideas at the state and local levels than at the federal. The states have earned the appellation "laboratories of democracy" because of their ability to innovate and experiment. Such experimentation can benefit the nation because it spreads the risk of failure. Of the six states that had started venture capital agencies by 1981, four (Maine, Massachusetts, Indiana, and Alaska) still had operational agencies in 1983, and one (Alaska's) is due to be phased out in fiscal year 1984. The Massachusetts Technology Development Corporation (MTDC) invested $2,160,000 of its own funds in small, high-risk companies in 1983 and helped raise an additional $7,713,500 from private firms for this

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4. This is known as the "Tiebout effect." See Charles M. Tiebout, "A Pure Theory of Local Expenditures," Journal of Political Economy, vol. 64 (October 1956).

purpose. In contrast, Michigan's New Business Investment Company did not succeed in establishing itself. Had a single venture capital agency been established at the federal level, it might have failed to find the few niches where it could have succeeded, while starting a number of such agencies increased the chance that at least some might be successful. Diversification of policy, like diversified investments, reduces the danger that any one error will be devastating.

Cost Sharing through State Financing. As shown in Chapter II, many of the state incentive programs share the same goals and objectives as federal programs. States have cofinanced or replaced federal financing in some instances (as when state support for applied research increased after federal funding decreased). From the federal perspective, such cost sharing can only be viewed as a positive contribution to national economic policy.

Greater Awareness of Local Conditions. By its nature, the federal government cannot differentiate among the various localities and legislate for all of the specific circumstances that characterize individual areas. State governments have an advantage in this. For example, although the federal Job Training Partnership Act (JTPA) programs are organized and administered at the state and local levels, states continue to spend millions of dollars annually on their own customized training programs, often citing the need to transcend the restrictions on the use of JTPA funds in order to best serve their business constituents. At the local level, officials have greater knowledge and contact with small and emerging businesses than do federal administrators. At the federal level, Eximbank has found it difficult to assist smaller exporting companies, partly because of the greater expense of guaranteeing many small loans rather than a few large ones.

Major Disadvantages

State incentive programs have a number of disadvantages:

- To the extent that states merely change the location of economic activity, they only reduce economic efficiency by inducing firms to move away from technically efficient sites;

- The provision of state government incentives is dominated by poor budgeting policy;

- In some cases, national needs ought to take precedence over the desire of states to control incentive programs;

- Taken together, state programs tend to draw too heavily upon scarce management resources; and

- State programs lead to expensive bidding wars for locational advantage.

Locational Inefficiency. Firms will normally locate where they can achieve the lowest production costs and operate most efficiently. To the extent that government locational incentives work (even if they only work marginally, as suggested in Chapter I), firms may be induced to locate in suboptimal sites. 5/ If locational incentives do not work, states merely give away funds to businesses without really affecting what they do. Locational incentives make poor public policy unless they serve some other purpose such as minimizing the costs of supplying public services when revenues rise faster than service costs.

Poor Budgeting Policy. The use of IRBs, which are subsidized by the federal government but authorized by state and local governments, involves poor managerial incentives. IRBs are viewed by those approving them as an unlimited, free resource. Funds are handled off budget and are not accountable to or controlled by those providing the funds. Because states are enabled to shift costs to the federal government, they are often less careful about analyzing the costs and benefits of projects financed with IRBs. The only limiting influence is that of the financial markets in their evaluation of state and local bond issues. Moreover, the projects financed by IRBs do not always meet the criteria of providing more than strictly local benefits. Another poor budgeting policy is the use of tax abatements by local governments rather than the direct appropriation of funds for business development purposes.

Conflict with National Purpose. National policies can set uniform standards and take into account spillover effects that cross state or local boundaries. Nonfederal programs often have inherent disadvantages. For example, state export promotion programs are questionable on grounds both of foreign policy and national economic policy: they may conflict with treaty commitments such as those in GATT, and their economic gains may be at national expense.

Administrative Duplication. One significant disadvantage of state incentive programs is that, taken together, they call too heavily upon scarce management resources. The states have created 50 separate business

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5. See, for example, Walter Isard, Location and Space-Economy (1956), pp. 24-54.

development policies, requiring 50 separate management organizations to administer them (not to mention the thousands of city and county programs). Altogether, these require extensive use of scarce and high-paid managers. Indeed, the more ambitious and complex a program, the greater its need for qualified managers.

Another issue raised by some programs is whether they are by nature too large-scale to be economically operated on the state level. Infrastructure development, for example, although often administered by the state governments, has traditionally been organized and funded under federal aegis. Research and development programs often require the long-term commitment and risk-bearing ability unique to the federal government. Finally, to the extent that business incentives are used to stimulate the general economy, it may make more sense to locate decisionmaking responsibility in the federal government than with state governments.

