DOES DECENTRALIZED WELFARE REFORM LEAD TO A RACE TO THE BOTTOM IN LOCAL ECONOMIC DEVELOPMENT AND LOCAL PUBLIC SERVICES?

American Agricultural Economics Association Meeting, August 5-8, 2001, Chicago, Illinois – Selected Paper

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I Introduction

This is an era of localization of economic growth and redistribution policies in the United States. In 1996, Congress passed welfare reform legislation that gave the states authority over many aspects of welfare programs that had previously been designed and administered at the federal level. Fifteen of the states have carried welfare program decentralization to the county level, giving county governments authority to administer and even decide some aspects of welfare policy at that level[1].

Over the past decade, many local governments have created or expanded economic development departments or have increased the funds they provide to non-governmental or quasi-governmental economic development organizations. It is evident that policies on economic growth and redistribution are now set to an unprecedented extent at the local level. It is therefore imperative for us to identify the distribution of these policies and to determine whether localities with large number of welfare recipients engage in economic development policies that differ from policies of localities with relatively few welfare recipients. With the welfare reform act welfare recipients are required to work and are allowed a limited number of time to be on welfare[2]. This has implications for economic development that need to be addressed or examined. This work requirement places extra pressure on local governments to create new jobs for the welfare recipients to go to as they strive to leave the welfare benefit system.

The literature on local economic development hypothesizes that this desire of local governments to create jobs for their residents may lead to certain local economic development choices that may not necessarily be beneficial to the society or community in the long run.

The disparities between localities in the administration of local development activities results in the different counties or state governments implementing certain policies that would help them get ahead of their neighbors. These policies, however, lead to regressive development strategies that decrease the level of economic development and reduce the provision of local services. The literature on local economic development indicates that states, as small open economies, are in competition with each other. According to Oates and Schwab (1991), there is no doubt that states and local jurisdictions actively compete against each other for jobs, investment, and other assets that promote economic growth. It is argued that each state looks at the welfare level and development programs in neighboring states before setting their economic development plans. Although competition is agreed to occur by most economists the effects of competition on economic development is still a controversial subject. Whiles some authors state that interjurisdictional competition leads to increased efficiency, others view competition as detrimental to economic development. Irrespective of the views on competition, it is evident certain that competition influences the levels and types of development activities that occur in counties and states.

The term “economic development” is usually used to refer to an increase in area employment, income or both. It could also be regarded in general as an increase in economic well being of area residents and is manifested by positive changes in the level and distribution of area employment and per capita income (Wolman and Spitzley, 1996). By local development in the study refers to sub-state levels.

This paper theorizes that decentralization of local economic development activities and welfare reform leads to localities choosing non-optimal levels of economic development. The localities may then not have the resources needed to implement certain development activities. Consequently, these activities and public services are under-provided. We test the hypothesis that devolution of welfare programs leads to heightened intergovernmental competition and a “race to the bottom” in the provision of local public services. The results of the study should be of interest to Congress, federal agencies, state legislatures, and policy research organizations and citizens groups focused on welfare and rural affairs.

In section II of this paper we discuss the theoretical background of the study. Section III gives information on the sample and the data used. In section IV we outline the model used in the analysis of the problem. In section V, results are presented, and the final section summarizes the findings of the study.

II Theoretical Background

Blakely (1994), and Shaffer and Summers (1989) define community development as purposeful action to create or maintain local business activity and employment. Local governments have economic development as part of their portfolio of services provided to the community. To achieve economic development, government officials or policy makers often offer tax incentives to new businesses so that they will locate in their respective regions. In some cases, tax incentives designed to provide to capital and or labor to induce investment and to enhance employment opportunities are targeted at depressed urban or rural areas (Papke, 1994). The most common tax incentives include exemptions from or reduction of local property taxes, tax increment financing and income tax credit for employers hiring residents from within the region. Others may include low cost loans, free land or land write-downs, utility rate reduction, infrastructure improvement financing amongst others.

The literature shows that many local jurisdictions engage in strategic behavior to better position their county or local area to attract outside business. The public finance literature going back to a 1957 paper by Stigler argues that when capital is mobile between jurisdictions, redistribution of income cannot readily be financed at the local level. Local governments, which receive much of their revenue from taxes on industrial and commercial properties, compete for footloose business capital. Localities that raise taxes for redistribution may become less competitive as compared to localities that do not redistribute. More recent writings, particularly those of Wildasin and Brueckner, suggest that strategic interaction among local governments competing for mobile capital may lead to a Nash equilibrium in which each government sets its economic development activities in response to policies in competing localities. While studies by Brueckner and Saavedra hypothesize that localities set a lower than optimal welfare benefit level to avoid attracting welfare dependents, our study focuses on strategic interaction in economic development activities. Local governments often give tax incentives to attract firms. Tax abatements reduce the "bit" of taxes that, in many localities, fund schools, transit, and other services that are redistributive in nature. The widespread use of tax abatements to attract capital underscores the truth of Stigler's maxim: redistribution is difficult to fund at the local level when capital is mobile. The competitive behavior of local governments seeking to attract mobile capital may lead to under-provision of public goods and services compared to what citizen-taxpayers would be willing to provide, and may lead to a "race to the bottom," in which localities that already provide few or poor quality local public services of a redistributive nature cut back even further on these services in an effort to keep taxes. Currently, very little is known about how local administration of welfare-to-work programs affects the level and quality of local public services, especially education, housing, and public safety. There is the need for researchers to study these issues.

