Simple Rules for Regional Economic Development

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Economic development is a desired goal for regional governments, public organizations, and others across the United States and around the world. The economic challenges faced by nations and regions during the first decades of the 21st century have served to increase the intensity of efforts to ignite economic growth. Not only is there an increase in the visibility of economic development efforts regionally, nationally, and internationally, but there are ample ongoing experiments utilizing a variety of strategies and tactics aimed at creating robust, sustainable economic growth.

The interest in understanding how to create economic growth has been further heightened by the dramatic reductions in public budgets over the past several years. It simply is no longer acceptable for public officials to invest in projects that do not have the potential for generating positive returns on investment. With money tight once popular investments in "high tech" or "clean tech" or "bio tech" no longer make sense if the expected payoff is not generated within reasonable time horizons. Of course, some regions attempt to build their economic development strategies around acquiring government contracts and "stimulus" money. Most recognize, however, that that is a short-term strategy because funds earmarked for specific programs could disappear after the next election cycle.

Most of the efforts to develop regional economic dynamics are undertaken by well-intended public officials, many of whom are duly elected by the local populace. Public officials operate in highly visible positions, and they are supported by taxpayer dollars. As such, they are under pressure to produce "results" during their appointed tenure.

While the motivations and pressures that drive some of this public action are understandable, they are indefensible from the perspective of long-term economic growth. Research investigating traditional approaches to economic development reveals their relative lack of long-term economic impact. Short term results are easy enough to obtain, but lasting economic growth that improves a region's resilience and economic dynamism require other, less visible, actions. For example, clearing the path for entrepreneurs and small business people to innovate, grow, and create jobs and wealth usually does not lead to individual laurels or acclimations. Often, such work requires *undoing* existing policies and practices rather than doing.

Unfortunately, there is no established "rule book" for creating economic dynamism in a geographic region. The reason that there is no single "rule book" for how to do it is that such a book would need to re-write itself to be consistent with modern ways of thinking, talking, and acting. The rules haven't changed much since Adam Smith analyzed the "Wealth of Nations" in the eighteenth century, but the way modern society talks about the rules for economic growth most certainly has changed.

This paper attempts to re-state the "simple rules" of regional economic development using language and concepts that reflect our modern age. In that sense, this is not intended to be a piece of original research, but more of an economic/philosophical update of our modern predicament with prescriptions based on the historical record and stated in modern terms. The methodology for this analysis is exegetic, primarily drawing from the broad pool of literature that is referred to as "political economy". Much of the political economy literature is empirical, but most of it is at attempt to extract prescriptive (one might say "policy") lessons from the data.

Large scale prescriptions, those that are intended to guide actions of large numbers of people, are inherently imprecise. Thus, I have attempted to consolidate various lines of research as well as empirical case studies into a short regime of simple rules. The main intent of compiling this regime is to provide a framework for thinking about and enacting economic development policies, actions, and investments.

Rule 1: Attract and Retain Creators

This article uses the term "creators" rather than entrepreneurs or innovators. Creators are people who are often a bit, shall we say, different from the norm. Their difference is manifest most obviously by how they want to live. They want to live free of the constraints of normal ways of life. They want to make a living by following their personal passions. Sometimes, especially when they are young, they whine that the world owes them a living, but they tend to grow out of that.

Richard Florida, author of the popular book "The Creative Class" said that communities that want to attract and retain creators must focus on what he calls the "Three T's": Talent, Tolerance, and Technology. According to Florida, the creative class includes scientists, engineers, university professors, poets, novelists, artists, entertainers, actors, designers, architects as well as the thought leaders such as writers, editors, researchers, analysts, and other opinion makers.

Of course the list can go on. People don't need a formal education to be creators, but many of them do have one. Universities play a role in fostering and unleashing creator power. We also, unfortunately, have too often created waves of corporate drones trained to work in large companies and collect steady paychecks.