Bidding Wars. States bid against each other to attract firms. But this gives each state an incentive to offer greater and greater assistance packages, if only for defensive reasons. The net result is an ever-spiraling subsidy to businesses for relocating inefficiently or for doing what they would have done anyway. The recent bidding by states to attract the Microelectronic and Computer Technology Corporation (MCC) is a strong case in point. MCC, a new joint R&D venture, had to establish its business home somewhere, and the unabashed subsidy war did not contribute to new economic activity.

CONCLUSIONS

Not all state-run economic development programs suffer from the defects outlined above. Each program and action must be assessed independently. The most common difficulty in evaluating state incentives is in deciding whether they are beneficial because they promote diversity and increased choice or detrimental because they lead to unconstrained bidding wars.

Are State Programs Beneficial?

The evidence is inconclusive. On the one hand, not all states pursue the same business promotion strategies. Some offer minimal services and low taxes; others provide more and charge more. But the fact that there are only 50 states, rather than the much larger number needed for true competition, coupled with the short-term political pressures to which state officials are exposed, tends to stifle any tendency toward greater diversity and choice. State strategies are generally aimed at a very few objectives--high-technology industry, basic manufacturing, or low-wage workers. Because of the limited number of players, competition over these objectives may result in states giving away more in subsidies than they are ever likely to recoup in greater tax revenues. Pennsylvania's "winning bid" for Volkswagen's U.S. manufacturing facility has been cited as an example of the tendency to overpay for business development.

The Volkswagen case is also a good example of the difficulty in evaluating state efforts. While the interstate competition offered Volkswagen a wider than usual choice of places to locate, the decision to locate in Pennsylvania may not have been best from the standpoint of technical efficiency. The question posed is: In the absence of government incentives, where was the optimal location for Volkswagen's American plant? If it was not New Stanton, Pennsylvania, then the business incentives offered Volkswagen to locate there only increased the costs to society.

Of course, the citizenry of New Stanton may see things differently. They were able to attract a major industry and secure employment for many people. The initial and continuing costs of doing this may appear to them to be justified. Moreover, they would probably argue that it was their right to choose to offer assistance to Volkswagen, regardless of how others might appraise the choice.

Some Generalizations

Despite the difficulty of achieving clear-cut answers to these issues, certain generalizations can be made about state incentive programs.

First, state programs promoting productivity and economic growth through new economic activity may be preferable to those that are purely relocational in intent, although it is often very difficult to distinguish between the two kinds. Such programs may include assistance to small business, R&D, and labor training, although even these may be questionable on overall economic grounds. To the extent that these programs improve the economy by expanding economic opportunities they are preferable to location subsidies that only rearrange (at a high price) activities that would have taken place anyway.

Second, states may have a clear advantage in targeting resources toward particular activities and filling in the gaps in federal programs, because of their greater proximity to and knowledge of local conditions. State and local governments may have more developed relationships with enterprises in their jurisdiction than can the federal government, although close relationships sometimes interfere with wise choices. States may have an additional advantage in serving small businesses, since federal agencies engaged in research and development or export promotion may be unable to overcome the high administrative costs of serving this clientele. In general, the superiority of decentralized jurisdictions for this purpose must be recognized.

Finally, state programs may enhance federal programs. For example, state employment training or small business programs complement federal efforts. Cost sharing in support of established policy objectives can only be beneficial.

How to divide state and federal responsibilities still creates theoretical and real problems, however. The federalist criteria sketched here may be useful in choosing among options. So will an understanding of the practical advantages and disadvantages of state programs. But they do not in themselves provide solutions to the difficult issues of federal and state policy. The next chapter examines some of the available options for federal and state support of business.

CHAPTER IV. OPTIONS FOR CHANGE

Federal and state programs for supporting business development were developed independently of each other. Hence in some cases existing governmental responsibilities are unclear, while in many cases they may be inappropriate. The Congress may wish to consider a number of options that would modify either federal or state roles (or both) in business incentive programs. Based on the analysis of Chapter III, three major strategies for modifying current federal and state programs suggest themselves--in addition to the option of making no change. They differ partly on the basis of how one views the costs and benefits associated with decentralized economic policy. The Congress could:

- Do nothing to change present federal support for state programs;
- Cut federal programs that support state development efforts;
- Control or coordinate funds or policies; and
- Turn back to the states federal programs and program funds that affect state development efforts.

Options for achieving these approaches are discussed below.

DOING NOTHING

While the present system of federal and state support for business development may not be ideal, there may be enough uncertainty over how to improve it to warrant leaving the system alone. Given the difficulty of deciding the merits of state economic development programs, together with the obstacles to finding a sustained workable balance among competing interests, and in the light of recent Congressional action to limit the use of IRBs, the Congress may determine that it would be better to let the current system seek its own equilibrium than to try to change it.