III Data and sample

A race to the bottom in the provision of redistributive services could occur at various levels of local government (county, municipal, township, or borough). This paper focuses on county governments, which are particularly important in rural areas in many states, providing public services that cannot be provided in a cost-effective manner by lower levels of government in sparsely populated regions. The study is based on a national survey of all county governments in 46 states. Survey questionnaires were sent county governments and appropriate persons (key informants) at the county level were asked to fill out the survey. Data were gathered on economic development programs, local public services, and welfare programs provided by county governments. A total of 1166 counties were used in the regressions.

Additional data from the Census of Population (US Bureau of the Census, 1996) and secondary data from the Regional Economic Information System (REIS) are also used in the study.

IV Methodological and model Specification

The study uses an econometric model to test for a race to the bottom in local economic development at the county level in the US. We regress the number of economic development activities in the counties on various socio-economic characteristics of the jurisdiction and the level of economic development in the counties. Linear least squares estimation is used in this study as a preliminary step. Ultimately, in the next phase of the research, a spatial model that allows for interaction among counties will be used.

We estimate a linear regression model of county governments where the behaviors under examination are the number and type of economic development policies. The level of economic development is used as the dependent variable in the model estimation. Explanatory variables include characteristics of the local economy, poverty levels in the county, whether there is competitive bidding between counties to attract businesses, existence of an industrial park, percentage of budget used to attract outside businesses, the share of manufacturing in total employment, and a zero-one variable indicating whether the county is located in a state that has devolved welfare reform to the county level. Some of the county characteristics include existence of property tax, location of county (either metropolitan or non metropolitan), amongst others.

We theorize that counties in which welfare has been devolved to the county level are more likely to engage in regressive economic development policies in an attempt to attract more businesses. The aggressiveness of neighboring counties or jurisdictions influences local officials decisions on levels of economic development and provision of public services. We therefore contend that there are spatial implications of devolution on local development policies. Since local officials are often most aware of the economic development practices of neighboring governments, we anticipate that strategic interaction is a spatial phenomenon. In the next phase of our research, we will test for the presence of a spatial lag and spatial autocorrelation, drawing on recent developments in spatial econometrics.

Some of the variables in our linear regression model are similar to those used by Clarke and Gaile (1992) and Saavedra (2000). Because some states have devolved welfare programs to the county level while other states have retained program control at the state level, we have a "natural control group" for testing the hypothesis that county-level devolution of welfare-to-work programs leads local officials to engage in more aggressive economic development policies than they would otherwise engage in. In particular, we hypothesize that county governments in states with county-administered welfare-to-work programs engage in greater use of tax abatements than county governments in states where welfare is administered by the state government.

The success of welfare reform depends heavily on whether or not employment grows in localities with large welfare populations. But if the lessening of central control over welfare programs leads to aggressive tax competition among local governments, local tax revenues to fund local social services may decline and the poor in some localities may be worse off. In an era of decentralized programs, it is important to examine whether the uncoordinated efforts of local governments may lead to self-defeating outcomes.

V Results and Analysis

The results of the study are given below. The coefficients of the variables all show the expected (correct) signs. The R-squared and adjusted R-squared are 45 and 44 percent. F-statistics of the regression show that the results obtained are significant at 1% levels. The regression output of the results is shown in the appendix.

The regression analysis tests hypotheses about whether decentralization of welfare reform leads to a race to the bottom in the level of economic development and local public services provided in a county. We consider counties with higher numbers of economic development activities to be more aggressive in their development policies and more likely to be engaged in a race to the bottom where the economic well-being of the poor worsens.

All the estimated variables are significant at the 1% levels except the share of manufacture in total employment, which is significant at the 10% level, and poverty levels, which is significant at the 5% level. The level of economic development activity in a county is significantly affected by whether the county is in a devolved state or not. Our result support our hypothesis that counties in devolved state are more likely to engage in aggressive economic development activities in an attempt to get ahead of competing neighbor counties.

The number of economic development strategies used by a county depends on whether it is in a metropolitan or non-metropolitan area. Our results show the metropolitan status of a county to be a significant ($p < 0.01$) determinant of the number of economic development activities in which county governments engage. The more metropolitan a county, the less likely it is to engage in numerous development activities to achieve economic development. In general, non-metropolitan areas have fewer market opportunities for employment creation and income expansion, and it is perhaps for this reason that they are more likely to utilize multiple economic development instruments.

