

THE POLITICS OF REVITALIZATION:
PUBLIC SUBSIDIES AND PRIVATE INTERESTS

Terry F. Buss
Youngstown State University

F. Stevens Redburn
U.S. Department of Housing and Urban Development

Forthcoming in:

Gary Gappert (Ed.), The Future of Winter Cities
(Beverly Hills: Sage, 1986, Chapter 22).

Authors' Note: The authors assume sole responsibility
for the views, interpretations, and conclusions
contained in this chapter.

The Politics of Revitalization: Public Subsidies and Private Interests

For the last decade, the core of national and local urban economic development policies has been the use of direct public subsidies for new private development and jobs in distressed areas. These policies, and a new array of quasi-public institutions and development programs, have been legitimized under the phrase--authored by the Carter Administration but accepted by the Reagan Administration as well--"public/private partnership." The philosophy of the "new" partnership has been summarized by the Committee for Economic Development (CED, 1982: 4):

"The economic base of an urban area provides goods and services for local consumption, jobs and income for residents, and a resource and tax base for community services and public amenities. Economic development today requires conscious effort by local government and private-sector organizations to retain existing businesses, facilitate the opening of new businesses, attract outside investment, create jobs for local residents (with special attention to training and placement of the hard-to-employ), and foster a climate supportive of business expansion that is compatible with other community goals.

- **Private initiatives** include actions by businesses or business associations in development assessment and planning, promoting the community's image, establishing favorable purchasing and hiring policies, providing technical assistance to other firms, and making corporate operating and investment decisions (especially with regard to siting) designed to enhance the local economy.
- **Government initiatives** include helping businesses to expand or solving problems that could lead to their departure, promoting the community to attract new investment, assembling land for development, providing physical infrastructure and public services, establishing incentives for business growth, and creating a healthy business climate.

- Collaborative efforts by government and private organizations include establishing joint development goals, joint-venture development projects, joint efforts to train and find jobs for the hard-to-employ, and "financial packaging" that includes a mix of resources that appropriately reflects the public and private interest in development."

In this essay, analysis focuses on the use of direct public subsidies to assist private sector development (See Hamilton, Ledebur, and Matz, 1984). This use of public funds distinguishes current economic development policies from the more traditional indirect public sector contributions to economic development through the building and maintenance of public capital infrastructure, the creation of new serviced sites for industry, education, training, and other supportive public services.

Public Subsidy and Private Interest: A Critique

The relatively new use of public authority to directly fund private enterprise has been increasingly attacked by market-oriented conservatives, who view such spending as inherently harmful to the economy. The Office of Management and Budget (OMB) under David Stockman, has repeatedly attempted to eliminate the major federal business subsidy programs, including those aimed at urban and regional revitalization. Development subsidies are said to distort patterns of private investment, thereby reducing the national economy's growth and competitiveness. Typical of these arguments is that directed by conservatives against the Urban Development Action Grant (UDAG) program (Ferrara, 1985: 3).

"The grant program, created in 1977, was intended to foster economic improvement and job creation in distressed urban areas by stimulating private investment with federal funds. But UDAG does not create new net investment or jobs for the economy as a whole. It simply redistributes investment and jobs from one part of the economy to another. And in the process, the program results in a net drain on the economy as a whole and a loss in total jobs.

UDAG now serves as a sort of 'urban slush fund,' redistributing investment and jobs toward politically powerful and influential cities at great costs to other jurisdictions."

Stockman, testifying before Congress in April 1985, also argued that UDAG's contributions to local economic growth "have to be weighed against the economy-wide harm to trade-competitiveness and agricultural sectors caused by high budget deficits--to which UDAG contributes." In his view, this harm "far exceeds" the value of any UDAG-induced local economic gains (Stockman, 1985).

Many theoretical criticisms of subsidy programs arise from a philosophy that attributes greater wisdom to the marketplace than to any conscious investment strategy pursued by the public sector. Defenders of such programs, conversely, point to the critical role that government has played in the development of agricultural regions and in shaping urban America through massive use of subsidies for transportation, housing, and the defense industry. They argue that a public role in regional development is not only potentially useful but necessary and inevitable. Nevertheless, the use of direct public subsidies for private ventures ranging from condominiums and restaurants to steel mills and office towers raises new practical as well as theoretical questions about the role of the public sector in economic development.