The competition among the states for economic advantage may have its own limits. While competition may provide benefits such as promoting diversity and improving market information, these gains may be offset by the negative effects on jurisdictions that overpay for business development, to the point where taxpayers demand that the programs be cut back. The recent defeat by Rhode Island voters of a proposed $250 million seven-year program for business development shows that there are political limits to such programs. Other constraints exist in the new limitations placed by the Congress on IRBs and other federal development programs, and in the capacity of the financial markets to supply private capital to state and local governments.

In the short run, however, competition among the states may lead to costly incentive packages. Moreover, the limits set by the Congress and by the financial markets are relatively loose and untargeted, so that federal support for state programs may continue to grow for some time despite the limits enacted on IRBs. Indeed, the growth of IRBs may crowd out some general-purpose state and federal government programs by raising interest rates on public offerings generally. Finally, the self-limiting aspects of the current system do not address the question of whether such programs serve to raise the level of national output or whether they merely change the composition of that output.

CUTTING FEDERAL SUPPORT

The Congress may decide that state programs are inefficient from a national perspective because of the disadvantages listed in Chapter III--for example, that they induce firms to move to suboptimal sites, or that they produce only local benefits at best. If so, it may choose to reduce federal costs by modifying or eliminating programs that now contribute to state incentives. Although it can be argued that states would increase their programs to compensate for the loss of federal funds, the amount of federal support is so large that they could not replace very much of it without redirecting resources from other programs. The federal government would cut its costs under this option, at least in the short run, unless states were able to compensate by passing on non-business assistance costs to the federal level.

The federal share of state incentive programs is largely made up of tax losses associated with state-issued industrial revenue bonds, amounting to over $4 billion in 1983. Accordingly, the best way to cut the federal cost of supporting state industrial incentives would be by further limiting the IRB program through:

- Disallowing tax-free treatment of IRBs; or
- Putting more restrictions on the use of IRBs.

Disallowing Tax-Free Treatment

A long-term option, not considered under legislation just passed by the Congress, might be to disallow completely tax-free treatment for IRBs. This would have the advantage of quickly and easily reducing general funding of business support activities. The Congress could even choose to give back to the states some portion of the revenue gain realized from taxing interest on private-purpose investment bonds. Calculating the tax gains to the Treasury and developing a scheme for rebating them might be difficult, but the principle of appropriating funds for development programs and making them transparent is a basic tenet of budgeting that should be considered. If half of the estimated $4 billion revenue loss was rebated to the states for direct expenditure, the average state program would be $40 million per year or $8.50 per capita. This option would lack selectivity, however, since it would not enable the Congress to reduce those activities deemed least worthy of support and to continue funding economically sound programs.

Limiting IRBs to Specific Activities

Many states have already limited the use of small issue IRBs to manufacturing and related facilities, or have otherwise curtailed the use of IRBs for certain purposes. The use of IRBs for service-sector industries has raised some controversy because many, such as retail stores and fast-food restaurants, are site specific and do not appear to be affected by marginal financing considerations. By limiting the use of IRBs to specific, economically dynamic activities, the Congress could reduce the overall volume of bonds issued while better targeting their benefits. This would support state business incentive programs but aim at focusing them better, reducing the possibilities for wastefulness and abuse, and encouraging the economical use of federal resources.

The Congress could reduce the federal role and encourage states to commit their own resources to projects by requiring state or local matching funds for IRB-supported projects. Alternatively, the Congress could remove all restrictions on IRBs and replace them with legislation that grants tax exemption only to bonds that are backed by the full faith and credit of the state or local governments. In either case, since governments would assume greater responsibility for IRBs, they would have an incentive to be more selective in issuing them.

CONTROLLING FEDERAL SUPPORT TO STATE INCENTIVE PROGRAMS

The Congress may want to retain the federal role in providing resources for state business incentive programs, but increase its control over the use of such funds. Although discouraging sovereign state governments from spending resources on policies they deem important is an extremely difficult task, the Congress could approach it by placing greater policy control in the hands of federal administrators to ensure that states follow productive strategies rather than pursuing locational activities that offset each other.

This strategy would allow states to continue their development programs while limiting, through federal oversight, some of the major disadvantages associated with these programs. This would increase the federal government's power to discriminate among programs by enabling federal officials to support or deny programs on the basis of national economic benefit.

Some have proposed the establishment of state development banks supported by federal funds. Such an arrangement is suggested in H. R. 4360, a bill reported out of the House Banking Committee, which would authorize a national industrial development bank to invest in the stock of public industrial development finance institutions established at the state, local, or regional levels. The national bank would hold at least one seat on the board of directors of every state development bank in which it invested. States would also be required to submit detailed plans to the federal bank delineating the states' programs, and justifying federal participation. State matching funds would also be required for federal participation. No support would be given for programs designed to attract businesses from other states.

