Why Have Local Economic Development Efforts Been So Disappointing?

This study briefly examines the changes to overall economic development policy, with an extended focus on the supply of firms that can be attracted to a region.

Key Findings

- Economic development has existed in much its current form since the Great Depression, but has now matured into a suite of specific fiscal and development efforts in US counties and municipalities.
- Research on the effectiveness of these economic development efforts is mixed, with the few findings of impact (including two from this author) reporting high costs among some development incentives.
- Over the past half century, the target of most economic development efforts (footloose firms) has shrunk considerably. The United States has created almost 90 million net new jobs since 1970, but there are now fewer footloose jobs in the United States than in the 1960s, and that number continues to drop.
- It is likely that less than 1.0 percent of all jobs are potentially ‘attractable’ to a region, and fewer than 100 factories of 500+ workers opens in the U.S. in any given year. At that rate, random distribution of factories will happen in each county every 35 years.
- Not only can fewer jobs now be attracted to a region, those few that can be attracted focus most heavily on workforce quality. So, traditional business attraction has largely failed to deliver prospects.
- Almost all successful future economic development will have to focus on attracting people, not businesses.
Introduction

Local economic development efforts have a long history in the United States, but it wasn’t until the Great Depression that many municipalities, primarily in the American South, began a formal effort to lure new business establishments to their regions. These efforts included tax incentives and industrial development zones, which offered a precursor to the modern industrial park (Mitchell and Jucia, 1934; Graves, 1938).

Despite the significant policy innovation in economic development practices, there has been substantial disagreement by researchers over its effectiveness and efficacy. While some early research hailed these developments (Graves, 1938), most empirically rich, modern research has reported no more than a modest influence of economic development practices on actual economic outcomes (see Fisher and Peters, 2003; Reese, 2013, 2014).

Moreover, even among those researchers who report the largest impacts of state and local development efforts find the public costs to achieving these effects are high (LaFaive and Hicks, 2011; Faulk and Hicks, 2013). This challenges the premise that municipal, quasigovernmental, or non-profit economic development efforts play an important role in economic outcomes between regions.

Still, in 2016, many if not most local economic development efforts remained focused narrowly on attracting and retaining businesses in their region. These efforts concentrate on ‘footloose’ firms, which comprise those businesses that can locate their production or headquarters independent of any local demand for goods or services. Even in places where alternative strategies have begun to influence local economic development efforts, resource allocation to those efforts is dwarfed by those used to attract business.

The most recent survey by the International City/County Management Association (ICMA) reports the average (mean) municipal expenditure on economic development at $1.3 million per year with traditional business attraction services comprising most of the expenditures (ICMA, 2010). In Indiana, perhaps $100 million is spent directly on supporting local business attraction efforts. Abatement of taxes for new business comprise a full quarter of all business personal property tax, and other activities such as tax increment financing (TIF) employ tax dollars to other development activities (see Hicks, Faulk, and Quirin, 2015; Hicks, Faulk, and Devaraj, 2016). This would seem a ripe venue for more research.

To begin this study, I first briefly review the practice of economic development, and then outline the type of current research into its effectiveness. I then present data outlining the extreme difficulty in attracting establishments to a region due to supply side limits on ‘footloose’ firms. I end with a summary with policy implications.

Review of Development Practices

Local economic development efforts are underway in most counties and municipalities in the United States. A survey by ICMA provides the best explanation for the scope of activities undertaken by local economic development organizations (LEDO) in the course of attracting and retaining business.

This survey identified local government activities partnering with local chambers of commerce in more than eight out of 10 municipalities or counties, and conducting business surveys or partnering with other groups in more than half of the municipal governments responding. There is widespread concern over the efficacy of these efforts.

Two recent studies evaluated local and state policies in Michigan, categorizing business attraction activities into four types: tax abatements, renaissance zones, tax increment financing districts and a technology workforce-based ‘Cool Cities’ initiatives (Reese, 2013; 2014). These practices demonstrate fairly consistent characteristics in other states.

