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## *Local Economic Development in a Global Market*

The vast majority of decisions affecting local economic development (LED) are made by private individuals or institutions. Often the decisions are made by persons living half a world away from the affected locality. These choices are generally made on the basis of self-interest after consideration of the costs and benefits. Many economic development practitioners seek to understand how market processes operate so that they can help their organizations make good decisions. Others seek to influence private economic decisions by affecting the real or perceived costs and benefits of decisions so as to stimulate economic development. In both cases, it is essential to understand how the market economy operates. This chapter describes how economists view economic activities and serves as a point of departure for understanding the development process.

### **How Economists View the World**

Students who have not studied economics sometimes fail to understand the role of models and assumptions in economic analysis, the economist's view of individual behavior, and how disagreements about policy can arise. A sketch of these important aspects of the economic paradigm will set the stage for further analysis.

#### MODELS AND ASSUMPTIONS

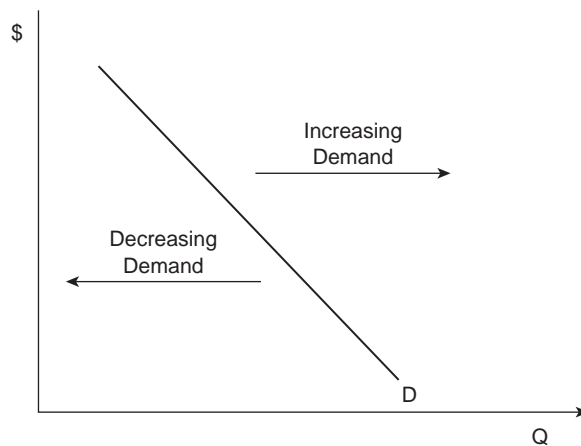
Economists often build deductive models to help understand economic processes. Models are deliberate simplifications of reality because the economy includes so many variables that interact with each other in so many ways that

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we can understand process only by focusing on a few variables at a time. The variables not under consideration are usually assumed to stay the same, the well-known “ceteris paribus” or “other things equal” assumption. For instance, when thinking about how quality of life may affect job growth, it is necessary to assume that the state of the national economy and other critical variables do not change when comparing areas. Otherwise, a city with very poor quality of life located in a fast-growing area might show higher job growth than a city with high quality of life in a slow-growing area.

An important application of the “other things equal” assumption is found in the law of demand. It states that if the price of a good falls, the quantity individuals are willing and able to consume will increase, holding other things equal. Figure 1.1 is a demand curve consistent with the law of demand; it slopes downward. Changes in tastes and preferences, incomes, the price of other goods, expectations, and market size could result in a situation where the relation between price and quantity demanded could appear to violate the law of demand. For instance, price and quantity demanded could increase at the same time if the size of the market also increased. Therefore, to focus only on the relationship between price and quantity sold, it is necessary to make explicit the assumption that everything stays the same except price and quantity.

Students often object to the many assumptions that are incorporated in economic models because they are unrealistic. In reality, other things do not



**Figure 1.1** The Demand Curve

NOTE: The demand curve shows how many units of a product consumers will purchase at various prices. Under some conditions, the demand curve represents social benefits. Thus, someone would value the 10th unit at \$5. Changes in income, market size, price of other goods, preferences, and expectations could cause the demand to increase or decrease.

remain equal, so why do economists assume that they do? The value of the assumptions is that they provide a systematic framework for analysis, and they may be relaxed so that the impact of changing certain assumptions may also be analyzed. For instance, the assumption that the size of the market or incomes do not change may be replaced by the assumption that market size or incomes increase. Then it can be shown that increases in market size or incomes will shift the entire demand curve to the right (called an increase in demand).

Spatial economic models are often predicated on unrealistic assumptions, such as perfect knowledge, profit-maximizing behavior, uniform transportation costs, consumers with identical tastes, and homogeneous space. The insights gained from these models can be increased if consideration is given to how the models will be affected if the assumptions were changed. Changing the assumptions of a model provides insights about the variables that were being held constant.

## INDIVIDUAL BEHAVIOR AND UTILITY MAXIMIZATION

For most economists, individuals are the building blocks from which group actions emerge, so it is important to understand what motivates them. The powerful assumption that economists make is that individuals are motivated to maximize their own utility. Money provides utility, but so do other things, such as love. In the sphere of economic development, money is usually the most powerful motivator, but individuals also receive satisfaction from things such as helping their community.

Adam Smith highlighted the importance of self-interest:

It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their own self-interest [in trying to get these things]. . . . We address ourselves, not to their humanity but to their self love, and never talk to them of our own necessities but of their advantages.

According to Adam Smith, a market system creates rewards and incentives that encourage utility-maximizing individuals to do what is in the public interest as if they were guided by an “invisible hand.”

Disagreements about the extent to which individuals seeking their own self-interest actually serve the public interest are at the heart of the debate between those who believe in “letting the market operate” and those who believe that government involvement is important for successful economic performance.

Economists also assume that individuals are rational in their efforts to maximize utility. The rationality assumption is essential if economic models are to predict behavior. If individuals did not act rationally, then all behavior could be explained as the result of irrational actions.