One of the potential uses of such a bank would be to assert greater federal control over state programs. Essentially, the bank would function like a grants dissemination board, monitoring the projects funded to ensure compliance with federal standards. The board could choose to support constructive programs at the state level, like R&D, while denying other programs such as trade promotion. A major drawback of such a federal program would be the effect federal policy control might have on the independence of state programs. If the strengths of state programs are their diversity, independence, and willingness to experiment, then federal oversight through project approval can only be seen as weakening that advantage through its tendency toward homogenization.

Another drawback would be the need for the bank to decide whether an investment represented a relocation of business from one state to another or simply an expansion by an enterprise on its own. It might not always be clear when new investment was a relocation and when it was not, particularly for start-ups and new branches. The less clear the choice, the more likely that political decision making would replace strict economic criteria in deciding whether to support questionable investments.

DEVOLVING FEDERAL PROGRAMS

Many of the state incentive programs detailed in Chapter II are consistent with federal policies and goals. For example, research and development programs, export promotion, and small business development are pursued on the federal as well as the state level. In some cases, state administration of these programs may be more effective than federal administration. For example, states are more likely to have the knowledge and expertise required to run small business programs efficiently. States may also be able to do a better job of targeting incentives, such as export promotion, to businesses that need them, as opposed to simply offering generalized incentives to all firms. Moreover, state and local programs may meet diverse social preferences by increasing the amount of choice available to firms and individuals.

The Congress may want to consider encouraging independent state development programs to take advantage of state strengths in targeting, diversification, and burden sharing--essentially devolving federal authority to the states. One proposal under consideration in the Senate is to establish a formula grant system of federal aid to state economic development agencies. This is similar in concept to the House Banking Committee proposal discussed above, although it suggests less federal control and is consistent with the notion of encouraging state incentives and diversification of policy.

Although funding is not discussed in the Senate proposal, one way of accomplishing the goal of encouraging state incentives, while at the same time reducing federal costs and responsibility, would be to combine funds from federal programs already allocated for small business, export promotion, and other business development purposes--such as SBA funds, Eximbank funds already earmarked for small business, Economic Development Administration funds, Community Development Block Grants (CDBGs), and Urban Development Action Grants (UDAGs)--into one economic development block grant or, if greater policy control is desired, a block grant plus categorical grants to ensure that more supportable programs continued being funded while less desirable activities were reduced (see Table 11). 1/ Of course, program and administrative savings could be taken to reduce the overall size of federal expenditures while turning over responsibilities for these programs to the states.

In the case of SBA and the Eximbank, the Congress would need to determine whether loan and loan guarantee authority should also be granted to the states. If properly structured to give state officials an incentive to screen and rank projects--for example, by giving states maximum credit levels or guaranteeing the first portion of a loan with the remainder guaranteed by the state--such authority might not represent any additional risk to the federal government. If left open-ended, however, as with the power to issue IRBs, then the delegation of authority to the states could prove to be costly. Otherwise, the Congress could choose to give to the states only the direct outlay costs of these programs without the associated loan and loan guarantee authorities.

The obvious drawback of this proposal is that, unless categorical grants were added to the block grants, federal oversight would be lost. Once programs were turned back to the states, interstate competition for industry could lead to many of the negative features discussed in Chapter III--wasteful duplication, smokestack chasing, and bidding for unproductive relocations.

CONCLUSIONS

The key issues facing the Congress with regard to state development incentive programs are two: what to do about the overall level of federal funding for such programs, and how to address the question of federal control. These questions are clearly not separable. The federal government already supports state industrial incentives to a large degree through industrial revenue bonds and other federal programs. IRBs are not controlled at the federal (or state) level, and the incentives for states to use them appear to be increasing. Eliminating federal funding would not necessarily solve the problem of control. States would be free to continue their locational competition, although one can hope that they would abandon these activities if they were seen to be fruitless.

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1. CDBG and UDAG funds are, of course, already block granted to the states. This proposal, however, would combine them with other funds into a super block grant and redirect their intended purposes somewhat.

TABLE 11. ECONOMIC DEVELOPMENT PROGRAM FUNDS, 1983-1986 (In millions of dollars)

Function	Actual 1983	Estimate 1984	Proposed 1985
Current Grants to States			
Community Development Block Grants			
Budget authority	4,456.0	3,468.0	3,468.0
Outlays	3,554.0	3,900.0	3,900.0
Urban Development Action Grants			
Budget authority	440.0	440.0	440.0
Outlays	451.08	480.0	490.0
Potential Additional Grants			
Economic Development Administration			
Budget authority	268.5	240.0	0.0
Outlays	265.0	332.1	287.1
Small Business Administration a/			
Budget authority	256.7	208.9	229.5
Outlays	269.9	243.6	246.1
Direct loans	149.4	242.3	41.0
Loan guarantees	2,585.6	3,280.0	3,280.0
Export-Import Bank b/			
Budget authority	---	135.0	313.0
Outlays	---	103.4	130.8
Direct loans	---	231.9	306.4
Loan guarantees	---	600.0	800.0
Totals			
Budget authority	5,421.2	4,491.9	4,450.5
Outlays	4,539.9	5,059.1	5,054.0
Direct loans	149.4	474.2	347.4
Loan guarantees	2,585.6	3,880.0	4,080.0

SOURCE: Budget of the United States Government, Fiscal Year 1985.

a. Excludes disaster assistance.

b. In accordance with Section 618 of P.L. 98-181, figures for 1984 and 1985 represent 6 percent and 8 percent, respectively, of the bank's total loan, guarantee, and insurance authority.