The International County/Municipal Association (ICMA) conducts frequent surveys of development activities. This survey is useful because it asks specific questions about activities undertaken by development officials. In the most recent survey, from 2009, the ICMA reports that 60-70 percent of municipalities or counties do three things to attract business: They directly contact prospective companies, they promote and advertise the municipality, and they participate in trade shows.
The ICMA survey also asks about specific incentives. Tax abate-
ments and credits are offered by 68.8 percent of communities, TIF
districts by 54.5 percent, direct infrastructure assistance by 57.1
percent. Direct grants are offered to companies by more than a third
of communities and between a quarter and a third of communities
report offering local or federal enterprise zones, special assessment
districts, free or reduced-price land, low-cost loans, and training
support. In all, more than 95 percent of municipalities or counties
reported offering business incentives.

Surprisingly, fewer than half of the counties or municipalities
reported using performance measures for their development efforts,
and just over a quarter counted the cost of such things as staff hours
towards development. Just over half did count the number of busi-
nesses they assisted and nearly 60 percent implemented a payback
for companies who did not comply with the terms of development
incentives. Overall regular reporting of performance measures took
place in roughly a third of communities, with less than a quarter of
communities reporting regularly to taxpayers.

Over the past two years, economic development practices have
come under increasing scrutiny. In 2012, the Pew Center for the
States began a comprehensive review of state economic development
incentives. This program partnered with states to focus on review
and analysis of incentives focusing on transparency and implementa-
tion of performance metrics. This effort also spawned a review
of incentives in Indiana (Faulk and Hicks, 2013; Hicks and Faulk,
2014; Hicks, Faulk, and Quirin, 2015) and a continued evaluation
of incentives in Indiana, of which this paper is a part.

In the same year, Good Jobs First offered an online collection
of economic development activities in a searchable database. The
record is incomplete, though it has dramatically improved in com-
prehensiveness in the past few years. Full accounting after the 2012
Pew Center initiative is obvious in the data. Table 1 summarizes

Interpreting these data sets is difficult because they are not com-
prehensive, and do not include direct payments such as infrastruc-
ture expenditures performed for a single business. Nor does this
investment count and use of tax increment financing, which is a
large subsidy for commercial operations in many counties. However,
there are some interesting elements to this, even if the data do not
support formal evaluation. First, these are large figures, comprising
more than 15 percent of an annual state budget in recent years. The
job reporting information for Indiana is typically unavailable until
the most recent years.

It is very clear that there is no correlation between either the level/
annual change in subsidies or the level/change in net employment
in a given year or in any combination of later years. In fact, there is
strong evidence of a business cycle effect, which suggests that overall
economic conditions play a large role in firm location and that
development incentives may not be the critical component of firm
relocation. For example, in 2008 (a full year of recession) Indiana
lost 28,000 jobs and gross assessed personal property declined by

Table 1. State and Local Subsidies in Indiana, 1999-2015
Source: Good Jobs First, Pew Center for the States

<table>
<thead>
<tr>
<th>Year</th>
<th>Subsidy Value ($Nominal)</th>
<th>Actual Employment Change</th>
<th>Change in Personal Property Gross Assessed Value ($M)</th>
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<tr>
<td>1999</td>
<td>214,000,000</td>
<td>53,100</td>
<td>n/a</td>
</tr>
<tr>
<td>2000</td>
<td>123,100,000</td>
<td>30,400</td>
<td>n/a</td>
</tr>
<tr>
<td>2001</td>
<td>71,393,380</td>
<td>-66,300</td>
<td>n/a</td>
</tr>
<tr>
<td>2002</td>
<td>86,170,550</td>
<td>-29,900</td>
<td>37,395</td>
</tr>
<tr>
<td>2003</td>
<td>318,162,463</td>
<td>-5,100</td>
<td>5,137</td>
</tr>
<tr>
<td>2004</td>
<td>81,557,200</td>
<td>31,500</td>
<td>-9,145</td>
</tr>
<tr>
<td>2005</td>
<td>327,381,837</td>
<td>26,600</td>
<td>-2,047</td>
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<tr>
<td>2006</td>
<td>387,407,411</td>
<td>18,900</td>
<td>241</td>
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<tr>
<td>2007</td>
<td>249,070,475</td>
<td>12,300</td>
<td>-6,364</td>
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<td>2008</td>
<td>153,286,140</td>
<td>-28,700</td>
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<td>2009</td>
<td>111,246,690</td>
<td>-171,400</td>
<td>1,923,571,377</td>
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<tr>
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<td>176,138,031</td>
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<td>3,197,571,377</td>
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<td>n/a</td>
</tr>
<tr>
<td>2015</td>
<td>1,084,581,362</td>
<td>n/a</td>
<td>n/a</td>
</tr>
</tbody>
</table>