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Students sometimes object to the concept of *utility-maximizing man*. One objection is based on the mistaken idea that utility-maximizing behavior is selfish. In fact, economists recognize that altruistic behavior can provide satisfaction to some individuals. The second objection is that the utility maximizing assumption does not examine how tastes and preferences are formed or why individuals differ in how they attain satisfaction. Economists tend to assume that individuals have a set of preferences, but little attention is given to how preferences are formed. It is likely that if economic life and social life were different, individuals would have a different set of preferences. Urban and regional economists often rely on the work of psychologists, sociologists, and planners, who are more informed about questions of preference formation.

#### IDEOLOGICAL PERSPECTIVES ON MARKET OPERATIONS

Economists explore two distinct types of questions. On the one hand, positive questions address the world as it is. On the other hand, normative questions inquire about how things should be or ought to be and involve value judgments. Economists disagree about appropriate policies either because of different analyses of how the economy operates (positive) or because they have different values (normative).

Sometimes policymakers are more concerned with economic growth than static efficiency, particularly individuals involved in economic development. A community that operates inefficiently but grows rapidly may be better off in the long run than a community that maintains a high level of static efficiency but does not grow rapidly.

Economic development policies are cast in a way that forces policymakers to choose between static efficiency and economic growth. Some critics of economic planning suggest that too much planning stunts growth because unemployed resources are necessary for innovation and the development of new products.

Equity refers to fairness. When a policy change hurts some individuals but benefits others, questions of fairness arise. If income is tilted too much toward one group, it may be difficult to maintain social stability. Imbalances in the distribution of income may reduce economic prosperity. Economists are not very good at deciding which actions are more equitable, because such decisions cannot be made on scientific grounds. Nevertheless, the appropriateness of most changes must be decided, at least partly, on the basis of fairness.

There are two alternative perspectives on the extent to which government involvement in the economy may improve economic welfare—conservative and liberal.

The conservative perspective places a high value on economic freedom and economic efficiency. Many conservatives agree with Friedman (1962) that

capitalism is necessary for political freedom. The analyses of conservative economists tend to show that the laissez-faire market works well. When competitive market conditions exist, individuals seeking their own self-interest act in society's interest. Consequently, conservatives tend to oppose government involvement in regional and urban problems. Even when their analysis leads them to believe that market outcomes are imperfect, conservatives tend to believe that imperfect market outcomes are preferable to government-imposed solutions (which may also be imperfect).

Liberal economists tend to place a high value on economic equity when viewing market operations as sometimes both inefficient and inequitable but still useful. Blinder (1987) referred to the liberal philosophy as combining respect for the efficiencies of the free market with concern for those the market leaves behind. Consequently, liberals tend to believe that government action is important for solving urban problems and securing a more equitable distribution of income. Fundamentally, liberals want to maintain the basic framework of market decision making; but they believe that there is substantial potential for government actions to improve market outcomes. In particular, government regulations and taxes may help when markets are not operating as they should.

Conservatives and liberals constitute the mainstream of economic thinking. Both perspectives rely on the market to provide information and establish the basic incentives that encourage socially desirable behavior. Most of the policy issues discussed in this text are within the liberal-conservative framework.

Radical economic analysis is outside mainstream thinking and often provides interesting challenges to traditional economic thinking. Radical economists are distrustful of the market. Many radical economists believe that the market is not an impartial mechanism that helps organized economic activities. Rather, the market is a means of social control. They are less concerned with whether market mechanisms are efficient than they are with whose interests the market serves. Government programs that affect economic outcomes often help the wealthy because the same interests that control the market also control government. Radicals tend to see urban problems as a reflection of class conflicts. Radicals see greater government involvement in the economy, including direct ownership of productive resources, as a more preferable solution to problems than either a policy of laissez-faire or government modification of market outcomes.

## **How Markets Work**

Markets are a process (not a place) through which buyers and sellers conduct transactions. Markets coordinate numerous economic decisions and provide

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incentives that influence behavior. To emphasize these important functions, Milton Friedman has claimed that no one in the world knows how to make a pencil. He meant that no one knows how to complete all the steps in the process—cutting the trees, mining the graphite, and so forth. Yet the market helps coordinate these decisions, and many more. Prices tell producers which components of the pencils are needed, what kinds of pencils folks want and provide an incentive for production and an incentive to use less.

When the market is working well, the incentives generated by the market encourage individuals to behave in a way that benefits society. For instance, when a community's economy starts to decline, local resources become idle. Prices of land, labor, intermediate goods, and other resources may fall. The declining prices send two signals. (1) If you own productive resources, do not bring them to this region because the resources can earn more elsewhere. Thus, new workers may not relocate to the area, and current residents may consider leaving. (2) At the same time, falling resource prices might encourage producers, wishing to employ resources, to consider relocating or starting in the region.