Even if theoretically defensible, subsidy programs must also be justified in terms of their actual performance. Direct use of subsidies may involve practical problems that are difficult to remedy either through better design or more careful administration. Subsidies are difficult to target to the places that most need them. It is difficult for public agencies to avoid subsidizing projects that would have gone forward anyway, with wholly private financing. Many of the intended benefits to poor people and distressed places leak away to affluent people and non-distressed places. And, many marginal projects fail financially, or at least fail to grow as expected.

The targeting problem. Targeting is accomplished, at a national level, through the use of need formulas, such as the UDAG "distress" and "impaction" formulas used to establish city eligibility, and similar formulas used to rank projects in the competition for funding (Gatons and Brintnall, 1984). However, the political compromises embodied in these formulas as well as serious data limitations produce a distribution of funds that is sometimes inconsistent with the programs' economic theory. Eligibility is usually defined in broad terms to ensnare Congressional majority support. Further distortions are introduced by variations in local governments' aggressiveness and capacity to generate fundable project proposals. For instance, through the first five years of the UDAG program two of the most entrepreneurial cities--Baltimore and New York--each received over 50 UDAG awards; but 20 percent of the almost 400 UDAG-eligible large cities and urban counties received no awards (Gatons and Brintnall, 1984).

Unwarranted subsidies. One of the nation's largest corporations, a member of the Fortune 500, acquired an abandoned industrial site adjacent to its headquarters--a site centrally located in one of the fastest growing and most affluent communities in that state. The corporation possessed enormous capital and was moving into new markets. It received debt interest subsidies from the public sector for expansion on this site, using the arguments that it could not otherwise afford the investment and that it might move its facilities. This particular expansion displaces local medical services which are in high demand and which cannot be transferred out of the community.

It is difficult for public officials to know the true intentions of private companies or to determine whether public subsidies are necessary to make a particular project feasible and sufficiently profitable. The near-impossibility of distinguishing between situations where subsidies are needed and those where they merely produce profit windfalls draws local public officials into destructive and costly bidding wars for new investment.

Benefiting those less in need. The benefits of subsidy programs tend to be distributed almost as widely as the benefits of any non-subsidized private investment. Thus, the lion's share of profits goes to shareholders and lenders who pay taxes far from the distressed city where the project occurs. If a project creates fine shops, luxury housing, or corporate office space for managers and engineers, it may also create entry-level jobs, new revenues for financially-pressed jurisdictions, and new customers for small store owners. Nevertheless, projects such as the UDAG to Stowe, Vermont, and the UDAG to Newport, Rhode Island, for hotel construction in these two upper-class resort towns invite skepticism regarding the balance of benefits between poorer and more affluent people.

Subsidizing marginal enterprises. One distressed city had attracted few industrial prospects, in spite of extensive promotional activities and the creation of a heavily subsidized industrial park. Then, the city was approached by a firm which promised to create many jobs in the area. City officials put together an impressive local, state, and federal development finance package. In their eagerness, the local officials required little in the way of formal agreements with the firm and never appreciated the fact that there was no market for its products. The firm soon failed and the development incentives were "eaten up" by the private entrepreneurs. In addition, the firm removed equipment and materials

valued at hundreds of thousands of dollars from an acquired industrial building and sold them at a profit. Because of the way the subsidies were expended and the on-site sales were managed, the city was forced to sue the firm. After three years, it has recovered nothing. Further, the city now cannot lease a large proportion of its industrial sites because of restraining orders by the courts. The litigation continues.

No one has, as yet, looked systematically at the frequency with which blue-sky and blue-suede-shoe operations are drawn to the honey pot of subsidy programs. No one has estimated the proportion of subsidized projects that quickly fail or the resulting cumulative waste of public funds.

Displacement of more desirable investment. Even more fundamental than these problems with the performance of subsidy programs may be the opportunity costs associated with such efforts. The kinds of projects subsidized are not always the kinds of projects that the distressed area or city most needs. In some cases, the resulting private investment may actually displace other, more desirable kinds of private investment--either those that would require subsidies or those that would not. In other cases, the public money spent on subsidies might have done more to foster economic development if spent on more traditional government responsibilities such as education or the provision of services or infrastructure.