Of course the notion that a region is able to attract creators presupposes that there is such a class of people and that they have a propensity to move about. This is an unspoken assumption behind much of Florida's work, but there is a body of supporting research in demographics and in the psychology of creative and opportunistic people.

Demographic research has been tracking a number of major trends since the early stages of the Industrial Revolution in the Western world. The most dramatic demographic shifts documented during the early days of the Industrial Revolution recorded the mass migration from farm and rural areas to city centers. The concentration of jobs, the need for skilled labor, and the comparatively higher wages that could be earned in the city are factors normally cited for this mass migration characteristic of industrialization. The same phenomenon has been documented in newly emerging economies like India and China over the past two decades. Massive new city centers have arisen in these nations, populated in large part by indigenous people who have migrated from rural areas. Clearly there is some indication that massive waves of migration to city centers does occur, and that there is some agreement on the factors that drive such mass migration.

Still, there is probably not much that can be learned by way of analogy between massive migration of indigenous rural folk to city centers and migration of creative folks to particular regions. It is doubtful that the demographic forces that drove and continue to drive new industrializing regions are the same forces that created, for example, Silicon Valley. We must look to other analyses to understand how regions such as Silicon Valley are born, because, after all, we are talking about post-industrial age emergence. Forces that drive creative types to pick up and migrate to entirely new areas must be different than the forces that drove and drive rural folks to industrial centers. But what are these different forces and how can regions harness them for their own use?

This question has received significant attention from researchers over the past several decades, and although there is no consensus as yet on the solution, there are several strong hints about what these forces are. For example, new research into industry cluster formation has pointed to a phenomenon called "industrial identity". Industrial identity is the identity a region has among people who live outside the region. For example, people who live outside of Silicon Valley think of it as a hotbed of technology entrepreneurship, where great ideas can acquire the capital needed to create new ventures. This "industrial identity" is not something that was crafted in a top-down manner by some well-meaning Chamber of Commerce officials, it is rather an identity that emerged from the bottom-up via activities of the people living and working there. These activities led outsiders to interpret them as evidence of a dynamic technology venture environment that is a great place for others interested in similar activities.

Industrial identity is created in a bottoms-up fashion, but that is not to say that it is created only accidentally. In fact research into industry cluster formation has pointed to several unique and unexpected clusters that have been intentionally fostered and that have created powerful industrial identities for the respective regions.

One of the prescriptions for cluster development is to build upon existing natural, human, and industrial capacities. There are three useful concepts to help policy makers and regional economic development experts think about these capacities. The first concept is competitive advantage. Competitive advantage refers to the capacities, skills, and other advantages a region has developed that help it compete with other regions for resources, jobs, and talented people. In today's global economy, competitive advantage comes more from an ability constantly to innovate than from protection of intellectual property advances.

Comparative advantage refers to the assets a region possesses by dint of nature or geography. For example, Saudi Arabia could attempt to develop a thriving software development industry, but that would be foolish given that it is perched on top of the world's largest preserve of petroleum. Saudi Arabia's comparative advantage is to develop its petroleum industry. When one considers the Southern Colorado region, there are no such patently obvious comparative advantages. Nonetheless, one could argue that the natural beauty and amenities of the region provide a comparative advantage in outdoor- and sports-related activities.

Finally, constructed advantage is the more recently understood phenomenon of advantages that are developed with strategic intent. One cautionary note of this type of advantage is that it is inherently derivative of the other two types of advantages already mentioned. That is to say, constructed advantage is developed by building on the competitive and comparative advantages that already characterize a region.

Rule 2: Organize Capital

It is clear that a major part of the attraction of creative types to a region is the presence of capital that is organized and willing to accept the risk of investing in specific venture types. Silicon

Valley became well-known for its concentration of technology savvy angel and venture capital investors. Youthful technology entrepreneurs became well aware that they needed to relocate to Silicon Valley if they were to capture the attention of these sources of growth capital.