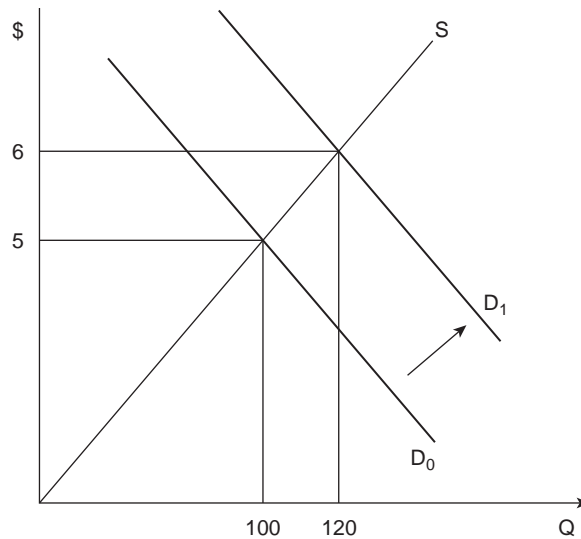
The example of community decline illustrates a situation where the market is working well. However, the market does not always generate outcomes that are socially beneficial. When markets create suboptimal or perverse outcomes, government officials attempt to intervene. Sometimes the interventions involve small changes in incentives, or “tweaking” the market, and at other times the market may be completely overridden.

Bartik (1990) contended that appropriate interventions in market outcomes is the hallmark of successful LED policy. Accordingly, an understanding of how markets operate is a prerequisite to understanding the forces that shape local economies and development policies.

### SUPPLY AND DEMAND

Figure 1.2 illustrates how supply and demand operate. The demand curve shows how consumer purchases will be affected as prices change, other things being equal. Similarly, the supply curve shows the quantity of output producers would be willing and able to sell at various prices. The higher prices will induce businesses to produce greater output, other things equal.

Let  $D_0$  be the operative demand curve. Price will be determined at the point where the quantity supplied and quantity demanded are equal, Point a in Figure 1.2. The price will be \$5. At that price, consumers will produce 100 units, and consumers will purchase 100 units. At any other price, there will be either a shortage or surplus of the product. The \$5 price is considered an equilibrium price because once it is attained it will not change unless the supply or demand curves shift. It may take the market a long time to find the equilibrium price; so at any given time, the actual price may not be in equilibrium.



**Figure 1.2** Supply and Demand

NOTE: The initial price and quantity of a product are determined by the initial demand and supply curves  $D_0$  and  $S$ , respectively. Equilibrium price and output will be \$5 and 100 units, respectively. If demand increased to  $D_1$ , price and output of the product would increase to \$6 and 120 units, respectively.

Suppose that economic development caused the population and incomes of residents to increase. As a result, the demand curve will increase from  $D_0$  to  $D_1$ . Price and output will increase. Immediately, we can visualize one of the impacts of economic development on the demand for local products. Similarly, factors that increase the demand for the output of local establishments can contribute to LED. For example, if demand for American-made cars increased, communities with automobile production facilities would probably experience increases in employment as the output of automobiles increased.

#### SUPPLY, DEMAND, AND EFFICIENCY

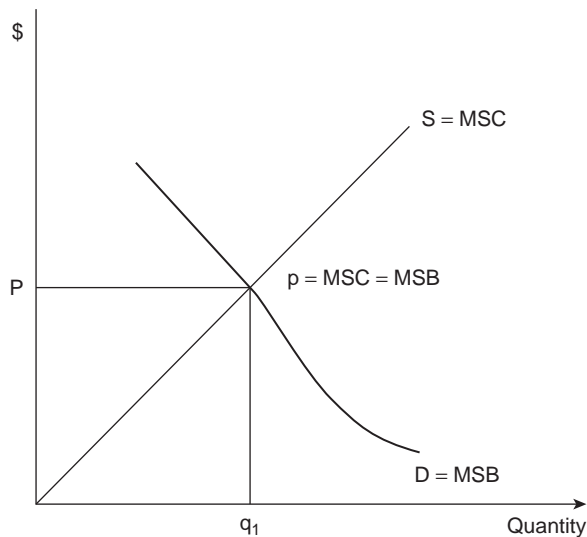
When there are many well-informed buyers and sellers, prices and output levels are determined by the interaction of supply and demand. Competitive markets can be very efficient. Economists believe that the sum of individuals' marginal private benefits (MPB) from consuming additional units of a product determines the demand curve in Figure 1.2. The demand curve slopes downward because benefits from additional units of a product fall as more units are consumed. Furthermore, if only the purchaser captures the benefits

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from the good or service, then the demand will reflect the benefits to society, the marginal social benefit (MSB). (The purchaser is part of society, so the benefits are considered social benefits.) Thus, individuals will purchase goods up to the point where price equals marginal benefits,  $P = MSB = MPB$ . The relationship between demand and MSB in a world where third parties are unaffected by the use of the good is shown in Figure 1.3.

When producers bear all production costs, the supply curve, which shows how many units they will sell at various prices, will equal the marginal social cost (MSC) curve. The costs paid by producers to make each unit reflect the cost of bidding for the needed resources from alternative uses. Those alternative uses are opportunity costs. Therefore, if the producers bear all the relevant costs of production, then  $S = MSC = MPC$  when quantity is  $q_1$ .