$169 million, and yet there were still more than $153 million in
subsidies offered to firms to open or expand operations in the state.

These subsides likely benefit individual firms, though there is
evidence that firms receiving subsides do not perform better than
those who applied and did receive incentives (Gabe and Kraybill,
2002). Still, the lack of correlation between overall economic ac-
tivity and the size of incentives should raise serious concerns among
policymakers of their benefit.

It also bears noting that Indiana is not especially lavish with
incentives when compared to other states. For example, in Sep-
tember 2014, Nevada offered the electric car producer, Tesla, $1.3
billion in incentives for the promise of 6,300 direct jobs. This was
a highly visible incentive offering for which Nevada was willing
to offer more than $200,000 per job. There are other more lavish
examples in states such as New York, as well as examples of states
reducing their reliance on incentives (e.g. Michigan's MEGA Cred-
its; California’s suite of RDA incentives).

Still, Indiana has reported incentives of more than $2.2 billion
since 2010, which are associated with 50,600 jobs (at a putative cost
of $43,700 per job). The deployment of incentives should be one of
considerable concern both to taxpayers and to state and local poli-
cymakers in Indiana. Because of this, there is likely to be a growing
interest in economic development practices, in their effect, and in
their efficacy. Fortunately, research has not been silent on these issues.
Research and New Findings on the Effectiveness of Development Efforts

State and local governments use a variety of economic development incentives, for which a critical body of research has developed in recent years. Wasylenko (1997) reviewed 90+ studies that evaluated the role of fiscal policy in economic growth in the United States. More recent studies attempt to explain differences in growth, wages, and industrial composition through analysis of interstate tax policy. A large research literature also evaluated whether infrastructure expenditures influence growth (see Fox and Porca, 2002). A considerably smaller number of studies attempted to evaluate the influence of individual targeted tax policies on economic growth. Bartik (2002) offers a comprehensive review of these studies.

Among the more notable contributions to research include Gabe and Kraybill (2002), who evaluate firm-level tax incentives on 350+ firms in Ohio from 1993 through 1995 that received targeted tax incentives. Using a treatment and control pool of 350+ firms, these authors discovered two phenomena of interest. First, self-reported employment growth in firms receiving the incentive was substantially overstated. Firms that did not participate in the program were more accurate. Secondly, they found no positive (and, in some instances, a negative) influence of the tax credit on job growth. Sohn and Knapp (2002) found that targeted incentives in Maryland generate some mild positive regional and sector-specific impacts, but conclusions regarding their magnitude were beyond the capacity of the available data.

In a very influential study, Greenstone and Moretti (2004) constructed a quasi-experimental sample of plant openings using site selector data. This data included both the county in which a plant located and the other counties considered by the firm. The authors reported growth in earnings (a one-time increase of 1.5 percent), and a one-time 1.1 percent increase in property values in the counties where the new plants located.

Other studies find smaller impacts of large new firms. These include Edmiston (2004), Fox and Murray (2004), Hicks (2004; 2007), and Hicks and LaFaive (2011). Edmiston (2004) finds that the impact of new large firms is almost always overstated, with actual multipliers often less than 1.0. He further reports that expansion of existing firms generate substantial effects, exceeding those of new firms. Fox and Murray test the local impacts of large firm relocation and report no significant net impacts in the regions in which they locate. Using a quasi-experimental approach, Hicks (2004) finds that large gambling and wholesale/retail facilities generate no net employment or income gains in the counties in which they locate.