The problems of the U.S. steel industry provide an illustration. Domestic production of basic steel is in considerable economic trouble: high production costs, foreign competition, dwindling markets, environmental regulation, and other factors are slowly wreaking havoc in this industry. One city has poured subsidies into the operations of two steel mills, both of which have failed. A new subsidized steel facility of the same kind is now under negotiation. In order to attract this latter venture, the city is required to create an enterprise zone, forgive all

property taxes, and provide loans and interest subsidies. By working such a deal, the city has denied itself much needed tax revenues and greatly reduced its capacity to assist other more viable operations, all in a desperate effort to hold onto its share of a failing industry.

Explaining the Misuse and Abuse of Subsidy Programs

Accumulating experience with the implementation of subsidy programs at the local level suggests several factors that contribute to their misuse.

Lack of strategic planning capacity. The lack of expertise in strategic development planning in local government contributes to the careless and wasteful use of subsidies. Strategic planning:

". . . requires the explication of alternatives; forces a future orientation; encourages broad-scale information gathering and evaluation; provides for communication and participation; emphasizes the importance of implementation. . . . (Olsen and Eadie, 1982: 7)."

Analysts have recognized that the absence of strategic planning capacity in local government has generally hampered public policy programs and initiatives in at least five ways (Walters and Choate, 1984: 11-12):

1. "Fragmented and disordered management practices permit no overall view of public needs and no overall specification of the roles of the respective levels of government or the private sector in meeting those needs.
2. In the absence of clearly documented needs and well-articulated priorities, pork-barrel politics often dominates public actions and public expenditures.

3. In this atmosphere, the short-term payoff is invariably favored over long-term goals. When public expenditures are treated as a source of patronage, it becomes difficult to create and maintain coalitions that can sustain long-term efforts, no matter how vital such efforts may be. As a result, most political leaders support those programs that can be financed and completed in a single year.
4. Without coherent strategies that set investment needs and ways to meet them, specific public investment plans cannot be systematically formulated. Nor can government leaders and the public determine critical linkages between various public functions.
5. Disordered management practices at one level of government are easily transferred to other levels."

In the past, the lack of strategic planning capabilities may have made little difference in local economies: the growth of many large cities, prior to the 1970's, occurred in spite of or without the need for local public planning or strategic interventions. However, in the 1970's and 1980's, planners have faced the dual challenge of stemming the tide of precipitous decline of established industries, on the one hand, and the need to position local economies so as to maximize growth opportunities should any arise, on the other hand. Public subsidies for development offer what appears to be a quick-fix solution, which is short-term and highly visible. The absence of strategic thinking and analysis make the temptation that much harder to resist.

Private sector dominance of subsidy programs. Local
! governments, always vulnerable to the claims of private capital, are
- especially so in hard times.

Local capital interests, including landowners and commercial or industrial developers, typically exert strong, direct leverage on public subsidy decisions. These economic actors benefit from subsidies in various ways:

- o less profitable or unprofitable vacant or unused land or facilities owned or controlled by a developer can be made to yield a profit;
- o land or facilities owned by others can be made profitable, indirectly benefiting the developer's existing investments or interests;
- o losses by a developer can be recouped or prevented by engaging public participation; or
- o competitors of a developer can be stymied or held at bay by marshaling public support.

Developers are often able to control the economic development decision process for several reasons. First, economic development is extremely complex, requiring detailed knowledge and experience in management, legal affairs, financing, construction, and land economics in order to be successful. Few actors in the marketplace or political arena have or can afford to purchase this expertise. Second, developers tend to be well-integrated into both public and private sector networks which make decisions about development. Developers, or more likely their surrogates, are often members of public planning or zoning boards and commissions, local economic development corporations (EDC's), Private Industry Councils (PIC's), or economic development task forces appointed by mayors, county commissioners, or Chambers of Commerce. Directly or indirectly, developers may be either catalysts or initiators of development, while most others are relegated to the sidelines. Third, developers, out of necessity, are often politically

active, especially in influencing candidates for or holders of public office. Campaign contributions and other forms of political influence are commonplace. Because of this, developers have a considerable say in what the public sector does or does not do. Finally, developers have a considerable stake in the community and are likely to have been and continue to be involved in the community over time. Having much to lose and to gain, local developers and landowners are willing to fight the battles necessary to dominate the revitalization process.