In a competitive, free-market economy, the price of each good reflects the value society places on the resources used to produce it. In Figure 1.3, the market-determined level of output will be  $q_1$  because the quantity supplied will equal the quantity demanded. If  $q_1$  is the actual output, in what sense is it optimal? If we assume that all relevant costs and benefits are borne by either the producer or the consumer, then the actual output,  $q_1$ , will also be at the point where  $MSB = MSC$ . Producing beyond  $MSB = MSC$  will result in producing output where the social costs of producing extra units are greater than the benefits, so



**Figure 1.3** Model in an Efficient Market

NOTE: In a competitive market, when all relevant costs are borne by the principles to a transaction (no externalities), output will tend to be optimal.



producing beyond  $q_1$  would be undesirable. If the output level were below  $q_1$ , increases in output would be desirable because MSB would exceed MSC.

## MARKETS ARE NOT ALWAYS EFFICIENT

If markets worked as effectively as suggested by the analysis underlying Figure 1.3, the role of governments in LED would be very small. There would still be an income redistribution role, but most interference with market outcomes would be inefficient. However, there are several realities that prevent markets from operating efficiently. This section discusses some widely recognized market failures and provides examples of how they may motivate LED activity.

### *Public Goods*

Sometimes markets will not provide goods that citizens want because there are inadequate payment mechanisms. This is a particular problem for the goods we share. For instance, how could roads be provided if not for the government? Few individuals would voluntarily pay for roads if they thought they could use them for free. Maybe some toll roads could be built privately, but their scope would be much more limited than today's highway and feeder road system. Furthermore, the cost of collecting tolls would be too high in the case of local streets, with their numerous entrance and exit points, so private businesses would not finance construction of local roads and similar infrastructure. If they are to be built at all, government must finance them. Goods that must be provided by local government include fire protection, health services, police protection, and amenities such as parks. Usually, provision of public goods in an area is necessary before private investment and businesses can be attracted. At the same time, economic development often increases pressure on governments to build more public infrastructure.

### *Externalities or Spillovers*

When all the costs and benefits fail to accrue to the principles of a transaction (buyers and sellers), third parties will be affected. Often governments need to intervene to protect these third parties. Polluting firms are an excellent example of a spillover effect. Private providers will often overproduce goods that have pollution as a by-product, because the producers will not be concerned with the costs of the pollution, which is borne by others. Negative externalities are a particular problem in high-density urban areas, because one negative spillover harms so many persons.

Local governments may also provide, or subsidize, many services that provide positive spillovers to encourage more production than would be provided by the market. Education is an excellent example, because an educated citizenry

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provides benefits not only to the person receiving the education but to others in the community. Local officials may seek to reduce negative externalities and increase positive externalities. Furthermore, economic development carries with it a set of externalities. When the local economy improves (declines), many individuals benefit (lose), even if they had nothing to do with the change. Officials are often concerned with which groups may benefit or lose from LED.

Externalities are particularly an urban problem. Urban areas are characterized by high density and the negative (and positive) effects of externalities are amplified in high-density places for two reasons. First, the greater the population is, the more the externality events that will occur. Second, the greater the population, the more the persons harmed by each externality event. For instance, an automotive breakdown may occur once in 50,000 miles. Also, the number of persons hurt by a breakdown will depend on the number of cars on the road. Say, 1/10 of the passengers will be affected by each breakdown. Thus, in a small rural area there will be fewer breakdowns than in high-traffic urban areas, and fewer persons will be inconvenienced by each breakdown. Based on this observation, it may be concluded that harm from externalities will increase faster than the rate of population increase. Conversely, benefits from positive externalities will also increase faster than the population does.

### *Monopolies*

The market will not work efficiently if there are only one or a few producers (or purchasers). Consequently, governments often intervene to control monopolies. The regulation of public utilities is an instance where government has intervened in the market process to ensure that firms do not take advantage of their market power. Monopolies can be a problem at the local level even in industries that are competitive at the national level. For instance, the hotel-motel industry is very competitive nationally, but in a small town in a sparsely populated region, there may be only one motel, a monopoly. Under some circumstances, local monopolies might be an impediment to economic development. Sometimes an LED official seeks to bring new businesses to a community that may increase the competition for existing businesses. Building on the hotel-motel illustration, it is possible that a community that had too few hotels could lose convention business.

### *Imperfect Information*

If some consumers or producers are uninformed, the market will not operate to maximize welfare. Therefore, governments sometime intervene to improve consumer and producer knowledge. Public relations and advertising associated with economic development are attempts to better inform (or misinform) business about the benefits of locating in a particular area. An important task of

many economic development practitioners is to gather information that is difficult to find about the local economy and provide it to businesses seeking to make local investments. At the same time, some local officials may exaggerate or distort information in an attempt to make their region appear better than it is in reality. Such information is often included in pamphlets that promote the area.

## THE ROLE OF PROFITS

In the market economy, profits drive production and employment decisions. Producers normally will not hire workers or establish businesses unless they anticipate earning a profit. In competitive markets, profits are assumed to be zero because total cost includes a normal return to the business owner or entrepreneur. To understand business decision-making, it is important to understand the concept of profit. The formula for profit is

$$P = TR - TC, \quad (1.1)$$

where  $P$  = profits;  $TR$  = total revenues; and  $TC$  = total costs, both explicit and implicit.