Direct appropriations would increase the federal presence, and might make locational competition less likely. But exerting control through a mechanism such as a bank might be expensive. A bank might also dampen the flexibility and diversity that are found in state-supported programs. If current federal programs were reallocated to the states as block grant funds, the federal presence and expense might be reduced, but so would the power to check interstate rivalry.

Ultimately, the Congress (and the states) may want to address the more fundamental question of whether any of the business promotion programs cited in this paper serve to increase national income and raise living standards. Each by itself is subject to the criticism that it may not improve on market performance. Together, their only effect may be to change the composition of national output rather than to raise its level. They represent 50 unorganized and haphazard state industrial development policies, plus a national policy superimposed upon them but poorly integrated. The issue is whether a more rationalized and coordinated approach to the 51 industrial policies would improve national and state economic performance--or whether the nation would be better off without most of them.

APPENDIX

TABLE A-1. TECHNIQUES AND TOOLS OF STATE ECONOMIC DEVELOPMENT

Financial Incentives

- Grants
- Loans
- Interest Subsidies
  - Direct subsidies
  - Loan guarantees
  - Industrial revenue bonds
  - General obligation bonds
  - Umbrella bonds
- Equity and Near-Equity Financing

Tax Incentives

Nonfinancial Assistance

- Business Consulting
  - Management training
  - Market studies
  - Site selection
- Licensing, Regulation, and Permitting
- Job Training
- Research and Development
- Business Procurement Assistance
- Specialty Services

Improvement of the Business Environment

- Physical Environment
  - Public infrastructure development
  - Land banking
  - Speculative buildings
- Business Councils and Economic Development Corporations

SOURCE: Directory of Incentives for Business Investment and Development in the United States (The Urban Institute, 1983).

TABLE A-2. TAX EXEMPTIONS, DEDUCTIONS, CREDITS, AND SPECIAL TREATMENT, 1981

State	Job Creation Tax Credit	Investment Tax Credit	Property Tax Abatement	Business Inventory	Goods in Transit	Research and Development	Pollution Control Equipment	Industrial Machinery and Equipment	Industrial Fuels and Raw Materials	Energy and Fuel Conservation Measures
Alabama	O	O	X	X	X	O	X	X	X	O
Alaska	O	X	O	X	O	O	O	O	X	O
Arizona	O	O	O	X	X	O	X	X	O	X
Arkansas	O	O	X	O	X	O	X	X	X	X
California	X	O	O	X	X	X	X	X	X	X
Colorado	X	X	X	O	O	O	X	X	X	X
Connecticut	X	O	X	X	X	O	X	X	X	X
Delaware	X	X	O	X	X	O	O	X	O	O
Florida	X	X	X	X	X	O	X	X	X	X
Georgia	O	O	O	X	X	O	X	X	X	X
Hawaii	O	O	X	O	X	O	X	X	X	X
Idaho	X	X	O	X	X	O	X	X	X	X
Illinois	O	X	X	O	X	O	X	X	X	X
Indiana	X	X	X	O	X	X	X	X	X	X
Iowa	X	O	X	X	X	O	X	X	X	X
Kansas	X	X	O	X	X	O	O	X	X	X
Kentucky	O	O	O	O	X	O	X	X	X	O
Louisiana	O	O	X	O	X	O	O	X	O	X
Maine	X	X	X	X	X	X	X	X	X	X
Maryland	X	O	X	X	X	X	X	X	X	X
Massachusetts	X	X	X	X	X	X	X	X	X	X
Michigan	O	X	X	X	X	O	X	X	X	X
Minnesota	O	O	X	X	X	X	X	X	X	X
Mississippi	O	O	X	X	X	O	X	X	X	O
Missouri	X	X	X	X	X	O	X	X	X	O
Montana	X	X	X	X	X	O	X	O	O	X
Nebraska	O	O	O	X	X	O	X	X	X	X
Nevada	O	O	O	X	X	O	X	O	X	O

(Continued)

TABLE A-2. (Continued)