Of the more recent studies of direct business aid, Hicks (2007) reports that extensive grants to a single large firm across many US jurisdictions failed to generate net employment growth despite what was, in several instances, more than $50 million invested in a single firm. In a review of the impact of Michigan’s Economic Growth Authority (MEGA) incentives on county employment growth in manufacturing, wholesale, and construction, Hicks and LaFaive (2011) found no discernible effect on employment in these sectors. However, the receipt of an incentive increased construction employment, with job effects of roughly $126,000 per construction job.

Research on the efficacy of economic development practices has primarily focused on individual efforts. With the exception of Reese (2013; 2014) and Faulk and Hicks (2013), few know of no recent studies that have approached the evaluation of multiple development practices on economic outcomes within regions. Reese studied development efforts in Michigan, and reports a very small impact on overall economic development outcomes of these efforts. She compares her findings to Fisher and Peters (2002), reporting that no more than one in 10 dollars spent on development have any effect. Faulk and Hicks (2013) modeled the effect of state and local tax incentives/abatements and regional development authorities on a number of economic development outcomes. This study was very complimentary to selected state tax abatements, finding that a new job was created for less than $5,000 in employment tax credits. However, the capital incentives offered by local governments resulted in a new job only after as much as $30,000 in abated property, mostly business personal property tax. These authors also found that RDAs increased employment, suggesting that a regional effort mattered to development outcomes.

This review hints at a very large and rapidly growing research literature on development incentives and practices overall. Most of this research has focused on the demand side of development incentives. The demand side has focused on incentives and the role of agglomerations in attracting firms, but has placed little emphasis on the target of incentives: footloose firms.
Footloose Firms

Footloose firms can choose where to locate without concern for local demand for their goods or services. Conversely, non-footloose firms are tied to the local consumption of their goods and services. This definition would include almost all manufacturing firms, most corporate headquarters, many logistics firms, some specialty software producers, and telecommunications providers, as well as perhaps a quarter of financial services firms. However, for the purposes of understanding economic development through the prism of the supply of footloose firms, this definition is extremely broad. Few of the industries described are footloose in the sense that they can choose from more than a very small number of locations. In most instances firms in these industries are very limited to location choices, and cannot freely move between locations due to constraints on available workforce or markets. The earliest definition of footloose firms (Hoover, 1948) focused on transportation costs, not demand-side considerations.

By my definition, almost all the New York financial district, all Hollywood film and TV production, all software development, and all headquarters of Fortune 500 firms are fully footloose. They surely are not; but, as will soon be clear, this overstatement of the share of footloose firms available to be attracted by economic developers is a terribly conservative assumption. A relaxation of this assumption will be saved for later work.

With economic development practice and rhetoric focusing on the attraction of business, it is useful to review the supply of footloose firms and how this has changed in since the birth of modern local and state economic development.

The Number of Footloose Firms

US consumer demand for goods and services has shifted over the past century. Prior to the development of the automobile, most expenditures were focused on the food, housing, and apparel that comprised 81.4 percent of household spending. These are all goods that can be produced anywhere and transported to local consumers. At the same time, total services, most of which must be performed locally, probably comprised less than 10 percent of consumption.

By the late 1990s, the share of earnings allocated to goods dropped to 51.9 percent, with transportation growing from an unmeasured category to 18.7 percent. This comprises transport services and the purchase of automobiles and petroleum products. Other services grew dramatically as a share of household spending. Insurance and direct healthcare expenditures, education, and entertainment all grew as a share of earnings.

From the mid-century to the end of the 20th century, with the exception of transportation, the share of spending on goods clearly declined. This is important because the manufacturing of goods is not necessarily tied directly to the local population base. The provision of services requires close attention to the physical location of consumers and so will be far less footloose than most service-producing firms. See Table 2.
**Relationship Between Capital and Labor**

Economic development practices that focus on attracting capital, such as property tax abatements, may be anticipated to influence employment as well. However, the level of capital investment for which businesses will require an additional unit of labor is not constant. The elasticity of substitution measures the ability of firms to substitute a unit of capital for a unit of labor while keeping production levels constant.

Elasticity of substitution is an important concept because many economic development efforts are designed to reduce the cost of capital. For example, business personal property tax abatements reduce the cost of business equipment (and some structures) in their production process. While the intent is to incentivize firms to relocate to a region, this abatement also incentivizes the substitution of capital for labor in the production process.