Total revenue equals the price(s) of the output(s) times the number of units sold. One way to sell more output is to lower the price. However, if the price decline offsets the sales increase, then total revenue will fall. If the increase in sales offsets the price decline, total revenue will increase.

Total cost represents all the private costs of production, including the opportunity cost of the owner's efforts and an adequate return on the owner's investment. Thus, the cost of inputs or the wages paid to workers are explicit costs, while the owner's time and the return that could be earned on the capital if it were invested elsewhere are implicit costs. Hence, there is a distinction between profits as used by economists and profits as used by accountants. Accounting profits do not deduct payment for the owner's time, efforts, skills, risks, and so forth.

To understand the nature of the profit equations, consider a person who owns a business with the following costs and revenues:

Total revenue = \$100,000

Cost of material = \$25,000

Cost of hiring workers = \$25,000

Other out-of-pocket costs = \$10,000

Other opportunity costs = \$50,000 (The other opportunity costs include foregone opportunities the owner could receive if the capital invested earned a normal return interest and if the owner worked for another employer instead of running the business.)

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To an accountant, this firm would be earning a profit because the accounting costs would be \$60,000 (total explicit costs that do not include other opportunity costs) and the total revenue would be \$100,000, so accounting profits would be \$40,000. However, the accounting analysis is misleading, because the total costs include the opportunity costs of the owner's capital and labor. If the firm were to operate, the investor-owner would give up opportunities to earn \$50,000. Thus, the opportunity cost of \$50,000 should be included to provide a comprehensive total cost estimate. After accounting for all costs, this business actually generates an economic loss of \$10,000.

Equation 1.1 is very useful in understanding business decisions. Suppose a firm is considering a decision to add to its output. Profits would increase only if the additions to total revenue (called marginal revenue) are greater than the additions to total cost (called marginal costs). Conversely, if marginal revenues are less than marginal costs, firms will not undertake the action under consideration. Accordingly, in thinking about how to increase profits, extra costs as well as extra revenues must be considered. Improving product quality or increasing advertising might increase sales and hence total revenue; but if these steps increase costs more than they increase revenues, profits will decline. If a business sells most of its products outside the area, policymakers have very few tools to help boost revenues. On the other hand, if a firm sells its product locally, most types of local economic growth will contribute to sales. On the cost side, both direct measures, such as business subsidies or tax breaks, as well as indirect methods may reduce costs.

Economic development practitioners are frequently concerned with attracting business by lowering costs, increasing revenues, or altering the perceptions of costs and revenues. Equation 1.1 has two important limitations. First, there are exceptions to the profit-maximizing assumption. Economists usually assume that business managers will behave to maximize profits because maximizing profits is one way to maximize utility. Sometimes, however, businesses may make decisions that may not increase profits but will enhance the utility of the business manager. For instance, a corporate executive may influence the company to donate a million dollars to a local charity. Such an action could reduce income for the stockholders (owners), but the prestige and community recognition that the manager receives may provide direct utility. Particularly, when managers run companies for stockholders, managers may put their own utility ahead of corporate profits or the owners' utility.

Second, future costs and benefits are often not well-known, and some things are impossible to predict. A business may give to charity because it is good public relations, which may increase profits in the long run. Such reasoning may be correct, but it is impossible to quantify. Often business decisions, such as the location of a new venture are undertaken on the basis of a hunch rather than careful calculation of the marginal costs and benefits.

Economic development officials may influence business decisions by describing how an action could increase revenues or lower costs in the long run without having to quantify the impact.

## **Economic Development Defined**

Economists distinguish between economic growth and economic development. Growth is an increase in the overall size of a local economy. Development requires that qualitative improvements occur (Partridge & Rickman, 2003). To illustrate the difference, consider, for instance, the location of a plant that paid very low wages. The plant location might result in growth because the size of the economy would likely increase. However, a diminished level of satisfaction for most residents at the time the plant was opened might also result. Thus, development might not always be associated with growth.

Economic development implies that the welfare of residents is improving. Improvement might be indicated by increases in per capita income (adjusted for inflation). However, economists recognize that income alone is an incomplete indicator of how well residents of a region are doing. Many other quantitative and qualitative factors are associated with welfare.

Some observers attempt to measure quality of life. However, measurement of quality of life is very amorphous. Hajiran (2006) showed that an adequate measure of quality of life requires measuring everything that we value in various “domains,” including some very subjective and difficult to measure facets of life such as recreation, spirituality, environment, safety, knowledge, and liberty. These domains are very subjective but important. The evidence that economic growth is associated with increases in subjective well-being, particularly in developed countries, is tenuous (Kenny, 2005).

Equity is another indicator of economic development. Even if average incomes did not grow, a change from a very unequal distribution of income to one that most people considered fairer could be a form of development. Similarly, improvements in the quality of life, such as better transportation systems, education, and cultural facilities, are also indicators of economic development. Sometimes indicators of economic development are difficult to quantify, but they are nonetheless important.