At the same time, it must be noted that not all industry clusters are going to be centers of angel and venture capital. Branson Missouri, for example, does not have the same concentration of venture capital firms or angel groups that exist in Silicon Valley. Instead, the type of capital organization appropriate to Branson focuses on real estate development, hospitality and entertainment, and service businesses. This type of investing is vastly different and requires different types of expertise, risk tolerances, and time horizons than the technology investors of Silicon Valley. Thus, it is clear that as respective regions leverage comparative and competitive advantages to develop unique industrial identities they must also organize capital consistent with that identity.

Despite the prescription to organize capital, it must be stated that this prescription is not reserved for, nor even intended to be led by, government agencies. There is a role for government to play in the organization of capital, but in general attempts to control or direct investing activity via government or politically oriented organizations is unlikely to generate real returns. Below I will talk about a specific type of government led intervention that has borne some fruit in the United States. First, however, let's examine how capital organization tends to occur and some techniques that can be used to enable that fortuitous occurrence.

Rivers of ink have been spilled attempting to understand how capital-rich regions such as Silicon Valley emerge. The proverbial chicken-egg scenario is almost always mentioned in the context of such inquiry. That is, does capital need to be organized and present before new ventures crop up, or do new ventures need to be present before capital arrives and gets organized.

While there is no definitive answer to the chicken-egg question, there are tantalizing hints about how a vibrant deal and capital community comes into being. Generally speaking, both capital and deals must be present in embryonic form for a vibrant entrepreneurial community to emerge. That is, some capital must be present for entrepreneurs and new ventures to have a chance to succeed. In the early days of the emergence of a new entrepreneurial cluster there is an exceedingly good chance that the nascent development will be stillborn. It requires not only nurturing capital to continue to grow and develop, it needs the sophistication and experience that usually accompanies organized capital. Experienced investors often have critical access to markets and distribution channels that can be pivotal to success.

So the answer to the chicken-egg question in fact upends the question. It identifies it as a reasonable, but incorrect formulation of the real question. The real question is: In what proportions are both new ventures and organized capital most congenial to developing a vibrant entrepreneurial cluster? There is a reciprocal relationship between capital and deal flow. The more deals that emerge, the more capital tends to flow, and the more capital tends to flow the greater is the deal flow. Notice that, in the parlance of economic science, both capital and deals are so-called flow variables. This is distinctive from what are referred to as "stock variables". Stock variables tend to be finite in nature and depleting. Flow variables are potentially infinite, and can be increased over time. As capital and deals are flow variables that tend to interact in an autocatalytic manner, the challenge is to ensure they are flowing in proportions that sustain their flow over time.

There are several things administrators and/or government officials can do to ensure the flow of these critical variables are adequately matched:

1. Many governments have organized local or regional "fund of funds" programs. These programs leverage capital from various public coffers, including pension funds, special bond issues, and others. A fund of funds is organized capital that invests across a variety of existing funds to ensure sufficient diversification. Often, one provision of such funding is that the destination funds will seek to invest and/or set up a satellite office in the region. This provision can be stringent, or flexible, depending on regional needs. In general, research has indicated that despite any provisions for local investing it tends to happen anyway as a result merely of greater deal visibility. That is, deals that had been pre-existing and relatively unknown in the region gain greater visibility to investor funds as a result of the region's fund of funds activity.

2. Legislation has been enacted in a number of states that offers significant tax benefits to individuals who invest in regionally headquartered private ventures. In some states this is called an "Angel Investor Tax Credit" or something similar. In general, investors who accept the risk of investing in local ventures receive a tax break in an amount equivalent to their investment. This equivalence is often bounded on the low and high sides (for example, in Colorado tax breaks begin at a minimum investment of $25,000 and end at a maximum investment of $150,000 for any single investor).