The results also show that the percentage of a county's budget that is used to attract outside business is highly significant at the 1% level. Higher budgets for attraction purposes makes it possible for county governments to engage in more competitive economic development activities.

The regression analyses show that mere existence of competitive economic development bidding in a region leads to higher usage of aggressive development strategies. This variable is significant at the 1% level. When there is competitive bidding for outside businesses each county government will strive to use more attractive incentive packages so that the mobile capital moves into their region.

In our regression, we wanted to find out the effect of a property tax in a county on the number of economic development activities used by the local government. We therefore added a dummy variable to indicate whether a county has property tax or not. We find that the existence of a property tax is significant. Taxes in general a small but nevertheless important cost of doing business. Since property taxes in some states and localities are lower than in others, property tax reduction is a key objective of the tax abatements offered by many local governments.

The existence of a new or expanded industrial park in the county is also significant. Counties with industrial parks are likely to use incentives to get investors to locate there so that the industrial parks do not stay idle. Counties with new industrial parks and those seeking to expand existing ones will therefore use a higher number of economic development activities or firm specific strategies to get new firms and capital into the county.

The presence of an economic development official on the county government staff proved to be significant as well. Such personnel help typically initiate and implement the economic development incentives that a county government may offer to attract new business.

Poverty level and the share of manufacturing in total employment are significant at the 5% and 10% levels, respectively. Communities with high levels of poverty use are more likely to use aggressive economic development policies. Similarly counties with higher share of manufacturing in the total labor force are more likely to use aggressive policies, as compared to counties where manufacturing is less prominent.

VI Conclusion

In this study we use a linear regression model to test whether devolution of welfare reform to the county levels leads local governments to set regressive economic development strategies thus resulting in a race to the bottom. County governments in 46 states were surveyed and the survey data were used for the analysis. Secondary data are used to supplement the primary data from the survey.

We conclude that the number of economic development activities in the counties sampled is positively related to the poverty rate, percent of employment from manufacturing, existence of a property tax, and percentage of budget used to attract outside businesses and competitive bidding. All the above are significant at the 1% level except the level of poverty and the manufacturing percentage of total employment which are significant at the 5% and 10% levels respectively. The implication of the results is that these factors lead to the increased usage of aggressive economic development policies. The selection of aggressive economic development policies by counties with the created poverty rate could lead to a race to the bottom, though such a conclusion cannot be drawn without further testing.

There could very well be spatial implication in the setting of local development policies in counties especially if local government official in one county consider the economic development strategies of nearby counties before setting theirs. In subsequent research, we will test for the presence of spatial effects on the levels of welfare set and the provision of local public services. The effect of decentralization on the quality of local public services like education, housing, health care and public safety also needs further investigation.

Notes

1. States that have devolved welfare reform to the local levels include: AL, CA, CO, GA, MD, MI, NJ, NY, NC, ND, OH, SC, TN, and WI.

2. Welfare recipients are given limited time on welfare (two years without work activity and a maximum of five years throughout an individual's whole lifetime) and are also required to work to be eligible for benefits.

Appendix

Regression output

Dependent Variable: ECONDEV
Method: Least Squares
Date: 05/15/01 Time: 18:58
Sample: 1 1166
Included observations: 1166

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DEVOL	0.427197	0.131200	3.256071	0.0012
METRO	0.656788	0.142956	4.594335	0.0000
IND_PARK	0.980517	0.163695	5.989913	0.0000
EPD_PARK	0.924000	0.164671	5.611206	0.0000
DEVSTAFF	1.407181	0.143212	9.825893	0.0000
NEWFIRMS	0.011358	0.003133	3.625779	0.0003
COMP_BID	1.515495	0.142108	10.66439	0.0000
PROP_TAX	0.712973	0.165340	4.312152	0.0000
POVERTY	0.015918	0.006903	2.306029	0.0213
MANU	0.789285	0.443484	1.779738	0.0754

R-squared	0.448052	Mean dependent var	3.292453
Adjusted R-squared	0.443755	S.D. dependent var	2.768814
S.E. of regression	2.065033	Akaike info criterion	4.296709
Sum squared resid	4929.600	Schwarz criterion	4.340116
Log likelihood	-2494.981	Durbin-Watson stat	1.992952

Where:
- Econdev is the number of economic development activities in the county.
- Devol is whether the county is in a devolved state.
- Metro is a variable for whether the county is in a metropolitan area or non-metropolitan area.
- Ind_park is a variable that shows whether the county has a new industrial park.
- Epd_park is a variable that show if the county has expanded an existing industrial park.
- Devstaff show if the county has an economic development professional on staff.
- Newfirms is a variable the percentage of the budget that is used to attract outside businesses.
- Comp_bid shows whether a county engages in competitive bidding with other localities in the state to attract outside businesses.
- Prop_tax is a variable that shows whether property tax exists in a county.
- Poverty is a variable that shows the percentage of county population in poverty.
- Manu is a variable that indicates the share of manufacturing in the total employment in the county.

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