Sustainability is another component in the definition of development. Sustainable development suggests that if growth is excessively destructive to the environment, it cannot maintain itself and hence is not true development. Unfortunately, sustainability is difficult to quantify (Howarth & Farber, 2002)

Beauregard (1993) pointed out that when we focus on the *economics* of economic development, there is a tendency to ignore the broader political and social issues that also affect the quality of life in a community. Since many

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aspects of economic development are difficult to measure, they are often ignored or devalued. In this book, the theory and tools of economic development will focus on production, consumption, and other resource allocation issues. However, we will not lose sight of the fact that LED is part of a larger process of community development.

Economic development and growth are tied together in significant ways. Growth is usually an important element in the economic development process because growth provides the resources needed for development. Growth helps economies afford improvements in the quality of life and poverty reduction programs. Without economic growth, there would be insufficient jobs to support even a slowly growing population, and forced out-migration may result.

### **Careers in LED**

Numerous career fields require knowledge of LED. Some jobs are concerned with directly establishing or implementing LED policies. Many more jobs combine local economic knowledge with knowledge in other areas because understanding local economic conditions is an important tool for achieving other ends. Thus, the field is built on an interdisciplinary base. In the practice of LED, economics is combined with insights from other areas of study.

Most areas, from large states to small cities, hire economic development officials charged directly with improving the local economy. Their jobs are primarily concerned with stimulating economic growth in a variety of ways, including direct business attractions, provision of a variety of subsidies, improving infrastructure, education and training, and so forth. Private organizations such as chambers of commerce also employ individuals charged with attracting new businesses and improving the conditions of existing businesses. National governments also employ LED experts to grapple with how to improve local economic conditions, often as part of national economic development efforts. In many cases, the efficiency of the national economy may depend on economic development activities at the local level. Federal departments dealing with commerce, housing, international affairs, labor markets, and public service delivery employ individuals who specialize in local economics at both the entry level and the most senior levels.

Many jobs require knowledge of economic development as part of a “kit of tools” needed to achieve other goals. For example, community development workers and many others employed in the private, not-for-profit sector seek to strengthen the local economy in order to improve the housing stock or local job programs. Local government officials must assess the local economy to make better decisions. For instance, the advisability of a spending or tax decision may depend heavily on local economic performance. Business and government

forecasters need to understand LED in order to tailor their forecasts to local economic conditions. Local officials recognize that the success of decisions may hinge on the local economy and that the decision will have an impact on the future local economy.

Private businesses are interested primarily in the success of specific enterprises. Knowledge of local economies is often an important tool in achieving that success. Property development companies, utilities, and transportation groups employ persons familiar with LED because the nature of the local economy influences the prospects of their business.

Consulting firms employ individuals to assist companies in location decisions and to advise local governments regarding how to increase economic activity. Banks and other financial institutions employ persons with knowledge about the local economy to assess the risks associated with large ventures and to place loans. Individual investors interested in property development regularly assess the strength of local areas before making an investment. Consider a farmer who sells a product in a market where prices are set by international supply and demand forces. It may seem as though the farmer may not be affected by the local economy. Yet in most cases, the farmer's assets are primarily embedded in his land. Decisions about whether to sell the land or buy more are related to the question of how the local economy will fare. Even the decision about which job to take may depend on the expected future of the local economy.

The great majority of LED jobs require individuals to relate economic insights to concerns in other fields. Accordingly, skilled practitioners should be equipped to relate economic knowledge and an understanding of the local economy to a variety of issues, some of which may not be the principal concern of academic economists. The practice of LED requires the ability and willingness to take an interdisciplinary perspective.

During the course of a career, there will be numerous instances where local economic issues intersect with social and political concerns. For instance, crime can be a deterrent to economic progress when working and middle-class people leave a certain neighborhood because of fear. Thus, sociological and economic knowledge as well as knowledge from other fields must be combined to address the problem. For most real-world concerns, economics may be part of the answer, but economics alone seldom provides the complete answer.

## **The Nature of Regions**

*Region* is a chameleon word, taking meaning from the context of its use. For instance, the phrase "the region around my house" normally connotes a neighborhood region. However, if someone were to say he or she lived in a cold

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region, the phrase would connote a multistate area. As trade between nations increases, international regions are becoming more important, and economists are more concerned with multinational regions. In keeping with common usage, both large and small regions will be examined in this text.

*Urban* is also a term that has different meanings. An urban area, no matter how it is defined, is a region, although not all regions are urban. Urban places are normally associated with large, high-population-density cities. Yet some places with populations as small as 2,500 are considered urban by the Census Bureau. Thus, a small village with only a few stores could be considered urban by the Census Bureau, although such a place might not be considered an urban area as used in everyday conversation.

Many social scientists define *urban* in terms of lifestyle rather than density. Urban society is often contrasted with traditional society. In this sense, urbanization reflects a social change in which diversity, rationality, tolerance, impersonality, functional relationships, and bureaucratic organizations become important characteristics. According to the sociological perspective, the farmer who uses a variety of advanced technologies in production, has major capital investments, buys and sells grain futures in a world market, and watches T.V. broadcasts from around the world via satellite is considered urban.

### TYPES OF REGIONS

The three types of regions are functional, homogeneous, and administrative.