3. Some regions promote their deal flow by organizing and hosting conferences for investors and featuring presentations by regional entrepreneurs. This is an effective technique for exposing the region's deals to investors, but runs the risk of being politically tainted. For example, politicians are generally not experienced private equity investors, and they may not have the ability to determine which of the region's deals should be exposed to sophisticated investors. This could lead to negative results where investors are turned off to a region because the deals do not meet *their* standards. In addition, such conferences run the risk of politicians promoting pet projects, such as income redistribution to solar, clean tech, green tech, or some other currently politically popular project. A regional "investor conference" has a greater chance of success if

politics is removed from the deal selection process and only so-called “investor grade” deals are allowed to present to the assembly.

These are three powerful initiatives that governments and administrators can undertake to calibrate deal and capital flows in a region. Each of these initiatives will be enhanced by ensuring that their structure, purpose, and coordination are managed through public-private cooperation. It is worth recalling that mere good intentions by public officials are inadequate to be successful in these initiatives. Each must be guided by the hard-headed realities of private business and by a return-on-investment mindset.

Rule 3: Don’t be too helpful.

Most entrepreneurs and business owners are a mistrustful of government interventions in their business and strategy. In fact, most entrepreneurs and business owners are skeptical about any outsiders being able to provide them with much assistance. In addition to government intervention programs, there are a lot of consultants out there who have peddled one form of intervention or another over the past 30 years. We’ve had everything from TQM to re-engineering to economic value added to activity based costing and on and on.

In the end, everyone in this room knows that there is not a soul on the planet who knows their business better than they know it. You are probably as skeptical of consultants and government assistance programs as the research indicates for business owners in general.

In that spirit, I relate the following descriptive data that was contained in a recent Kauffman foundation study titled “The Anatomy of an Entrepreneur: Making of a Successful Entrepreneur”. The study was released in November 2009. The researchers interviewed 549 entrepreneurs from a variety of industries, including aerospace and defense, computer and electronics, health care, and services. Some of the key findings include:

- 96 percent ranked prior work experience as an important success factor; 58 percent ranked this factor as extremely important
- 88 percent said learning from previous successes was important
- 78 percent said learning from previous failures was important; 40 percent said learning from previous failures was extremely important
- 82 percent said the management team they chose was important; 35 percent said this was extremely important
- 73 percent said “good fortune” was an important factor in their success; 22 percent ranked this factor as extremely important
- 70 percent said their university education was important

The factors noted above are ones that, other than “good fortune”, are controllable by the entrepreneur. These success factors can be learned by individuals aspiring to launch their own ventures, and used as guides to building successful ventures. For example, it’s fairly clear that some prior work experience, a good management team, and the ability to make and learn from mistakes are important success factors. It’s also clear that some university education can be useful, although it is well documented elsewhere that university education is not necessary to be a successful entrepreneur.

From the perspective of regional and state interventions that are designed to promote and/or support entrepreneurs and entrepreneurship, several interesting findings were revealed:

- The vast majority of those surveyed (86 percent) ranked the assistance provided by the state or region as “not at all” or “slightly” important
- Only 19 percent indicated that university or alumni networks were important
- 68 percent considered availability of financing/capital as important; 96 percent of those who had actually raised external capital ranked this factor as important
- 73 percent said professional networks were important to the success of their current business; 62 percent said personal networks were important

The key takeaways from this research are that the primary factors for entrepreneurial success reside primarily with the individual. Only the individual entrepreneur can decide to enter the competitive fray, knowing full well that the uncontrollable “good fortune” factor will play some role in their success. Of course, the good fortune involved in entrepreneurial success is not the same as that needed to win at the gambling table. Entrepreneurs improve their chances by learning both from their successes and their failures. They also hedge bad luck by surrounding themselves with professional and personal acquaintances that possess critical knowledge and skills.

The current study also echoed findings from other studies regarding the role of regional and state initiatives to promote entrepreneurship. Such initiatives, although well intended and politically popular, generally do not have impact on entrepreneurial success rates. The state or regional administrators of such programs often measure their success by the number of aspiring entrepreneurs in their programs. In contrast, investors, who must generate return on invested capital, focus more on the quality of the entrepreneurs they support. Investors must use as careful due diligence to select potential winners. Public programs to support entrepreneurs normally aren’t as selective.

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