State	Job Creation Tax Credit	Investment Tax Credit	Property Tax Abatement	Business Inventory	Goods in Transit	Research and Development	Pollution Control Equipment	Industrial Machinery and Equipment	Industrial Fuels and Raw Materials	Energy and Fuel Conservation Measures
New Hampshire	O	O	X	X	O	O	O	X	O	X
New Jersey	O	O	X	X	X	X	X	X	X	X
New Mexico	O	O	O	X	X	O	O	X	X	X
New York	X	X	X	O	O	X	X	X	X	X
North Carolina	O	O	O	X	X	O	O	X	X	X
North Dakota	X	X	X	X	X	O	O	O	X	X
Ohio	X	X	X	O	X	O	X	X	X	X
Oklahoma	X	X	X	O	X	O	X	X	X	X
Oregon	O	O	O	X	X	O	X	O	X	X
Pennsylvania	O	X	X	X	O	O	O	X	X	O
Rhode Island	O	X	X	X	X	X	X	X	X	X
South Carolina	O	O	O	X	X	O	X	X	X	X
South Dakota	O	O	X	O	X	O	O	X	X	X
Tennessee	O	X	X	X	X	O	X	X	X	X
Texas	O	O	X	O	X	O	O	X	O	X
Utah	O	O	O	X	X	O	X	X	X	X
Vermont	O	O	X	X	O	X	X	X	X	X
Virginia	X	X	X	O	X	X	X	X	X	X
Washington	O	O	O	X	X	X	X	X	X	X
West Virginia	O	X	O	O	O	X	X	X	X	X
Wisconsin	O	X	O	O	X	X	X	X	X	X
Wyoming	O	O	O	X	X	O	X	X	X	O
Total	19	23	31	35	43	14	39	45	44	41

NOTE: X = has concession. O = does not have concession.

SOURCE: Larry Ledebur and David Rasmussen, State Development Incentives (The Urban Institute, 1983).

TABLE A-3. DIRECT STATE LOANS, FISCAL YEARS 1983-1984 a/

State	Number of Investments	Millions of Dollars
California	2	0.41
Connecticut	41	2.43
Florida	0	0.0
Hawaii	35	1.97
Illinois	7	0.44
Indiana	8	0.95
Kentucky	40	5.40
Louisiana a/	30	1.22
Maryland	6	0.45
Minnesota	11	0.73
Mississippi	4	0.22
Montana	11	1.34
New Jersey	35	7.16
New York	11	0.37
Ohio	2	0.19
Oklahoma	6	1.60
Oregon	5	1.38
Pennsylvania	234	74.09
Texas	2	0.30
Vermont	37	2.72
West Virginia	25	11.40
Total (21 states)	552	114.77 b/

SOURCE: Congressional Budget Office.

a. These loans had been approved but not yet disbursed.

b. Data collection methods differ among states so that totals reflect both calendar and fiscal year obligations, depending on the state.

TABLE A-4. LOAN GUARANTEES, FISCAL YEARS 1983-1984

State	Number of Guarantees	Millions of Dollars
California	74	4.82
Connecticut	1	1.20
Indiana	9	9.84
Louisiana	6	0.28
Maine	5	0.24
Maryland	8	1.50
Mississippi	5	0.25
Missouri	1	0.20
New Jersey	11	4.12
Ohio	5	0.56
Vermont	1	0.18
Total (11 states)	126	23.19

SOURCE: Congressional Budget Office.

a. Data collection methods differ among states so that totals reflect both calendar and fiscal year obligations, depending on the state.

TABLE A-5. STATE GRANTS, FISCAL YEARS 1983-1984

State	Number of Grants	Millions of Dollars
Alabama	3	1.15
Connecticut	1	0.96
Indiana	33	2.55
Ohio	5	0.73
Total (4 states)	42	5.39

SOURCE: Congressional Budget Office.

TABLE A-6. ACTIVITY OF STATE CHARTERED/FUNDED VENTURE CAPITAL CORPORATIONS, FISCAL YEARS 1983-1984

State	Number of Investment	Millions of Dollars
Alaska	12	1.52
Indiana	8	2.50
Maine	3	0.28
Massachusetts	23	5.36
Wisconsin a/	0	0.00
Total (5 states)	46	9.66

SOURCE: Congressional Budget Office.

a. Not yet operational.