I measure the national manufacturing elasticity of substitution using a canonical Cobb-Douglas production function,

\[ Y_{kl} = AK^a N^{1-a} \].

This estimate on US manufacturing capital and labor from 2001 through 2012 yields and elasticity of substitution of 2.04.\(^1\) A value of 1.0 would mean that capital (\(K\)) and labor (\(N\)) are perfect substitutes and that a small relative change in the cost of either would have no effect on the ratio of capital and labor used to produce a fixed set of goods. A higher number (such as the reported 2.04) means that capital and labor are highly substitutable and that a small shift in the relative cost of these two factors of production would yield a large shift in the mix of machinery and workers a factory chooses to use to produce a fixed quantity of goods.

A result of this is that firms receiving property tax abatements on capital would experience a higher capital-to-labor ratio than the average firm. As evidence of this, our recent study on property tax abatements (Faulk and Hicks, 2013) reported that roughly $1,000,000 in business personal property was abated for each additional job created by that firm. Nationwide, in 2012, the average amount of capital used in all US manufacturing firms for each worker is $211,000. This may suggest that incentivized firms have higher capital-to-labor ratios, partially due to the abatement itself.

It is important to note that a high elasticity of substitution does not mean that there are fewer jobs in an economy, simply that firms that receive property tax abatements should be expected to shift some of their inputs towards capital, raising the capital-to-labor ratio at that firm only. Economy wide, this would shift employment from the industries that receive abatements to those that do not. Heavy use of abatements might also accelerate the pace of capital substitution. While this would surely increase the productivity of firms, it also exposes labor to a more rapid loss of employment due to technology than markets would otherwise dictate. This would increase relocation and retraining costs associated with technologically related job displacement.

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1. The estimate was \( Y = 1.43 + 0.403 K + 0.598 N \); with MRTS =1.48 and Elasticity of substitution = 2.04.
in a nearly uniform rate since the late 1940s. Today no more than 10 percent of incomes could conceivably relocate, the remaining 90 percent respond to local demand and so respond to population and income changes, not development incentives. Examining actual jobs does not permit as lengthy a review, because incomes are higher in attractable jobs, the best data available suggest that much less than 10 percent of jobs, and maybe less than 2.0 percent lie in firms that could conceivably relocate to any municipality.

An examination of net employment growth from the late 1960s to the present provides a very clear picture. During this period, total employment has almost doubled as the population and labor force participation have risen. However, this period saw no net job growth in footloose firms. Indeed, the actual number of footloose jobs shrank, so that more than 100 percent of net job growth in the United States since 1969 has occurred in firms that choose locations based primarily on local demand for their services. These numbers represent the upper-bound estimate of employment. Incomes for most firms that are not tied to a population base to provide services still remain bound to a region due to specific input requirements that cannot be realized in alternative locations. It is worth restating that fewer than one in 20 jobs are in firms that actually can relocate to any municipality.

The implications of these findings are important. Business attraction efforts targeting footloose firms are likely to be disappointing for a variety of reasons. First, it appears that the composition of consumption strongly points toward an increase in consumption of local demand for local goods and services. This, combined with productivity growth in manufactured goods, means that a smaller share and lower level of employment in footloose firms is likely. Finally, there is strong evidence that firm relocation is on the wane, and business attraction efforts, which have traditionally targeted large footloose firms, are less likely to yield useful results.

Stated more plainly, traditional economic development efforts targeting footloose firms have performed poorly in terms of generating better economic outcomes. More importantly, the prospects for these policies has largely disappeared, leaving hundreds of economic development organizations in Indiana, and tens of thousands nationwide, executing expensive policies that do not deliver prosperity. Fortunately, there is a useful alternative.
Alternative Policies to Traditional Business Attraction

A significant body of research, both technical and policy-oriented, points to the role household migration plays in growing regions. Much of this is reviewed in Hicks and Faulk (2016), who tested the question, ‘What comes first, people or jobs?’ This study updated a research question three decades old, which estimated simultaneously the effect of population change on employment and the effect of employment change on population. This study examined Indiana counties, controlling for educational attainment, initial population size, urbanization, and natural amenities (as did earlier studies). To that model, the authors added income inequality and intergenerational income mobility. The chief innovation to this model is important for public policy is the examination of two different time periods, the 1970s and the 2000s.