Private opportunities versus public responsibility. The misapplication of public business subsidies has also to do with the inherent difference between the incentives/opportunities for private investors and the public responsibilities that public officials are charged with. The long-term development interest of a locality and the short-term profit-seeking considerations that drive private developers and investors should often lead the two sectors to different conclusions regarding what kinds of development are most desirable. This is especially so in declining areas, where the public sector should be most aggressive in pursuing an adaptive economic development strategy.

Nearly all private entrepreneurs--at least those who have survived over time--invest their capital with the expectation that the return on investment will be commensurate with the risk undertaken: the greater the risk, the greater the expected return. Reinvestment has declined and disinvestment has accelerated in distressed cities because private entrepreneurs perceive returns on investments to be insufficient and attendant risks to be too high.

↓

The public sector, on the other hand, has traditionally and properly invested its capital in areas where the financial return is long-term, indirect, and uncertain. Public support for infrastructure improvements and education are prime examples of this traditional public role in support of the local economy, which complements and supports investments made by the private sector. With the rise of subsidies, the sharp distinction between public and private objectives has blurred. Because the public sector is often the weaker partner in negotiations with the private sector--for reasons discussed above--it is vulnerable to arguments that any new private investment advances the goal of revitalization. The best way for the public sector to escape from its vulnerable position may be to back out of the subsidy game and return to more traditional methods of supporting economic development. However, many in the public sector now enjoy and benefit personally from the subsidy programs.

Rise of public entrepreneurs. Subsidies may be misapplied more frequently today due to the rise of a new bureaucratic class of "public entrepreneurs" whose career interests, thinking processes, and often backgrounds are like those of the private sector developers and investment bankers with whom they do deals. For present purposes, a public entrepreneur may be thought of as ". . . one who gathers and risks political capital or support in order to reshape politics and create new sources of power by establishing new programs (or "products") (Mollenkopf, 1983: 6)."

Although revitalization can be viewed purely as a question of economics, revitalization is, at the same time, a way of using public resources to further the interests of particular individuals in both public and private sectors, thereby serving as a political resource for public entrepreneurs.

This entrepreneurial approach, and the rise of this new class, has been promoted through HUD's administration of the UDAG program. Cities are encouraged, in bargaining with developers, to maximize their net financial return from each project through inclusion of loan payback and profit participation provisions in UDAG contracts. HUD's emphasis on this form of benefit reduces the city's ability to negotiate with private investors for other benefits. This makes it harder to use UDAG for projects with less direct financial return but more in line with cities' long-run development needs (Clarke and Rich, 1985).

"Off-budget" decision-making. The tendencies described above are all reinforced by the movement, at all levels of government, to off-budget investment mechanisms that take subsidy decisions out of the political limelight and, more and more frequently, place them under direct private sector control (Clarke and Redburn, 1983).

These "off-budget" mechanisms include any continuing publicly-created incentives to the private sector which do not require specific legislative authorization or annual appropriations. The two major categories are "tax expenditures," such as the federal income tax exemption for interest on industrial revenue bonds (IRB's), and "credit activities," such as publicly-capitalized revolving loan or venture capital funds and public loan guarantees.

Both public and private sector entrepreneurs gain by using off-budget, rather than on-budget development instruments. For instance, when IRB's are awarded by a quasi-public development corporation and approved by local political officials, typically no public hearings are held to determine whether or not issuance is in the public interest. Officials may take credit for development, or quietly allow deals to occur without any public

notice. If a quasi-public corporation awards the bonds, only the public sector is even less directly accountable. In the unlikely event that a public outcry occurs, officials may argue that no one in the local area is hurt by the issuance of bonds--the only loser is the U.S. Treasury.

Private sector entrepreneurs thrive on the subsidies which off-budget devices allow; and private interests can more readily influence the use of public funds when there is no direct appropriation or other opportunity for public debate prior to the decision to invest.