TABLE A-7. STATE NONFINANCIAL ASSISTANCE TO SMALL BUSINESS, 1983

State	Regulatory Flexibility Act	Paperwork Reduction Act	Equal Access to Justice Act	MWOB Assistance a/	State Small Business Office
Alabama	--	--	--	X	--
Alaska	P	P	P	X	--
Arizona	X	--	X	--	--
Arkansas	--	--	--	X	--
California	X	X	X	X	X
Colorado	X	--	--	X	X
Connecticut	--	--	--	X	X
Delaware	X	--	--	--	X
Florida	--	--	--	X	X
Georgia	P	--	P	X	--
Hawaii	--	--	--	--	--
Idaho	--	--	--	--	P
Illinois	X	--	X	X	X
Indiana	--	X	--	--	X
Iowa	X	--	X	--	X
Kansas	P	--	X	X	--
Kentucky	X	--	X	X	X
Louisiana	--	X	X	X	X
Maine	X	--	X	--	--
Maryland	X	--	X	X	X
Massachusetts	P	P	X	X	X
Michigan	P	X	P	--	X
Minnesota	X	--	--	--	X
Mississippi	--	--	--	X	X
Missouri	--	X	--	--	--
Montana	X	--	--	--	--
Nebraska	--	--	X	--	X
Nevada	--	--	--	--	--

(Continued)

TABLE A-7. (Continued)

State	Regulatory Flexibility Act	Paperwork Reduction Act	Equal Access to Justice Act	MWOB Assistance a/	State Small Business Office
New Hampshire	X	--	--	--	--
New Jersey	--	P	P	X	X
New Mexico	--	--	--	X	--
New York	X	--	--	X	X
North Carolina	--	--	--	X	X
North Dakota	--	X	--	--	--
Ohio	X	--	--	X	X
Oklahoma	--	--	--	--	--
Oregon	X	X	X	X	--
Pennsylvania	X	X	X	X	X
Rhode Island	--	--	--	X	X
South Carolina	--	--	--	--	X
South Dakota	--	--	--	X	--
Tennessee	--	X	P	X	X
Texas	X	--	--	X	X
Utah	X	--	X	X	--
Vermont	--	--	--	--	--
Virginia	X	X	X	X	X
Washington	X	X	--	X	--
West Virginia	X	X	--	X	X
Wisconsin	P	--	--	X	X
Wyoming	--	--	--	--	--
Puerto Rico	--	--	--	--	--
Virginia Islands	--	--	--	--	--

SOURCE: U.S. Small Business Administration, The States and Small Business: Programs and Activities (1983).

NOTE: X = exists in that state. P = legislation pending.

a. Minority and Women-Owned Businesses.

TABLE A-8. TECHNICAL ASSISTANCE BY STATE AND TYPE OF ACTIVITY, 1981

	Trade Missions	Trade Shows	Mar-keting Assis-tance	Market Develop-ment	Export Educa-tion	Invest-ment Infor-mation	Invest-ment Missions	Adver-tising	Inter-national Tourism	Total Number of Pro-grams or Activities
Alabama	X		X	X	X	X	X	X		7
Alaska	X	X	X	X	X		X	X		7
Arizona	X	X	X	X	X	X			X	7
Arkansas	X	X	X	X	X	X	X	X		8
California	X	X	X	X	X	X	X	X		8
Colorado		X	X	X	X	X		X		6
Connecticut	X	X	X	X	X	X	X			7
Delaware	X	X	X	X	X	X	X	X	X	9
Florida	X	X	X	X	X	X	X	X	X	9
Georgia	X	X	X	X	X	X	X	X	X	9
Hawaii	X	X	X	X	X	X	X	X	X	9
Idaho	X	X	X	X	X			X		6
Illinois	X	X	X	X	X	X	X	X	X	9
Indiana	X	X	X	X	X	X	X	X	X	9
Iowa	X	X	X	X	X	X	X	X		8
Kansas	X	X	X	X	X	X	X	X		8
Kentucky	X	X	X	X	X	X	X	X	X	9
Louisiana	X	X	X		X			X		5
Maine	X	X	X	X	X	X	X	X	X	9
Maryland	X	X	X	X	X	X	X	X	X	9
Massachusetts	X	X	X	X	X	X	X		X	8
Michigan	X	X	X	X	X	X	X	X		8
Minnesota	X	X	X	X	X	X		X		7
Mississippi	X	X	X		X	X	X	X	X	8
Missouri	X	X	X	X	X	X	X	X	X	9
Montana	X	X	X	X	X	X	X	X	X	9
Nebraska	X	X	X	X	X	X			X	7

(Continued)

TABLE A-8. (Continued)

	Trade Missions	Trade Shows	Mar-keting Assis-tance	Market Develop-ment	Export Educa-tion	Invest-ment Infor-mation	Invest-ment Missions	Adver-tising	Inter-national Tourism	Total Number of Pro-grams or Activities
Nevada			X							1
New Hampshire			X	X	X	X	X			5
New Jersey	X	X	X	X	X	X	X	X	X	9
New Mexico	X	X	X	X	X	X				6
New York	X	X	X	X	X	X	X	X	X	9
North Carolina	X	X	X		X	X	X	X	X	8
North Dakota	X	X	X							3
Ohio	X	X	X	X	X	X	X	X	X	9
Oklahoma	X	X	X	X	X	X	X	X	X	9
Oregon	X	X	X	X	X	X		X		7
Pennsylvania	X	X	X	X	X	X	X	X	X	9
Rhode Island	X	X	X	X	X	X		X		7
South Carolina	X	X				X	X	X		5
South Dakota	X	X	X	X	X	X			X	7
Tennessee	X	X	X	X	X	X	X	X		8
Texas	X	X	X	X	X	X	X			7
Utah			X	X	X	X			X	5
Vermont	X	X	X		X	X	X			6
Virginia	X	X	X	X	X	X	X	X	X	9
Washington	X	X	X	X	X	X	X		X	8
West Virginia	X		X		X	X	X	X		6
Wisconsin	X	X	X	X	X	X				6
Wyoming	X	X								2
Total	46	45	48	41	46	44	35	35	25	Mean = 7.3