#### *Functional Regions*

Functional regions are distinguished by the degree to which they are integrated internally. If interaction of components within a region is significant compared with interaction with other places, the basis for a functional economic region exists. An area in which local businesses traded with each other more than they traded with the rest of the world would constitute a functional area. Often a functional region is characterized by a major center and the contiguous areas that are economically linked to the center, or node. Most metropolitan areas have a central core. Transportation systems are usually anchored at the core, and key financial and governmental activities are also located there.

Metropolitan areas exhibit hierarchical patterns that characterize functional regions. Specifically, employment activity and retail activity tend to be concentrated in the central business district and in other subcenters throughout the metropolis. The nodes of concentrated economic activity complement and contrast with residential areas. However, the business concentrations and residential areas are dependent on each other. Many LED policies are best implemented at the metropolitan level because of the interdependence within the region.



### *Standard Metropolitan Statistical Areas*

The concept of a functional economic area has been operationalized in the statistical construct of metropolitan statistical areas (MSAs). These areas are defined on the basis of a core area containing a large population nucleus and adjacent communities having a high degree of economic and social integration with the core. Because of the importance of MSAs to analysis and policy, it may be useful to describe their structure in detail.

Central cities are the heart and node of the MSA. Each MSA must include one city with 50,000 or more residents or a Census Bureau–defined urbanized area of at least 50,000 inhabitants and a total MSA population of at least 100,000 (75,000 in New England).

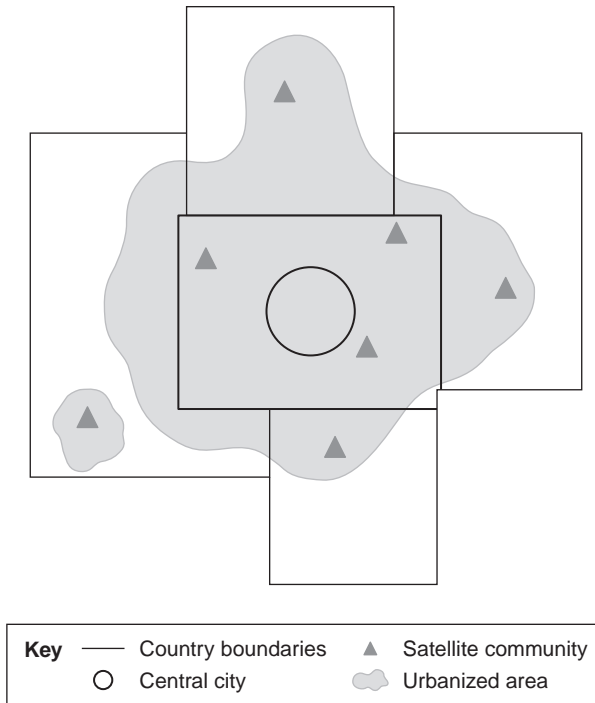
Counties are the building blocks of MSAs. The central county(ies) (containing the central city) plus all contiguous counties that have close economic ties to the central county and are metropolitan in character are included in the MSA. The extent of economic linkage among counties is measured by transportation and communications patterns. The metropolitan character is measured by population density and percent urban. MSAs in New England are based on groups of cities and towns because there are no counties in New England.

MSAs contain suburbs, or urban communities that are closely linked to the central city. Suburbs include satellite communities and bedroom suburbs. Satellite communities (sometimes referred to as “edge cities”) normally have an active local economy, often including a substantial manufacturing base. Frequently, businesses in satellite cities developed independently of the central city. In contrast, bedroom suburbs lack an independent economic base. While a few retail and service stores may be located in bedroom communities, their primary function is to provide a residence for individuals who work elsewhere. Because bedroom communities often provide an environment sheltered from many urban problems, an anonymous wit referred to bedroom communities as a “womb with a view.” In addition, there is usually some agricultural activity within the outlying counties of most MSAs. Figure 1.4 presents a stylized picture of an MSA.

An advantage of collecting MSA data by county only rather than by cities or by the urbanized portion of an MSA is that the geographic boundaries of a county seldom change. Although counties may be added or dropped from particular MSAs, it is relatively easy to establish a consistent time series by aggregating data collected for individual counties. In contrast, when city boundaries change or an urbanized area increases, it is usually very difficult or impossible to reconstruct a consistent time series. However, the use of counties as the units from which MSAs are built results in more diversity within the MSA than would be the case if only the most urbanized areas were included.

As urbanization has increased, metropolitan areas have grown together. As urban areas have overlapped, commuting and other economic relationships have extended beyond the original metropolitan area.

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**Figure 1.4** Anatomy of an MSA. Metropolitan areas include inner cities, central business districts, various types of suburban areas, and even farms.

A consolidated metropolitan statistical area (CMSA) is a combination of contiguous metropolitan areas. It is defined as a metropolitan area that has a population of at least 1 million. The metropolitan components of CMSAs are designated as primary metropolitan statistical areas (PMSAs). For instance, the Cleveland-Akron-Lorain CMSA is composed of the Akron, Cleveland, and Lorain-Elyria PMSAs. PMSAs are similar to MSAs except for their inclusion in a larger metropolitan complex.