The study found that for Indiana counties in the 1970s, population growth followed employment growth, meaning households were relocating to employment opportunities. However, at a stronger level, jobs also followed the movement of people, suggesting that in the 1970s household relocation exerted a stronger force on job creation than job creation did on employment change.

The study examined the same question on data from the 2000s and found that the effect of jobs following people strengthened significantly, but the movement of people to jobs had ceased to play a statistically significant role in county population change. This does not mean that households did not continue to relocate to find jobs, simply that, as a statistical explanation for population change, this occurrence no longer rose to the level of statistical significance. The overall findings from this study are consistent with more than 25 previous published works. More importantly, they provide supplementary evidence to that information in this work. Simply put, people today relocate to places they wish to live, and the jobs follow.

This finding is also bolstered by evidence from the American Housing Survey, which since the 1970s has asked relocated households a lengthy series of questions. Although the questionnaire changed modestly over the years, two questions offer important insight for this group. The first question asked why individual or household chose to relocate. The second asked the household why it was in the home it moved to. The first question was asked from the beginning of the survey in 1973, while the second question was not asked until the late 1980s. The answer to both questions is reported in Figure 6.

A host of previous studies along with evidence of modern migration decisions suggest that a viable alternative to business attraction policies. It is to that we now turn our attention.

Summary and Policy Discussion

This study has reviewed some of the literature that portrays individual economic development efforts as minimally effective in altering regional economic outcomes. Among the newer work that has jointly reviewed multiple development efforts, these results of minimal effectiveness are confirmed (Faulk and Hicks, 2013; Reese, 2013; 2014).

In order to better understand how development efforts yield benefits, I outline the declining share of footloose firms (the supply side of business relocation efforts). This declining share of employment options in footloose firms has the opposite effect on households. Today, workers are free to choose among a wide variety of communities with a lessened dependence on the location decision of their employers.

The first clear policy implication is that efforts to attract households should receive a greater share of emphasis and local resources than policies attempting to attract businesses. This implication has effects on the behavior of local development organizations, municipalities, counties, and state government.

Boards of local economic development organizations should consider explicit shifts of effort from traditional business attraction to quality of place efforts. This should include efforts to support local schools directly, and through their efforts to incent businesses.

Performance measures for economic development organizations should very explicitly shift away from counting ‘contacts’ or ‘prospects’ and instead measure actual economic performance of a region—employment and incomes. This will institutionalize priority towards developing conditions fruitful for non-footloose firms and away from activities to focus attraction efforts on the shrinking share of our economy.

Local governments should require greater focus on policies that promote quality of place and human capital from supported local development organizations. This should include a closer review of development activities which involve direct fiscal effects, such as property tax abatements, TIF districts and direct spending activities. Of particular concern is that evaluation of economic development
efforts are limited to such factors as gross new jobs created from an activity, and not on benefits in particular.

State governments should consider limiting the development incentives offered by local governments and require that local governments establish transparency goals for development spending. Moreover, the state should not promote the deployment of local abatements as an “a priori” measure of local government commitment.

It is natural that municipal and county governments concern themselves with the development of their economy. There is abundant research to suggest that the role of amenities and taxes play a significant role in prosperity. However, economic development in practice does little to improve either of these factors, focusing instead on the gross movement of jobs to particular projects, without any specific linkage to benefits to communities. This paper offers evidence that these benefits are significantly lower than at any previous time over the past century and by extension these benefits will continue to shrink over the coming decades.

Performance measures for economic development organizations should very explicitly shift away from counting ‘contacts’ or ‘prospects’ and instead measure actual economic performance of a region—employment and incomes.

Credits

References


Hicks, Michael J., Dagney Faulk and Srikant Devaraj. 2016. What Comes First, People or Jobs? Evidence and Lessons for Indiana. Center for Business and Economic Research, Ball State University.


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