SOURCE: Export Development and Foreign Investment: The Role of the States and Its Linkage to Federal Action (National Governors' Association, 1981).

TABLE A-9. STATE PROCUREMENT SET-ASIDES, 1983

States	Small Business (Percentage of purchases)	MWOB (Percentage of purchases) a/
Alabama	10	--
Arkansas	--	10
California	5 b/	5 b/
Connecticut	15	4
Illinois	25	15
Kansas	10	--
Louisiana	10	2
Maryland	5 b/	--
Massachusetts	5	--
Michigan	--	Varies
Minnesota	25	6
Montana	Varies	--
New Jersey	15	--
New Mexico	--	20 c/
Oregon	--	Varies
Pennsylvania	--	--
Tennessee	25	--
Texas	10	--

SOURCE: U.S. Small Business Administration.

a. Minority and Women-Owned Businesses.

b. State gives an automatic 5 percent reduction on firms' bids for state contracts rather than setting aside a percentage of purchases.

c. Legislation pending.

TABLE A-10. STATE SUPPORT FOR APPLIED RESEARCH AND DEVELOPMENT, 1983

State	Millions of Dollars
Alaska	0.80
California	3.60
Colorado	0.00
Connecticut	2.86
Hawaii	0.30
Illinois	2.30
Maryland	0.60
Massachusetts	20.00 a/
Michigan	3.00
Minnesota	0.60
Mississippi	4.20
Missouri	1.34
New York	9.60
North Carolina	7.66
Pennsylvania	10.35
Tennessee	0.20
Washington	0.00
Total (17 states)	67.41

SOURCE: Congressional Budget Office.

a. Contingent upon attracting an equal amount from private sources.

TABLE A-11. PERCENTAGE OF TOTAL FEDERAL OBLIGATIONS FOR BASIC RESEARCH BY PERFORMER, FISCAL YEARS 1982-1984

Performer	1982	1983 a/	1984 a/
Intramural b/	26.7	27.0	26.8
Industrial Firms	4.9	5.0	5.0
FFRDCs-Industrial c/	1.6	1.5	1.5
Universities and Colleges	50.0	50.0	49.8
FFRDCs-University d/	9.4	9.5	10.0
Other Nonprofit Institutions	6.5	6.1	5.8
FFRDCs-Nonprofit e/	0.1	0.1	0.1
State and Local Governments	0.4	0.6	0.4
Foreign	0.5	0.5	0.5
Total f/	100.0	100.0	100.0

SOURCE: National Science Foundation, Federal Funds for Research and Development, Fiscal Years 1982-84, vol. 32, pp. 52-54 (September 1983).

a. Estimated.

b. Agencies of the federal government.

c. Federally funded research and development centers administered by industrial firms.

d. Federally funded research and development centers administered by universities or colleges.

e. Federally funded research and development centers administered by other nonprofit institutions.

f. Totals may not sum to 100 percent because of rounding.

TABLE A-12. PERCENTAGE OF TOTAL FEDERAL OBLIGATIONS FOR APPLIED RESEARCH BY PERFORMER, FISCAL YEARS 1982-1984

Performer	1982	1983 a/	1984 a/
Intramural b/	36.2	36.2	35.6
Industrial Firms	25.0	25.3	26.0
FFRDCs-Industrial c/	5.3	5.3	5.0
Universities and Colleges	17.5	17.2	17.0
FFRDCs-University d/	7.2	7.3	7.7
Other Nonprofit Institutions	5.1	5.3	5.0
FFRDCs-Nonprofit e/	1.3	0.9	1.1
State and Local Governments	1.3	1.4	1.4
Foreign	1.1	1.1	1.1
Total f/	100.0	100.0	100.0

SOURCE: National Science Foundation, Federal Funds for Research and Development, Fiscal Years 1982-84, vol. 32, pp. 71-74 (September 1983).

a. Estimated.

b. Agencies of the federal government.

c. Federally funded research and development centers administered by industrial firms.

d. Federally funded research and development centers administered by universities or colleges.

e. Federally funded research and development centers administered by other nonprofit institutions.

f. Totals may not sum to 100 percent because of rounding.