#### *Homogeneous Regions*

Economic development officials sometimes deal with homogeneous regions that are designated on the basis of internal similarity. The many informal belt regions—corn, bible, rust, sun, snow, and so forth—are homogeneous regions based on common activities or climate. Likewise, the Appalachian region is distinguished by common economic development problems.

Many neighborhoods are distinguished by ethnic or economic similarities and, hence, are basically homogeneous regions. The census provides data on

census tracts, which are small areas consisting of several blocks. While census tracts are not necessarily established on the basis of homogeneity, data on homogeneous neighborhoods are often derived from census tract information.

### *Administrative Regions*

Administrative regions are formed for managerial or organizational purposes. Both private organizations and governments find administrative regions useful. Whereas observers might disagree regarding the exact boundaries of functional or homogeneous regions, administrative regions are normally more clearly delineated because they are used to delegate spheres of activity for businesses or governmental organizations. Administrative regions are also important because they frequently become the basis for policy. Cities, states, and counties are important administrative regions.

Administrative regions often overlap or evolve into functional or homogeneous regions. For instance, a company may establish a set of sales districts based on similar (homogeneous) tastes for product lines within each district. If regional offices provide support services for local sales offices, the administrative region will assume the characteristics of a functional area as well. Furthermore, once an administrative region is formed, the various components may develop commonalities that make the region more homogeneous, and chains of communication, trade, and control that are characteristic of functional regions may emerge.

The number of governmental regions is numerous. There are approximately 85,000 units of local government in the United States. Within the Chicago metropolitan area, for example, there are 1,214 units of local government, ranging from well-known governments such as cities, counties, and school districts to many special-purposes districts that are nearly unknown to average citizens, such as water control districts, lighting districts, recreation districts, and so forth. With so many districts, it is rare that workers in an urban business have the same district profile. In the Chicago area, there are 1.7 units of local government per 100,000 people. Many observers believe that political fragmentation is a major impediment to good government, while others believe that diversity of governmental units contributes to wise decision making.

## **Local, National, and Global Economic Development**

Previously, economists have studied LED as a subject distinct from national economic development. Textbooks addressing the problems of poor countries had a national perspective, seldom emphasizing the localities within those countries. Today, observers view local economies as the critical building blocks of national development. There is a need for national governments to not only

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address the needs of specific areas but also ascertain which localities can support economic development and which areas will generate the greatest bang from assistance. Efficient use of economic development resources should be the goal when planning and implementing national development policies.

A theme of this book is that appreciating the process of LED is integral to understanding national and global development. Scott (2001) examined the relationship between increased globalization and the increasing importance of urban regions. He contended that as international trading agreements have reduced trade barriers, unimpeded capital flows and population mobility have reduced the economic importance of national borders. Thus, the significance of national entities to economic development has diminished. Simultaneously, localities are economically linked by a variety of networks that are central to cost-efficient production and innovation. In other words, the economic ties that bind nations have weakened, while similar linkages within regions are becoming more important.

### Summary

The vast majority of economic development decisions are based on private costs and benefits. Sometimes market forces align individual costs and benefits with outcomes that enhance welfare, but sometimes they create perverse inducements. This book is predicated on the proposition that understanding of market forces is critical to understanding LED. Largely through market forces, local economies are linked to national and international events. At the same time, LED is integral to understanding and improving national and global development.

Economists build models based on assumptions. "Other things being equal" is one of the most useful assumptions. This assumption allows economists to focus on a few variables by assuming other factors to be constant. As the cost to customers increases, the quantity of a product consumers will be willing and able to purchase declines, *other things being equal*. The other things being equal assumption may be relaxed to provide a more complex analysis of how other variables affect quantity. Economists also assume that individuals are motivated by self-interest; they seek to maximize utility or satisfaction. Satisfaction is sometimes interpreted broadly to include things such as emotional satisfaction or narrowly to include only income or profits.

Market processes coordinate numerous economic decisions between buyers and sellers. Market processes set prices and determine outputs. Price changes transmit signals to market participants and thereby influence behavior. Supply and demand curves are used to illustrate how prices and outputs are determined in competitive markets.

The operation of supply and demand free of governmental restriction may generate efficient outcomes. However, public goods, externalities or spillovers, monopolies, and imperfect information can result in inefficient markets. Correcting these market failures may improve local economies.

Profits influence business decisions. Profits equal total revenues minus total costs. In a simple case, total revenues are prices of output times quantities. In a simple case, total revenues equal the prices of output times quantities sold. When considering costs, analysts must recognize opportunity cost—alternatives foregone in order to produce.

Economic development includes economic growth, but it can also include issues of quality of life and income distribution. Qualitative measures of economic development may be difficult to measure, but they are important.

There are various types of regions. A functional region is defined on the basis of the degree of economic integration. Standard metropolitan areas are based on high levels of interaction between the central city(ies), suburbs, and nonurban areas in the region. Counties are the building blocks for regions. Homogeneous regions are based on internal similarity. Neighborhoods are often defined on the basis of common characteristics of the residents and may, therefore, be considered homogeneous regions.

Knowledge of LED is important not only in careers directly developing and implementing policies but also in many careers where knowledge of local economies must be combined with expertise in other fields.