Community Economic Development

Modern Notions of Business Climate

Of all the concepts within community economic development, business climate is perhaps the most misunderstood and misused. Historically business climate is viewed through the lens of neo-classical firm location theory where firms maximize profits through picking the lowest cost location. Communities marketed themselves as places with low land and labor costs, low taxes and limited regulations. This logic may apply for firms in mature manufacturing industries. Unfortunately, these same firms which at one time found smaller more rural communities attractive are now relocating overseas in their strive to continually lower costs.

Over time two things have happened within the U.S. First, the backbone of our economy has shifted from goods to service producing industries. Service producing firms look at fundamentally different location factors when compared to goods producing firms. Second, our theoretical understanding of what drives firm location decisions has progressed beyond the simple insights provided by neo-classical location theory. Firm behavioral location theory, for example, tells us that firms lack perfect information and the ability to process all the information that is available. Here notions of risk and uncertainty become very important. Firms may select a more expensive location to operate if that location minimizes risk and uncertainty.

Perhaps more important our theoretical insights help us better understand what economists call "external economics" or "spillover effects". Firms can enhance their profitability by locating in close proximity to particular types of firms. This is the notion of clusters. Critical masses of specialized input suppliers and labor supply creates an environment that may overwhelm other locational cost considerations.

With these fundamental changes to the U.S. economy and refinements in our theoretical understanding of firm location decisions our understanding of business climate has also fundamentally changed. Returning to the systems thinking approach to community economic development outlined in the Shaffer Star, three elements can be brought to bear: rules, society and decision-making. Let us discuss each in turn.

Rules, or in the traditional view of business climate regulations, are often considered a cost faced by the firm and hence must be minimized. Today regulations are viewed as a means to minimize risk and uncertainty: firms are better aware of what they can and cannot do. But, inconsistent or contradictory regulations can create risk and uncertainty. Perhaps more important, what appears to be random or haphazard changes in regulations can create confusion within the business community. Thus, well thought out and consistent regulations, or rules, can actually enhance the business climate of the community by reducing risk and uncertainty.

With respect to business climate, society speaks to the entrepreneurial spirit of the community. Entrepreneurial communities have a greater capacity to adjust to constantly changing economic conditions surrounding it, willing to embrace those changes and mobilize networks, both internal and external, to address opportunities. Entrepreneurial communities are willing to experiment with new ideas and ways of doing things and learn from their mistakes. They also realize that the community economic development process is the long-term envelope of short-term projects and is in need of constant reevaluation. They can manage political relationships both within and outside the community. Finally, the community entrepreneur can manage interpersonal relationships by working with other people and motivating them. Entrepreneurship is the adaptive process of replacing or changing social patterns that have become obsolete. As we are dealing with increasingly turbulent times around us this requires people who are able to make sense out of the overwhelming complexity.

The final element of the Shaffer Star that is relevant to a contemporary way to think about business climate is decision-making. In short, effective decision-making means that the community can separate symptoms and underlying causes of the issues facing the community. Here there is significant overlap between the society and decision-making nodes of the Shaffer Star. Entrepreneurial communities are more adapt at effective decision-making. The notion of public-private partnerships that bridge the business community and local government is a move toward being more entrepreneurial and effective in decision-making. Effective decision-making also minimizes the chance of randomness in changing regulations.

Effective decision-making also helps find the proper balance between taxes and public services. The empirical research on firm location is clear: taxes deter firm location but quality public services attract firm location. Businesses need key public services such as police and fire protection, quality transportation systems, refuge collection and quality school systems. Increasingly firms are looking at public services that enhance the quality of life within the community such as park and recreational opportunities and libraries. Public services are what economists call a "normal good" which means that as income grows we demand higher quality services. The challenge is that different industry types look to different characteristics and the "correct" mix of taxes and services for one industry might be "wrong" for another.

As the U.S. economy has shifted to a service producing economy and our understanding of firm location processes, our notions of business climate has changed. The old view of low costs through cheap land, labor, low taxes and limit regulation has given way to a more entrepreneurial view. Communities that are more entrepreneurial in how they approach community economic development and willing to try new ideas, learn from their mistakes, and work with the business community as a partner are said to have a stronger business climate. Equally important is that the community as a vision of itself and works to achieve that vision.

Risk and uncertainty in an economic setting means that we lack full information and the ability to process all the information that is available. Risk is when we know that we lack information on some important aspect, but we can make probabilistic statements (i.e., educated guesses) as to potential outcomes and implement strategies to minimize that risk. Uncertainty is when unforeseen events occur. As Defense Secretary Rumsfeld stated, we know what we know (certainty), we know what we don't know (risk) and we don't know what we don't know (uncertainty).

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