Conclusion

The greatly expanded use of direct public subsidies for private development in the Carter years and after has used the symbolism of economic development to justify policies that, not surprisingly, serve the interests of local capital and political entrepreneurs. Unfortunately, the politics of revitalization and the recent reliance on direct subsidies have done little to eliminate fundamental barriers to the economic recovery of distressed urban areas. These areas need to develop a new social/institutional base that will support human development and investment, while fostering the political support and governing capacity to sustain recovery. There are alternatives, the briefest outline of which is offered below.

Soundly-conceived local economic development policy must embody two principles, which are in conflict with the recent trend in U.S. economic development policy:

1. Development is not equivalent to private investment but depends, rather, on particular kinds of private investment.
2. The right kinds of private investment will only be made if the requisite institutional and infrastructural base for such investments is present.

The right kinds of private investment are those which integrate well with the existing local economy--or more specifically, which extensively use products and services of existing local industries in their own production, produce products and services that substitute for imports from outside the region, and generate exports to the outside. Preferably, also, the profits and personnel savings generated by these investments will be retained by local people and reinvested in the local economy. Such investments reinforce the existing economic strengths of an urban area and can set off a rapid chain reaction of related private investment. This, according to Jane Jacobs (1984) is the only way in which city economies grow.

Although direct subsidies, used very selectively, may support the right kinds of private investment, they are not the key ingredient in successful local economic development. Especially where the problem is revitalization of an area declining due to the loss of established economic functions, the primary public sector responsibility is for the institutions and infrastructure on which appropriate kinds of private investment depend.

The problems of infrastructural provision and institutional development are familiar in the context of non-industrialized regions. Much less is known about the problems of re-orienting and rebuilding these bases for growth in distressed urban areas. Incubation strategies approach the problem from a microeconomic perspective by starting with a fledgling firm and its entrepreneur, identifying their particular needs, and acting to meet their needs. From the rapidly accumulating local government experience with incubation strategies may emerge general knowledge about the needs of emerging firms, which can lead to other economic development policies
!
- focused on institutions and infrastructure. For instance, local government may work with local financial institutions to improve access to credit by

new or expanding firms producing for local industry, or may work with local technical training and education institutions to provide specialized skills training to new or expanding firms." Such programs offer a possible route of escape from the subsidy trap into which all levels of U.S. government have lately fallen.

1

Bibliography

Olsen, John B. and Douglas C. Eadie.

The Game Plan: Governance With Foresight, (Washington, D.C.:
Council of State Planning Agencies, 1982).

Walter, Susan and Pat Choate.

Thinking Strategically: A Primer for Public Leaders, (Washington,
D.C.: Council of State Planning Agencies, 1984).

Clarke, Susan E. and Michael J. Rich.

"Making Money Work: The New Urban Policy Arena," Research in
Urban Policy, Vol. 1 (Greenwich, Conn.: JAI Press, 1985: 101-
115).

Clarke, Susan and F. Stevens Redburn.

"Off-Budget Urban Policy," Paper presented at the Annual Conference
of the Association for Public Policy Analysis and Management, Phila-
delphia, PA (October, 1983).

Ferrara, Peter J.

"It's Time to End the Urban Slush Fund," Washington Times,
Tuesday, April 2, 1985, p. 30.

Gatons, Paul K. and Michael Brintnall.

"Competitive Grants: The UDAG Approach," in Richard Bingham and
John Blair (Editors), Urban Economic Development, Volume 27,
Urban Affairs Annual Reviews (Beverly Hills, CA: Sage, 1984).

Hamilton, William, Larry Ledebur, and Deborah Matz.

Industrial Incentives: Public Promotion of Private Enterprise,
(Washington, D.C.: Aslan Press, 1984).

↓
Jacobs, Jane.

Cities and the Wealth of Nations, (New York: Random House, 1984).

Mollenkopf, John H.

The Contested City, (Princeton: Princeton University Press, 1983).

Stockman, David A.

Testimony before the Housing Subcommittee of the Senate Banking,
Housing, and Urban Affairs Committee, photocopy (April 15, 1985).